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SOME ASPECTS OF THE INDIAN STOCK MARKET IN THE POST-LIBERALISATION PERIOD

K.S. Chalapati Rao, M.R. Murthy and K.V.K. Ranganathan

As a part of the process of economic liberalisation, the stock market has been assigned an important place in financing the Indian corporate sector. Besides enabling mobilising resources for investment, directly from the investors, providing liquidity for the investors and monitoring and disciplining company management company managements are the principal functions of the stock markets. This paper examines the developments in the Indian stock market during the 'nineties in terms of these three roles. Share price indices have been constructed for the years 1994 to 1999 at select company category and industry levels to bring out the investor preferences and their implications for the resources mobilising capacity of different segments of the corporate sector.

Introduction

Under the structural adjustment programme many developing countries made substantial policy changes to pull down the administrative barriers to free flow of foreign capital and international trade. In the same vein, restrictions and regulations on new investments in reserved areas for public sector witnessed radical change. Strengthening of capital markets was advocated for successful implementation of the privatisation programmes and attracting external capital flows [World Bank, 1996, p. 106; UN, 1996, p. 4].[1] The main attraction of the capital markets is that they provide for entrepreneurs and governments a means of mobilising resources directly from the investors, and to the investors they offer liquidity [*India*, 1986, p. 6]. It has also been suggested that liquid markets improve the allocation of resources and enhance prospects of long term economic growth [Demirguc-Kunt and Levine, 1996, Pp. 291-321]. Stock markets are also expected to play a major role in disciplining company managements.

In India, stock market development received emphasis since the very first phase of liberalisation in the early 'eighties. Additional emphasis followed after the liberalisation process got deepened and widened in 1991 as development of capital markets was made an integral part of the restructuring strategy. After 1991, as a part of the de-regulation measures, the *Capital Issues Control Act, 1947* that required all corporate proposals for going public to be examined and approved by the Government, was dispensed with [Narasimham Committee Report, 1991, p. 120].[2] The Securities and Exchange Board of India (SEBI) which was set up in early 1988 was given statutory recognition in January 1992 to frame rules and guidelines for various operations of the Stock Exchanges in India. The Over the Counter Exchange of India (OTCEI) established earlier for serving the smaller companies became operational in September 1992 and the National Stock Exchange was set up in Mumbai in 1994. India's official *Economic Survey 1992-93*, observed that the process of reforms in the capital market

> ... needs to be deepened to bring about speedier conclusion of transactions, greater transparency in operations, improved services to investors, and greater investor protection while at the same time *encouraging corporate sector to raise resources directly from the*

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market on an increasing scale. Major modernisation of the stock exchanges to bring them in line with world standards in terms of *transparency and reliability is also necessary if foreign capital is to be attracted on any significant scale* (emphasis added) [*Economic Survey*, 1992, p. 67].

This paper seeks to examine the developments in the Indian stock market in the post-liberalisation period in respect of the main functions of resource mobilisation and providing liquidity. The detailed exercises cover 1996 to 1999 and are based on the daily trade data at The Stock Exchange, Mumbai (BSE).[3] A further attempt has been made to examine the share price movements during 1994 to 1999 at certain company category and industry levels. An attempt has also been made to study the implications of the prevailing shareholding pattern of listed companies for monitoring the managements. Another important aspect, relating to foreign portfolio investments on the Indian stock exchanges, forms the subject matter of the accompanying paper 'Foreign Institutional Investments and the Indian Stock Market'.

Growth of the Indian Stock Market

Stock exchanges have a long presence in India. The BSE, the oldest one, was established in 1875. At the time of Independence there were seven stock exchanges functioning in different parts of the country. The 'eighties witnessed impressive expansion in the number of listed companies, amount of capital listed, market capitalisation and value of shares sold and purchased on the exchanges (Table 1). Eleven stock exchanges were given recognition during this period. The number increased further to 22 (excluding the National Stock Exchange) by 1995. The overall number of exchanges continues to be the same. The expansion during the 'eighties was probably the after-effect of the acceptance of the recommendations of the Study Group on Financing of the Private Corporate Sector in the Sixth Five Year Plan (1980-81 to 1984-85). The Study Group suggested measures (i) to improve attraction of various investment instruments for small savers; and (ii) strengthen the infrastructure of the capital markets [*India*, 1982, Pp. 117-121; Nagaraj, 1996, Pp. 2,553-63].

Table 1. Select Indicators of Stock Market Growth

(Amount in Rs Crore)

Year	Number of Stock Exchanges#	Number of Listed Cos.	Market Value of Capital of Listed Cos.	GDP at Current Prices	Market Capitalisation as % of GDP [(4)/(5) x 100]
(1)	(2)	(3)	(4)	(5)	(6)
1980	9	2,265	6,750	1,22,772	5.50
1985	14	4,344	25,302	2,32,370	10.89
1991	20	6,229	1,10,279	5,52,768	19.95
1995	22	9,077	6,39,575	9,92,802	64.42

Note: Market capitalisation and GDP correspond to calendar and financial years, respectively.
Excluding the National Stock Exchange (NSE).
Source: Based on: (i) Bombay Stock Exchange Official Directory, 'Organisation of the Stock Market in India', Vol. 9(II), 1997 and (ii) Bombay Stock Exchange, *The Stock Market Today*, 1992. GDP data are taken from *Economic Survey: 1997-98.*

Dilution of foreign equity by FERA (*Foreign Exchange Regulation Act, 1973*) companies[4] during the latter half of the 'seventies and early 'eighties also helped in popularising stock market as a means of investment by individual investors. Due to the relatively higher return on the shares of FERA companies, it was considered safer and more profitable by the general Indian public to subscribe to public issues by FERA companies [Goyal, 1979].[5] The attraction of FERA companies for the Indian shareholders can be gauged from the fact that a number of issues were oversubscribed multiple times [Chaudhuri, 1979, Pp. 734-44].[6]

The growth in numbers and paid-up capital

(PUC) may not fully reflect the importance of the stock market in the economy. The market capitalisation ratio which is arrived at by dividing the value of listed shares by the GDP is regarded as a measure of the size of stock market in a country. The ratio increased from about 1:5 in 1991 to almost 2:3 by 1995 [Kunt and Levine, 1996].[7] Another indicator of the relative importance of stock market could be the share of equity capital of listed companies in the paid-up capital (PUC) of Indian corporate sector. The value of PUC of companies listed on the stock exchanges of India is, however, not available in a longer time perspective. Since the BSE is the oldest exchange and it has been the most significant one, operations of the BSE can be taken to reflect the growth in size and pattern of stock market in India.[8] At the beginning of the 'nineties, the equity capital of BSE listed companies accounted for a little more than 30 per cent of the paid-up capital of all public limited companies (Tables 2a and 2b). Their share rose sharply thereafter and by 1995-96 almost trebled to 93 per cent. Though this appears to be an over estimate, it does indicate the relatively important place attained by the stock market for the Indian corporate sector [*CMIE, Capital Markets*, 1997].[9]

Resource Mobilisation

With the repealing of the *Capital Issues Control Act, 1947* (CICA) in May 1992 it is no more necessary to obtain prior government approval for access to the capital market. The rapid increase in the number of companies listed on the BSE during the early part of the liberalisation period, has to be seen in this background. The number of companies listed on BSE more than doubled between 1991-92 and 1995-96 and the equity capital increased by more than five times. The number of issues increased from 455 in 1991-92 to nearly 1,700 each in 1994-95 and 1995-96 (Table 3).[10]

Table 2a. Importance of Listed Companies in the Corporate Sector

(Amount in Rs Crore)

Year end #	Number of Public Limited Cos.	Number of Cos. Listed on all the Stock Exchanges	No. Of Cos. Listed on BSE	Paid-up Capital of all Public Limited Cos.	Equity Capital of Cos. Listed on BSE
(1)	(2)	(3)	(4)	(5)	(6)
1990-91	27,358	6,229	2,471	38,567.7	12,205
1991-92	29,792	6,480	2,601	50,809.0	16,128
1992-93	34,112	6,925	2,861	57,929.7	24,527
1993-94	38,000	7,811	3,585	71,836.2	48,809
1994-95	46,662	9,077	4,702	92,422.9	61,514
1995-96	57,402	9,100	5,603	1,13,042.2	1,05,284

Year ending 31st March.
Source: Based on BSE publications and Ministry of Law, Justice & Company Affairs; *Annual Report of the Working and Administration of the Companies Act, 1956* for various years.

Table 2b. Relative Importance of Listed Companies in the Corporate Sector

Year-end	Number of Listed Cos. as Percentage of all Public Limited Cos.	Number of PUC of BSE Listed Cos. as Percentage of	
		All Public Limited Cos.	PUC of all Public Limited Cos.
(1)	(2)	(3)	(4)
1990-91	22.77	9.03	31.65
1991-92	21.75	8.73	31.74
1992-93	20.30	8.39	42.34
1993-94	20.56	9.43	67.94
1994-95	19.45	10.08	66.56
1995-96	15.85	9.76	93.13

Source: See Table 2a.

Thereafter, the issues declined steeply and reached 156 in 1997-98, which is about one-third of the 1991-92 level. In terms of the amounts rasied the decline was sharper in case of non-government companies [SEBI, 1998-99].[11] Besides the repealing of CICA, a few major factors seem to be responsible for the initial increase in the number of issues. *First* is the stock scam.[12] Share prices increased rapidly within a span of three months (Jan-Mar 1992) during which time the BSE Sensitive Index (Sensex) more than doubled from about 2,000 to 4,400. This seems to have given the investing public an idea of the windfall gains that can be had from the stock market and created a 'herd' mentality. During the boom period, shares of even loss-making companies commanded high premium [India, 1948, p. 5].[13] In such a situation, it would

Table 3. Capital Issues through the Stock Market#: 1991-92 to 1997-98

Year	Number of Issues			Amount Raised (Rs Crore)		
	Government	Non-Govt.	Total	Government	Non-Govt.	Total
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1991-92	31	424	455	4,080	5,361	9,441
1992-93	31	964	995	7,162	18,597	25,759
1993-94	30	1,115	1,145	11,458	20,236	31,694
1994-95	43	1,643	1,686	10,868	26,460	37,328
1995-96	37	1,651	1,688	9,721	14,624	24,345
1996-97	25	863	888	8,340	8,227	16,567
1997-98	38	118	156	8,623	3,236	11,859

Public and Rights issues.
Source: CMIE, *Capital Markets*, October 1998.

not be difficult to raise money from the market. The *second* factor is the optimism generated among entrepreneurs by the virtual demolition of the industrial licensing system. *Third* is the entry of small companies (especially financial companies) with the main aim of making quick money through price manipulations [SEBI, 1995; CMIE, 1997]. *Last*, is the issues of government companies including banks and public financial institutions which added significantly to the amounts issued.

Apart from the doubtful quality of many of the new issues, an important case which shook the markets in early 1995 was the Rs 350 crore fully Convertible Debentures issue in February 1995 of M.S. Shoes. The company was accused of inadequate disclosures. Taking advantage of free pricing of issues, many companies charged high premium. But the post-listing returns proved to be disappointing. One major case cited in this regard is the post-listing price of Industrial Development Bank of India, which in July 1995 raised about Rs 2,400 crore at a premium of Rs 120 for a Rs 10 share.[14] Contrary to the expectations, the initial listing price was much lower than the issue price [*Business Standard*, 1995]. The price fell gradually to reached Rs 94 within a few days. During the pre-liberalisation period, proposal for raising capital through public issues were generally for manufacturing companies and involved public financial institutions, which provided assistance (equity or term loans) to the project after appraising the projects.[15] In the post-liberalisation period a good number of companies were not only non-manufacturing ones but the purpose of issue also varied from project finance to working capital. A number of public issues have been made without any critical scrutiny (Table 4). In terms of number, about one-third of the issues were by financial companies with a preponderance of non-banking financial companies (NBFCs) [CMIE, 1998].

Apart from the loss of interest of the general investor due to these developments, the decline in number of issues is attributed to the strengthening of the criteria for public issue by the SEBI. Two main criteria in this regard are: (i) issuing companies should have paid dividend for at least three years out of preceding five years; and (ii) a manufacturing company without the three year track record of dividend payment can access the securities market if its project has been appraised by a public financial institution or a scheduled commercial bank and the appraising agency participates in the project by way of loan or equity to the extent of minimum 10 per cent of the project cost. Subsequently, these norms were made applicable to all types of companies.[16] Regarding these changes, SEBI explained:

Table 4. Distribution of Public Issues According to the Appraisal Status

(Number of Issues)

Year	Issues Appraised By FIs/Banks/MFs	Issues not Appraised by such Agencies	Total	Percentage of Unappraised Issues (3)/(4) x 100
(1)	(2)	(3)	(4)	(5)
1994-95	891	452	1,343	33.66
1995-96	582	846	1,428	59.24
1996-97	210	543	753	72.11
1997-98	34	77	111	69.36
1998-99	15	43	58	74.13

Source: (i) 1994-95 to 1996-97: Praxis Consulting & Information Services Pvt. Ltd. *Prime Annual Reports, Part-I: Public Issues*, various years. (ii) 1997-98 and 1998-99: SEBI, *Annual Report: 1998-99*.

Table 5. Proportion of Shares and Debentures in the Financial Assets of Household Sector

(Amount in Rs Cr.)

Year	Total Financial Assets	Of which, Investment in Shares and Debentures	
		Amount	Percentage in Total
(1)	(2)	(3)	(4)
1990-91	56,858	8,412	14.79
1991-92	70,851	15,704	22.16
1992-93	72,099	12,943	17.95
1993-94	1,09,597	14,772	13.48
1994-95	1,45,503	17,381	11.95
1995-96	1,24,871	9,047	7.25
1996-97	1,56,726	10,472	6.68
1997-98	1,80,724	3,637	2.01

Source: Based on India, Central Statistical Organisation, *National Accounts Statistics*, 1995 and 1999.

> With the rapid expansion in the primary market, there were concerns raised about the quality of some of the issuers who were able to raise funds from the market in the period after the repeal of the Capital Issues (Control) Act, 1947. In response to these concerns, SEBI had strengthened norms for public issues, raised the standards of disclosure in public issues to enhance the level of investor protection without seeking to control the freedom of eligible issuers to enter the market and freely price their issues. This was done in 1995-96... [SEBI, 1996-97; *Economic Times*, 1999].[17]

It appears from Table 4 that the while the changes did make much impact in terms of making more companies get their projects appraised, the stipulation of paying dividends did prevent new companies from entering the market [RBI, 1999,

p. 950; CMIE, 1998, Pp. 16-20].[18]

Thus within a few years of repealing the *Capital Issue Control Act*, restrictions on capital issues had to be introduced, albeit in a different manner, to safeguard investor money and protect the institution of stock market itself. Even in the 'eighties, taking advantage of the boom in the stock market and increase in the exemption limit for capital issue, many non-manufacturing companies issued shares to the public. The rapid growth in the number of listed companies during this period was in part due to the entry of companies promoted by unscrupulous persons who included stock brokers, auditors, and those associated with business houses [Rao, 1997, Pp. 3-12; Rao, 1996-97]. It does appear that while liberalising issue norms after repeal of CICA, this experience was not taken into account. Some of those involved in floating such issues later on became merchant bankers and mutual fund promoters.[19] According to a former President of the BSE, among the 'anti-investor steps taken by SEBI or the Government' during the post-liberalisation period, were:

- Abolition of CCI and allowing free pricing of shares - which led to fleecing of investors;
- Licensing of hundreds of Merchant Bankers without ascertaining their credentials and antecedents CRB being the classic example of the same. In the free for all, the only consideration seemed to be collecting money; and
- Clearing all kinds of undesirable issues by fly-by-night operators by issuing them authorisation cards [Damani, 1997, Pp. 5-18].

The fall in new issues is also reflected in the steep decline in the importance of shares and debentures in household savings (Table 5) [CMIE, 1999, p. 101].[20] Further evidence to the decline in the importance of stock market for mobilising resources is reflected in the falling share of new equity capital raised from outside sources in the sources of funds for the large private corporate sector. The share declined sharply from about 33 per cent in 1993-94 to 7.7 per cent in 1997-98 (Table 6). On the other hand, the share of borrowings from banks and financial Institutions recovered from a low of 7.3 in 1993-94 and exceeded the 'early' nineties levels by 1995-96.

Table 6. Changing Importance of Select Sources of Funds for the Indian Private Sector

(Percentages)

Year	Percentage Share in Total Sources of Funds		
	Total External# Finance	Fresh Share Issues (incl. premium)	Borrowings from Banks & Institutions (excl. Fixed Deposits and Debentures)
(1)	(2)	(3)	(4)
1991-92	72.0	7.9	24.7
1992-93	74.9	24.7	25.7
1993-94	76.4	33.4	7.3
1994-95	76.9	32.6	21.6
1995-96	71.7	15.1	27.8
1996-97	72.1	8.2	29.4
1997-98	69.4	7.7	28.4

Col. (2) is inclusive of Cols. (3) and (4).
Source: Based on CMIE, Corporate Sector, May 1999.

Liquidity

The aggregate market turnover is an important component in the measurement of the stock market size and liquidity [Kunt and Levine, 1996, p. 295; Gupta, 1992].[21] While the overall turnover at BSE increased significantly during the post-liberalisation period, the increase has been more substantial after 1995-96. The fall in turnover in 1992-93 following the exposure of scam was more than recovered in 1993-94. This is also the year when FIIs made their presence felt. This was, however, followed by decline in trading turnover in 1994-95 and 1995-96 which was attributed to the ban on *badla* [Gupta, 1992, Pp. 85-90; 1996, Pp. 20-28].[22] Following the re-introduction of *badla* in a revised form, turnover more than doubled from about Rs 50,000 crore in 1995-96 to Rs 1,24,000 crore in 1996-97 and further to Rs 2,07,600 crore in 1997-98. 1997 was an important year for the BSE as it was allowed to expand its on-line trading network to locations outside Mumbai. The increase continued in 1998-99 as the turnover at BSE increased by about 50 per cent compared to the previous year (Table 7). These increases appear to contradict the general sentiment reflected in the primary market and may be disguising some of the more serious problems facing the stock market. In this context, it is significant to note that in the face of the growing market turnover, the average number of companies traded (daily) on the BSE declined from June 1996 onwards. The decline appears to be steeper and steadier in case of the number of companies traded relative to those listed. The situation did improve in 1999 as towards the end of the year about two-fifths of the companies were being traded (Annexure and Graph-A).[23]

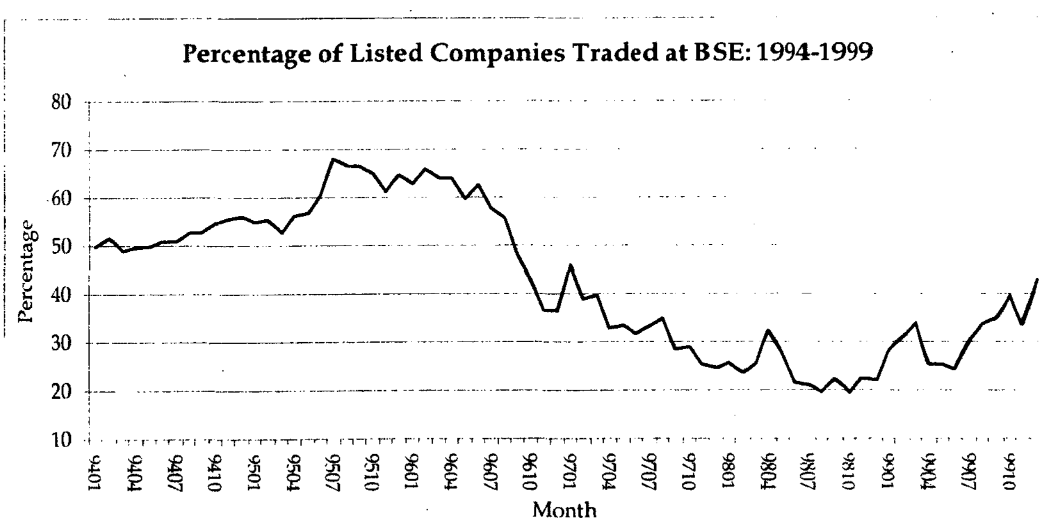
Table 7. Market Turnover at the Bombay Stock Exchange

(Amount in Rs Crore)

Year	Total Turnover	Turnover at BSE	Average Daily Turnover at BSE
(1)	(2)	(3)	(4)
1990-91	N.A.	36,012	188.54
1991-92	N.A.	71,777	332.33
1992-93	N.A.	45,696	238.00
1993-94	2,03,705	84,536	387.78
1994-95	1,64,057	67,749	292.02
1995-96	2,27,368	50,064	215.79
1996-97	6,46,116	1,24,284	517.85
1997-98	9,08,691	2,07,644	851.00
1998-99	10,23,381	3,11,999	1,283.95

N.A.: Not Available.
Source: Bombay Stock Exchange, *Facts & Figures, 1997* and BSE, *Stock Exchange Review*, various issues. BSE website and SEBI, *Annual Report: 1998-99*

Graph - A



Source: Based on CMIE, *Capital Markets*, October 1998, BSE Stock Exchange Review, various issues and the daily trade data obtained from Asian CERC.

In 1997, out of the total number of 5,843 companies listed, 831 were not traded at all. In addition, for more than 2,800 companies, the last traded price was less than Rs 5 per share against the par value of Rs 10.[24] In the following year, the number of non-traded companies more than doubled to 1,800 (Table 8). If the fact that many companies issued shares at heavy premium, the erosion in issue prices will be far more than that reflected from the face values.[25] It thus emerges that out of the nearly six thousand companies listed on the BSE, about 30 per cent were not traded at all during 1998. It appears that a good number of companies whose last traded price was less than Rs 5 ceased to be traded in 1998. Of the total number of companies traded, shares of nearly two-thirds were traded below par. If all those companies which were not traded during the period had their last quotes below par value, the number of below-the-par value cases would be three-fifths of the total listed ones! This could be a reflection of the extent of sickness and crisis in the listed corporate sector and the quality of new public issues.

Table 8. Incidence of Below-par Trading at BSE: 1997 and 1998

Last Traded Price per Share	Number of Companies		Share in Total (%)	
	1997	1998	1997	1998
(1)	(2)	(3)	(4)	(5)
Not Traded#	831	1,805	14.22	30.84
Below Rs 5	2,853	2,041	48.83	34.88
Rs 5 - 10	673	644	11.52	11.00
Sub-Total (below par) (including 'not traded')	*4,357*	*4,490*	*74.57*	*76.73*
Rs 10 and above	1,486	1,362	25.43	23.27
Total	**5,843**	**5,852**	**100.00**	**100.00**

Difference between the number of companies traded and the number of listed companies reported by the BSE.
Source: Generated from BSE company-wise daily trading data.

Concentration in Trading

Heavy concentration in turnover has been an important characteristic of the Indian stock market. While the overall turnover witnessed an impressive increase, the number of companies responsible for the expanded turnover continued to be a few. For instance, out of the turnover of 2,400 companies listed on BSE in 1989-90, the share of top 50 was nearly 82 per cent [Gupta, 1992]; and it stood at nearly 86 per cent in 1996 (Table 9).[26] The concentration remained high in the subsequent years. Shares of different sets of top companies in turnover at the National Stock Exchange (NSE) also reflect high levels of concentration. In case of BSE the share of the top one hundred companies was 96.36 and for NSE it was 97 per cent (Table 10).[27] The increase in concentration is more apparent in the case of the number of share transactions. The top 50 companies accounted for 44.03 per cent of the value of the overall transactions in 1996. This increased to 72.0 per cent in 1998. On a closer examination of the values traded of the top 20 companies, it is observed that there is greater dispersal among the top. Compared to the experience of 1996 to 1998, as we shall see in the following, 1999 presents a somewhat different picture as share prices experienced a general recovery. This was accompanied by a somewhat better distribution among the top companies both in terms of turnover and number of transactions. However, partially at the 100 company level and more so at the 500 company level, the situation in 1999 was similar to that existing in the earlier years.

Table 9. Value Traded and Number of Transactions in Different Groups

(Percentages)

Share of Top$ Companies	Value Traded				No. Of Transactions			
	1996	1997	1998	1999	1996	1997	1998	1999
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Top: 5	67.24	71.36	49.96	37.66	26.57	41.98	25.75	17.47
10	74.57	82.14	67.20	54.70	32.42	54.45	39.25	29.99
20	80.55	89.28	80.18	72.68	37.02	65.02	53.97	44.51
25	81.92	90.74	83.43	76.70	38.60	67.89	58.90	49.41
50	85.76	94.45	90.71	87.11	44.03	75.36	72.07	63.93
100	89.14	97.05	96.36	93.48	50.85	81.35	84.77	76.26
500	96.15	99.59	99.82	99.58	71.78	92.07	96.95	94.36
All	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
No. Of Traded Cos.	5,612	5,012	4,047	3,929	5,612	5,012	4,047	3,929
No. of Cos. Listed#	5,999	5,843	5,860	5,863	5,999	5,843	5,860	5,863

$ According to annual market turnover.
# At the end of the year.
Source: Generated from BSE company-wise daily trading data.

Table 10. Comparison of Turnover Concentration in BSE and National Stock Exchange: 1998

Top Companies* (1)	BSE (2)	NSE (3)
10	67.20	70
25	83.43	86
50	90.71	93
100	96.36	97
500	99.82	N.A.
All	100.00	100
No. Of Companies	4,047	N.A.

* Classified according to the trading values.
Source: Col (2): Table 9 above, and Col (3): NSE *Newsletter*, December 1998.

Not only the value of trading, which might depend upon the price of a share, but also the number of transactions is confined to a few companies. Companies in which 1 lakh or more transactions take place increased and such companies accounted for over 89 per cent of the total turnover in 1998. On the other hand, that trading is only nominal in quite a large number of companies is reflected from the fact that companies in which less than 10 trades took place constituted 22 per cent of the total number of companies traded during the year. Indeed, for half of the companies the number of trades were less than 100! This represented a substantial worsening from the 1996 position (Table 11). The situation appears to have improved relatively in 1999 as companies with less than 10 trades formed only 13.85 per cent of the total possibly due to the improvement in the over all sentiment. In terms of turnover, however, companies with 1,00,000 and more transactions accounted for more than 90 per cent of the total.

Table 11. Distribution of Traded Companies According to the Intensity of Trade

No. Of Transactions	Percentage of Companies				Percentage of Turnover	
	1996	1997	1998	1999	1998	1999
(1)	(2)	(3)	(4)	(5)	(6)	(7)
Less than 10	5.54	13.29	23.46	13.85	negl.	negl.
10 - 100	12.18	27.13	27.60	17.51	0.01	negl.
100 - 1,000	45.15	41.64	31.53	32.30	0.22	0.05
1,000 - 10,000	33.52	15.25	13.20	25.71	0.98	0.94
10,000 - 1,00,000	3.43	2.25	3.88	8.32	9.22	7.46
1,00,000 & above	0.18	0.44	1.33	2.32	89.57	91.55
All Traded Companies	100.00	100.00	100.00	100.00	100.00	100.00
No. Of Companies	5,612	5,012	4,047	3,929		

Source: Generated from BSE company-wise daily trading data.

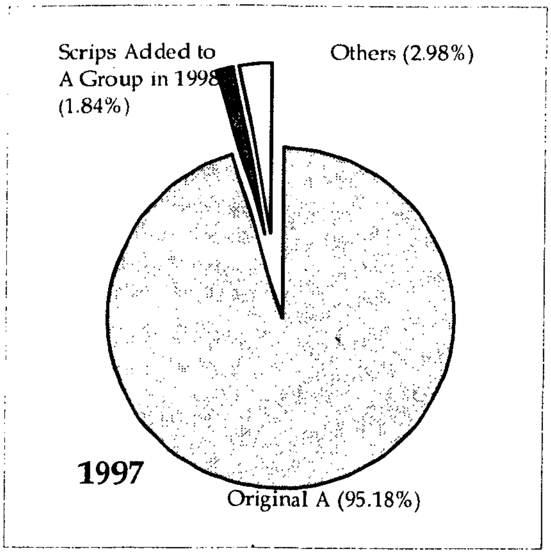
Large turnover companies are only a few and most of them belong to the A Group, or the Specified Group. Under the BSE rules the facility to carry forward the deals without actually taking delivery of shares is permitted only for A Group companies. Because of the carry forward facility, trade in A Group companies is quite often speculative in nature. The size of A Group turnover could be quite related to the number of companies in the Group in which speculative trading is possible. Interestingly, the Group was expanded in early 1998 with the addition of 50 more companies to the existing 100. This seems to have had an immediate impact on the trading values. From Rs 16,419 crore in February 1998 the net turnover of BSE increased to Rs 23,310 crore in March 1998. The turnover of A Group companies increased from Rs 15,717 crore to Rs 22,492 crore [BSE, 1998]. The pattern of the turnover data for different groups of companies shows that the newly included companies accounted for 1.84 per cent of the turnover in 1997. But by 1998 their share increased 25.30 per cent (Table 12 and Graph B). Thus, an overwhelming part of the increased turnover in 1998 was due to the 50 newly added companies. It is important to note that the new entrants included 18 FCCs, six pharmaceutical companies (including FCCs), five banks and four computer software companies. It thus appears that but for the expansion of the specified group, the turnover in 1998 would probably not have been as high as it turned out to be. As we shall see later, the expansion of A Group seems to have had a significant impact on the distribution of turnover at the industry and company category levels. The composition of the A Group underwent another change in September 1999. Interestingly, out of the 17 new entrants as many as 6 are computer software/hardware companies [BSE, 1999].[28] Two each are in pharmaceuticals, telecommunication equipment manufacture, and oil refinery.

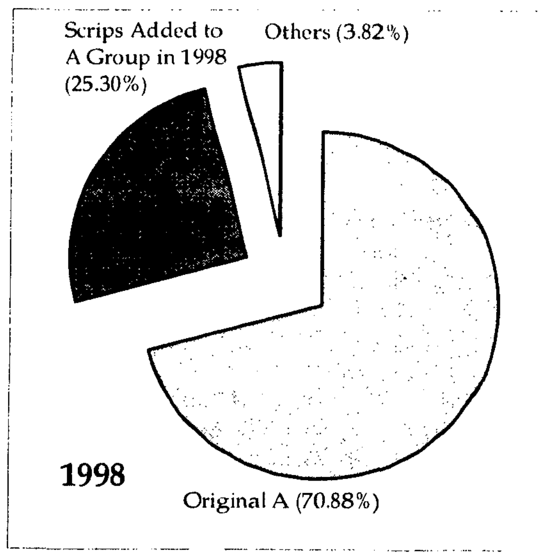
Table 12. Impact of Enlargement of the Specified Group in February 1998 on Market Turnover

Scrip Category	Net Turnover (Rs Cr.)		Share in Net Turnover (%)	
	1997	1998	1997	1998
(1)	(2)	(3)	(4)	(5)
Original A Group Scrips (100)	1,83,384	1,87,463	95.18	70.88
50 Scrips added to the A Group in February 1998	3,553	66,920	1.84	25.30
Other Scrips	5,736	10,095	2.98	3.82
Total	1,92,673	2,64,479	100.00	100.00

Source: Generated from BSE company-wise daily trading data.

Graph B. Impact of Enlargement of Specified Group in 1998 in BSE Turnover





The importance of speculative trade is also reflected in the low percentage of actual deliveries. For BSE the delivery ratio in 1997-98 was 12.73 per cent, and for NSE it was 15.97 per cent. While the ratio improved in 1998-99 at BSE to 20.34 per cent, it continued to be low for NSE at 15.15 per cent. At the national level the figures were 9.96 per cent and 12.88 per cent for 1997-98 and 1998-99, respectively [SEBI, 1998-99, Table 2.19]. Thus, an overwhelming part of trade in the Indian stock market may be termed as speculative. This position would worsen if the transactions of the Foreign Institutional Investors (FIIs) are deducted from the total deliveries.[29]

A few top companies may be accounting for substantial turnover due to their large size. Share in aggregate turnover may not, therefore, adequately reflect the trading activity in smaller companies. In spite of the fact that they do not have a high share in aggregate turnover, if the smaller companies have turnover comparable to their respective market capitalisation, their shares could be termed liquid. This, however, does not seem to be the case. In 1996, the turnover to market capitalisation ratio fell progressively sharply from 1.47 for the top five companies to just 1.05 when the top 10 companies are considered. For all the companies for which data on both turnover and market capitalisation are available, the ratio was 0.25. For companies other than the top 500, the ratio was only 0.03 (Table 13). A test check revealed that in 1988 also the picture was similar.

Table 13. Turnover Size-wise Turnover Ratios for BSE Listed Companies: 1996

Top Companies$ (1)	Turnover Ratio (Turnover/Market Capitalisation#) (2)
5	1.47
10	1.05
20	0.64
25	0.61
50	0.48
100	0.37
500	0.29
Remaining Cos.	0.03
All Companies@	0.25

$ Based on market turnover.
# Based on the last traded price during 1996 and amount of equity capital at any time during March 1996 to March 1997.
@ Total number of companies for which we could get information both on equity and share prices were 3,109.

Industry-wise Distribution of Turnover

The annual turnover data can be tabulated to bring out the relative importance of different industries in the changes noticed at the aggregate level. This may indicate the type of industries that are attracting investor attention and resource mobilising potential of different industries. The exercise will have certain limitations in view of (i) heavy concentration in trading and (ii) only a few large companies being engaged in one industry or product. The results based on the industry classification[30] of top 500 companies (according to turnover) in the years 1996, 1998 and 1999 are shown in Table 14. In 1996, public sector banks were at the top with nearly 28 per cent of the turnover followed by the diversified companies which accounted for another 25 per cent. Metals and metal products also had a considerable share (13.59 per cent). Next in importance was Food, Beverages and Tobacco products. In the top ten categories also figured Cement, Power Generation & Distribution, Non-Electrical Machinery, Telecommunications and Textiles. By 1998, the situation changed significantly. The fourth placed Food, Beverages and Tobacco products climbing to the top with a little more than one-fourth of the turnover. An important new entrant is the second placed Computer Software Development and Training group. Entertainment/Electronic Media, Auto Ancillaries and Allied Products, Personal Care products and Pharmaceuticals also entered the top ten displacing Metals and Metal Products, Power Generation and Distribution, Non-Electrical Machinery, Telecommunications and Textiles. Public sector banks were relegated to the fourth position. Food, Beverages & Tobacco Products and Personal Care Products, which form the core of what are now being termed as the 'fast moving consumer goods' (FMCG), together accounted for 29.5 per cent of the turnover in 1998.

Table 14. Shares of Top 10 Industries in Turnover: 1996, 1998 and 1999

	1996		1998		Change in Share between 1996 and 1998	1999	
(1)	Industry (2)	% in Total (3)	Industry (4)	% in Total (5)	(6)	Industry (7)	% in Total (8)
1	Public Sector Banks	27.88	Food, Beverages & Tobacco Prod.	25.98	19.42	Computer Software & Training	29.28
2.	Diversified Companies	25.16	Computer Software & Training	18.32	18.13	Diversified Companies	10.32
3.	Metals & Metal Products	13.59	Diversified Companies	10.23	-14.93	Pharmaceuticals	9.73
4.	Food, Beverages & Tobacco Products	6.56	Public Sector Banks	7.67	-20.21	Food, Beverages & Tobacco Prod.	7.64
5.	Automobiles	3.46	Automobiles	4.96	1.50	Entertainment/ Electronic Media	6.72
6	Power Gen. & Distn.	2.69	Entertainment/ Electronic Media	4.32	4.27	Computer Hardware	5.09
7.	Cement	2.69	Auto Ancillaries & Allied	3.92	3.10	Telecommunication Equipment	4.11
8.	Non-Electrical Mach.	1.75	Personal Care Products	3.52	2.72	Public Sector Banks	4.09
9.	Telecommunications	1.72	Pharmaceuticals	3.17	1.97	Automobiles	3.79
10.	Textiles	1.39	Cement	2.59	-0.10	Cement	2.41
	Total of the above	86.89		84.68			83.18

Based on total turnover of top 500 companies in respective years.

By 1999, the relative positions changed further with the Computer Software segment reaching the top with about 29 per cent of the turnover. While the diversified companies retained their share, Pharmaceuticals improved substantially and reached the third position with an almost 10 per cent share. The two new entrants are Computer Hardware and Telecommunication Equipment. These displaced Personal Care Products and Auto Ancillaries and Allied Products. The share of public sector banks fell further to 4.09 per cent. Higher consideration for Computer related companies, pharmaceuticals, consumer products (especially FMCG) and television channels/programming does indicate the possible advantages not available to other industries for raising resources from the public.

The somewhat better distribution of turnover and number of transactions in 1999 could be due to the preference for these sectors shown by the investors cutting across the different groups of companies. The composition of A, B1 and B2 groups was changed again during 1999 [CMIE, 1997, p. 141].[31] During the last quarter (October-December), when the group composition was somewhat stable, computer software/hardware companies and pharmaceutical dominated the B1 Group to such an extent that out of the top 10 turnover companies, eight belonged to the first category and the remaining two the second.[32] The ten companies accounted for half of the turnover of the group. Similarly, in case of the B2 Group, among the top ten, nine belonged to the former category [*Dalal Street Investment Journal*, 2000, Pp. 9-16].[33] The tenth was a company owning a television channel. The combined share of the ten was more than half of the group's total turnover. This sectoral preference may thus have contributed to the decline in concentration in trading values among the top companies in 1999 compared to 1998. The sectoral preference was also reflected in the capital raised and number of issues. Leaving aside the banking sector and public financial institutions, information technology companies mobilised the largest amount of Rs 480 crore (35.5 per cent of the total after excluding Banks and FIs) during April-October 1999. In terms of number of issues also they were far ahead of the rest with 13 out of the 32 issues [SEBI, 1999, Table 9]. Interestingly, the issue of Hughes Software during October 1999 is reported to have attracted subscriptions worth Rs 6,000 crore. A far more impressive response was reported in case of HCL Technologies whose offer through the book-building route attracted bids worth Rs 20,000 crore [CMIE, 1999, p. 73]. In contrast, the Rs 200 crore bond issue of West Bengal Infrastructure Development Corp. received poor response and the closing date was extended by one month [CMIE, 1999, p. 78].

Another aspect of the trading at the BSE could be in viewing the market turnover in terms of foreign-controlled companies (FCCs), public and private sector constituents. We have grouped BSE listed companies under three heads:

(i) **Public Sector:** companies belonging to Central and State public sector including public financial institutions and companies promoted by them (excluding companies promoted with private parties in the joint sector);

(ii) **Indian Large Houses:** those belonging to Large Industrial Houses registered under the MRTP Act and companies promoted or taken-over by the Houses later on and excluding (a) those over which they lost control and (b) those classified as foreign controlled; and

(iii) **FCCs:** companies having 25 per cent or more of foreign equity (excluding those in which the foreign equity has been divested) and companies promoted by them.

Classification of the companies was limited to the top 500 companies identified on the basis of the size of their market turnover. The results are presented in Table 15. The exercise could not be extended to 1999 due to the non-availability of shareholding pattern of a large number of companies.

Table 15. Distribution of BSE Turnover According to Major Company Categories: 1996 and 1998

(Amount in Rs Crore)

Category	No. Of Companies		Market Turnover		Share in Turnover (%)	
	1996	1998	1996	1998	1996	1998
(1)	(2)	(3)	(4)	(5)	(6)	(7)
Indian Large House Cos.	56	68	40,248	58,659	45.25	22.22
Public Sector Cos.	26	34	29,397	32,418	33.05	12.28
Foreign Controlled Cos.	82	114	7,703	80,886	8.66	30.64
Others	336	284	11,599	92,097	13.04	34.86
All Companies	500	500	88,947	2,63,990	100.00	100.00

Note: Based on turnover data of top 500 companies identified on the basis of their annual market turnover in the respective years.
Source: Generated from BSE company-wise daily trading data.

In 1996, the Indian Large Houses accounted for about 45 per cent of the turnover but by 1998 their share came down to less than half *i.e.*, 22 per cent. The share of public sector companies also recorded a substantial decline from 33 per cent to about 12 per cent.[34] On the other hand, the share of foreign controlled companies increased from 8.66 per cent to about 30 per cent. The number of FCCs in the top 500 of the BSE increased from 82 in 1996 to 114 in 1998. There has been a marked change in the significance of FCCs. Shares of FCCs were obviously at a premium. A noteworthy feature of the period is the substantial increase during 1998 in the share of 'Other' companies. To a large extent this is due to the emergence of computer software and pharmaceutical companies in 1998. The important position attained by FCCs is also reflected from the fact that their combined weight in the revised BSE Sensex was 39.58 per cent at the time of revision.[35] In all, FCCs in personal care products, foods, beverages and tobacco products had a combined weight of 34.49 per cent in the Sensex [BSE, 1998].

Share Price Changes of BSE Listed Companies

In spite of the increasing availability of a number of indices representing the movement of share prices, the 30-share BSE Sensitive index (Sensex) continues to be the best known and most often referred index [*Economic Survey*, 1998-99, Pp. 56-57].[36] The Sensex is based on market capitalisation. Just before the process of liberalisation began in July 1991, the Sensex having its base as 1978-79 = 100, was in the vicinity of 1,300. Thereafter, it rose quickly to reach a high of 4,467 in April 1992. After the stock market scam broke out, the index fell sharply and by early June 1992, it reached 2,530. After some fluctuations it fell further to 2,037 by April 1993. Following the entry of foreign institutional investors (FIIs), the index started rising again from mid-1993, and by February 1994 it recovered much of the lost ground and reached 4,286. By December 1994, the index reached the post-scam high of 4,631.[37] The slide that followed brought the index down to 3,117 by mid-May 1995. Thereafter till early 1999, the index generally remained in the 3,000 - 4,000 range. Thus, the Sensex remained in a band for about four years. This period happens to be the one in which the turnover at the Bombay Stock Exchange recorded significant increase. In other words, the increases in turnover occurred when the index was oscillating in a band, the primary market was sluggish, shares and debentures as a proportion of household savings were falling and contribution of equity from new issues to company expansion was diminishing. The year 1999, however, presented a different picture. Share prices recovered significantly during the year. From mid-July onwards the index was generally above 4,500, which was the position during September 1994. By the middle of October the Sensex crossed 5,000 for the first time. Among the important policy measures introduced at the beginning of 1999 were (i) amending the *Companies Act, 1956* to allow share buy-backs and free inter-corporate investments from governmental approvals, (ii) reducing the long term capital gains tax from 20 per cent to 10 per cent for resident investors, and (iii) fully exempting the income received from investments in UTI and other mutual funds from income tax. Consequent to the relaxation given for mutual funds, the resources mobilised by the funds increased substantially during the year. During April-December 1999 the funds raised, in gross terms, Rs. 35,915 crore against Rs 16,288 crore during the corresponding months of 1998. Their performance in 1999 turns out to be more spectacular when looked in net terms: Rs 12,194 crore against Rs 950 crore. Another important development in 1999 was the better performance of private sector mutual funds in resource mobilisation [*India*, 1999-2000, p. 67].[38]

Short-term business sentiment is reflected in the daily share price movements. In the long term, however, divergences can occur between different sets of companies. To examine these in detail, we constructed indexes of share prices of companies belonging to different industry/activity groups and ownership categories. For this exercise, we have adopted the Reserve Bank of India (RBI) 'Use-Based Classification' of industries [*RBI*, 1993, Pp. 129-130]. Financial, software and other service sector companies were treated separately. The companies were initially selected in 1998. The main criteria for selection were that the companies should have been traded on at least half of the total number of days traded in 1998 and that there should be wide industry/activity representation. The 500 companies represent 75 industry/activity groups. While extending the exercise to 1999, the same set of companies was maintained. Closing price data was separated for different fortnights starting from January 13, 1994 and ending on December 27, 1999. Wherever prices for a selected day were not available, the closing quotation for the immediately following/preceding days was taken. Changes in each company's equity during 1994 to 1999 were traced. As in the case of analysis of market turnover, for purposes of this exercise, companies having 25 per cent or more of foreign equity by foreign collaborators are classified as foreign controlled companies (FCCs). Also included in this category are companies promoted by FCCs. The 500 companies selected for this exercise covered 92.48 per cent of the market turnover of BSE (excluding turnover of public sector) in 1998. Public sector companies have been kept deliberately outside to enable broad comparison with the earlier study of Institute for Studies in Industrial Development (ISID) which covered the period mid-1991 to the beginning of 1994 [Goyal et al]. The present study covers the six-year period 1994-1999. The two studies have a large number of companies (394) in common. Share price indices for different categories of companies were calculated for each fortnight. The share price index of the 500 companies will be referred to in the following as ISID Index (Sidex).

The methodology for constructing the Sidex is the same as followed by the BSE in constructing its Sensex and National Indices [BSE, 1993, Pp. 2-4]. The price of each component share in the index is weighted by the number of shares outstanding so that it will influence the index in proportion to its respective market capitalisation. The index for a day (fortnight ending) is calculated as the percentage of aggregate market value of the equity shares of all the companies on the day to the average market value of the equity shares of the same set of companies during the base period. This method of compilation has the advantage that it has the necessary flexibility to adjust for price changes caused by the issue of right and bonus shares. In case a company, included in the compilation of the index, issues 'bonus shares' the new weighing factor will be the number of equity shares outstanding after the bonus issue has become effective. This new weighing factor will be used while computing the index from the day the change becomes effective. If a company issues 'right shares', the weighing factor for this share gets increased by the number of additional shares issued. An offsetting or proportionate adjustment is then made to the Base Year Average. Weighing factors are also revised when new shares are issued by way of conversion of debentures, of loans into equity by financial institutions, mergers, etc. The base year average is also suitably adjusted to offset the change in the market value thus added. The formula for changing the base year average is as follows:

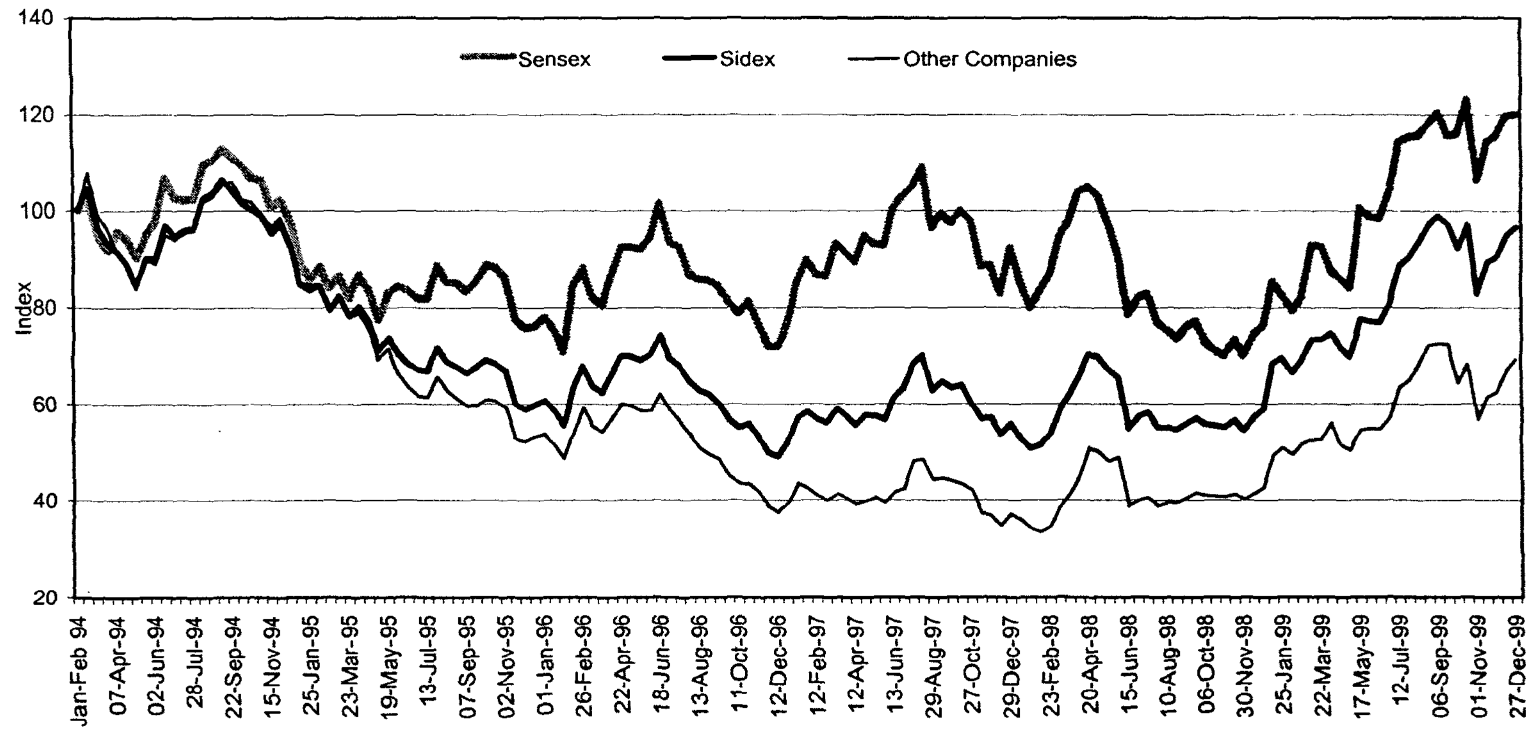
New Base Year Average = Old Base Year Average x (New Market Value/Old Market Value)

In line with Sidex, Sensex has been reworked taking the average of the figures for the three corresponding fortnightly days as the base. The results of the exercise are presented in the following. It can be seen from Graph-C that in the over all, Sensex remain higher than the Sidex and the two started diverging from each other from the beginning of 1995. The divergence between the two grew wider from the middle of 1996. It was only from early 1999 that the two started coming closer once again. It is relevant here to note that the composition of Sensex was revised by the BSE in mid-1996 by replacing half of the 30 companies with new ones. Those brought in included large public sector companies, namely, Bharat Heavy Electricals (BHEL), Steel Authority of India (SAIL), Hindustan Petroleum Corp (HPCL), Indian Petrochemical Corp (IPCL) and Mahanagar Telephone Nigam (MTNL). Public financial institutions — Industrial Credit & Investment Corp of India (ICICI), Industrial Development Bank of India (IDBI) and the State Bank of India (SBI) — were also brought in [BSE, 1996, Pp. 5-14]. The latest revision effected in November 1998 removed IPCL and SAIL from the Sensex. Such changes might reflect the prevailing market sentiment better. However, these will not help in understanding the developments in individual sectors. The Graph-C also features index of 'Other' companies after excluding the 24 companies common to the latest revised Sensex and the 500. This index is expected to represent the share price movement of companies other than those covered by Sensex. While there is a high degree of similarity in the direction of change in all the three indices, 'Others' index remained far lower. At the end of 1999 it was only about 70 per cent of the initial value (beginning of 1994). On the other hand, Sensex was higher by 20 per cent over the corresponding figure. The over all index, namely, Sidex barely managed to reach the 1994 level. Sensex whose composition underwent major changes during the period may thus be projecting a more optimistic picture than what the reality is.

It can be seen from Table 16 that while during the first two and half years, (following liberalisation) the share price index increased by about one and a half times, consumer non-durables showed a distinct pattern as increase in their case was the highest at 2.4 times. Relatively speaking, index of basic goods grew the least followed by capital goods. Having already started from a low level, basic goods suffered the worst again in the following period. The decline in intermediate goods was also substantial. While the poor performance of basic and intermediate goods continued in 1999, capital goods fared somewhat better. This may be due to the classification of computer hardware under this category and presence of a large number of FCCs in the capital goods sector.[39]

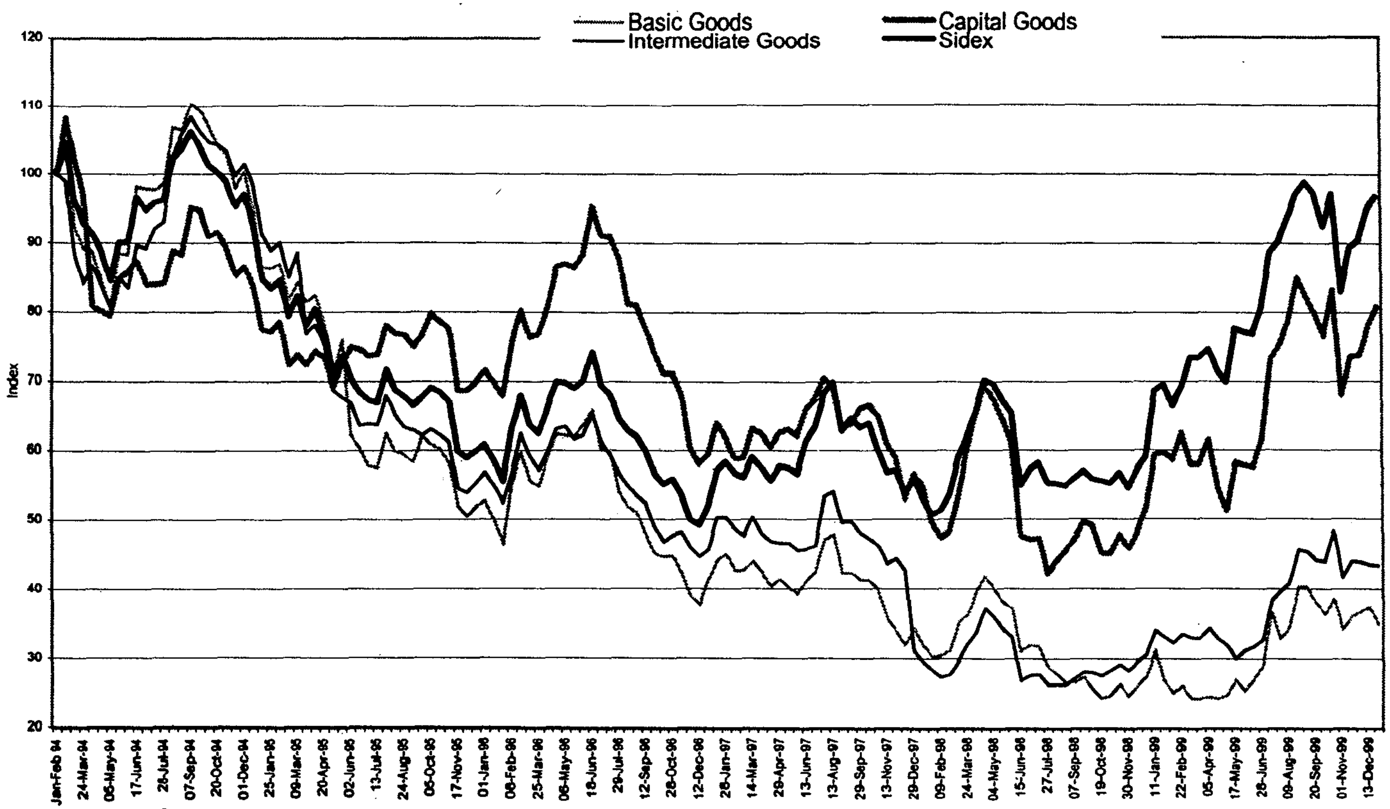
Graph C

BSE Sensex and ISID 500 Companies Share Price Index



Base: Average market capitalisation in the first three fortnightly points of 1994.
Original base of the Sensex is 1978-79=100.

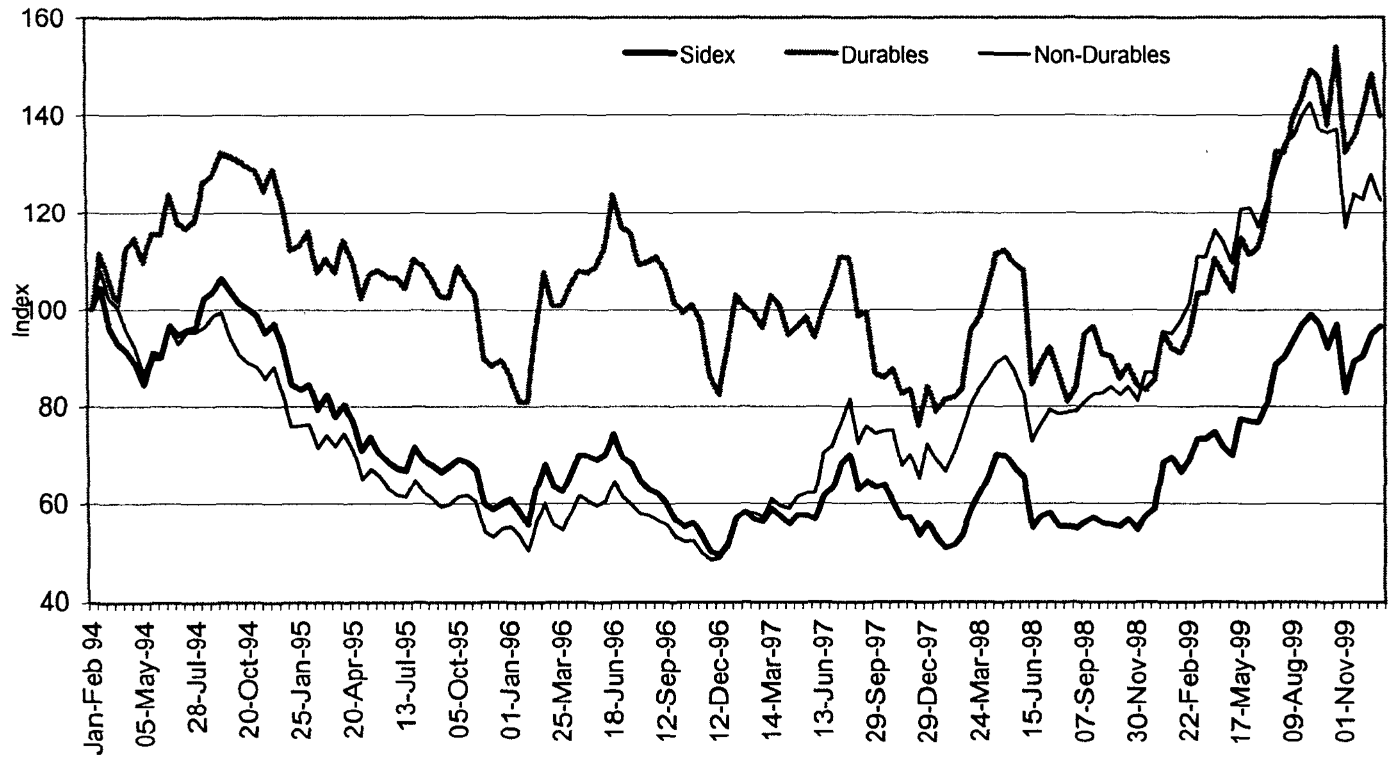
Graph D
Share Price Indices of Basic, Capital and Intermediate Goods Companies



Base: See Graph - C.

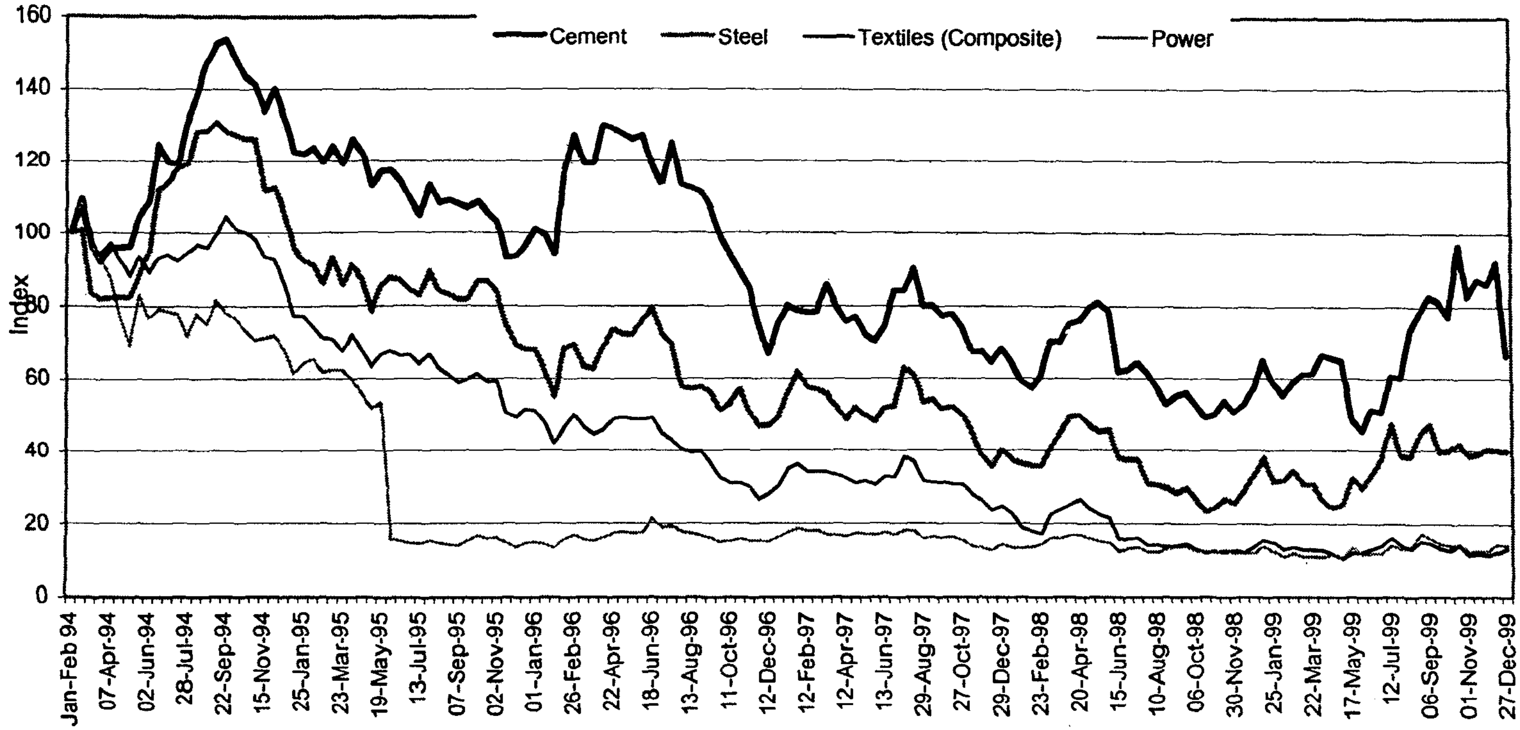
Graph E

Share Price Indices of Consumer Durables and Non-Durables



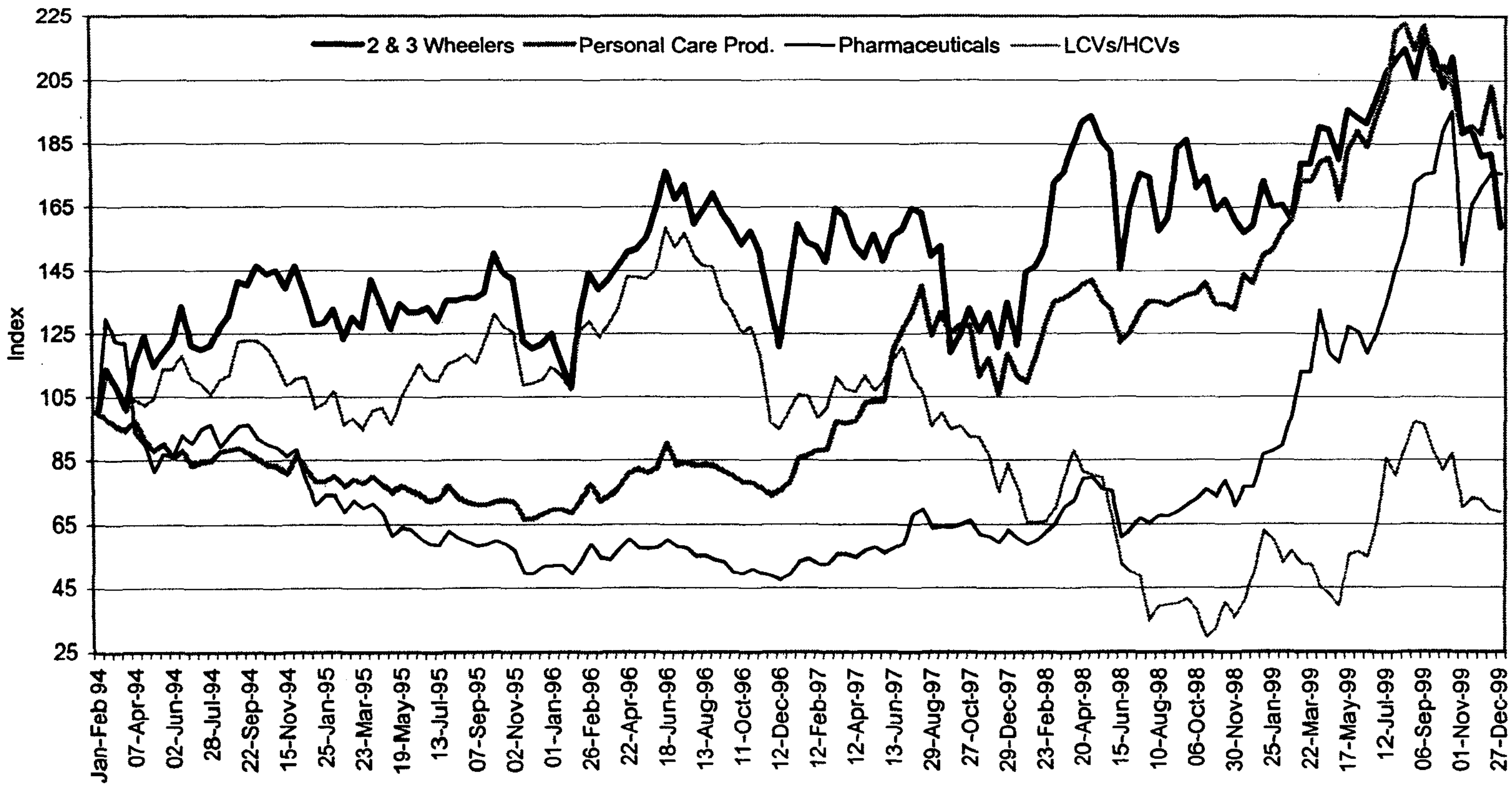
Base: See Graph - C.

Graph F
Share Price Indices of Select Industries - I



Base: See Graph - C.

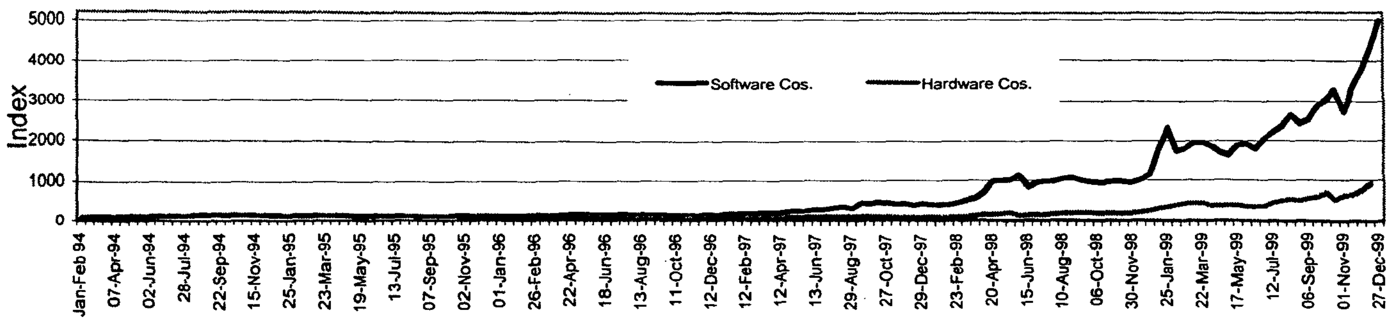
Graph G
Share Price Indices of Select Industries - II



Base: See Graph - C.

Graph H

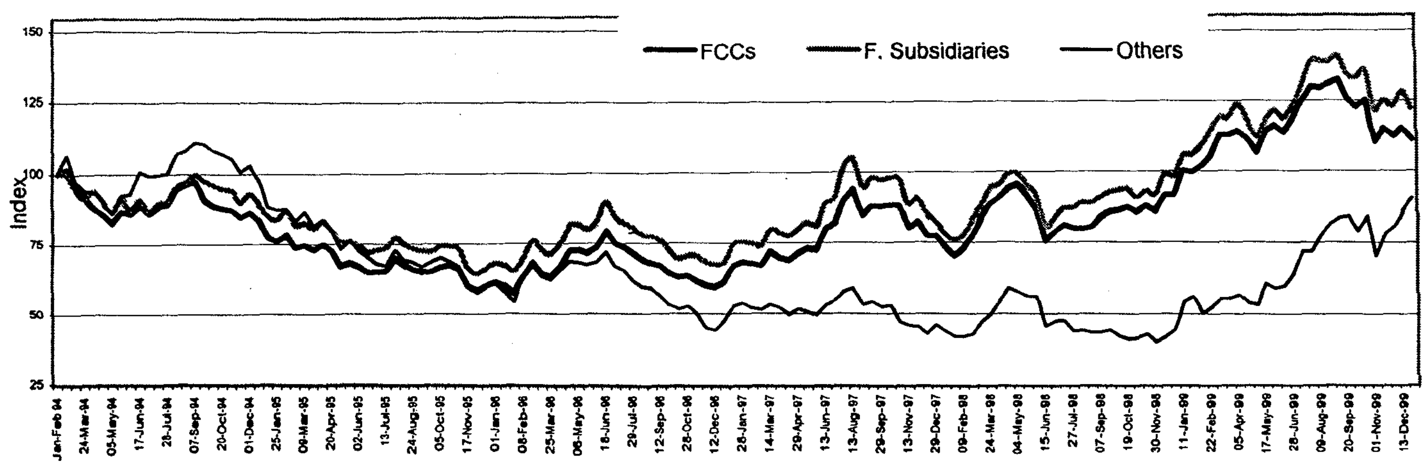
Share Price Indices of Computer Software and Hardware Companies



Base: See Graph - C.

Graph I

Share Price Indices of Foreign-Controlled Companies and Others



Base: See Graph - C.

Table 16. Share Price Indices Based on Use-based Industry Classification

Industry Category@ (1)	Beginning of 1994# (2)	End-1998$ (3)	End-1999$ (4)
Basic Goods	188.66	25.89	36.31
Capital Goods	203.66	44.53	77.40
Intermediate Goods	227.67	29.30	43.58
Consumer Durables	222.67	84.48	142.90
Consumer Non-Durables	340.33	85.53	124.50
All 500 Companies	258.67	58.34	94.03

@ Based on RBI Use-based Classification of Industries.
# Base: Average of the market capitalisation during the selected fortnights of April-June 1991.
$ Base: Average of the market capitalisation during first three fortnightly points of 1994.
End-period values are averages of the indices corresponding to the three final fortnightly points.
Source: Col. (2) is based on S.K. Goyal, et al, *ISID Development Indices*, a report submitted to the Ministry of Finance, 1994. Col. (3) and (4) are based on Sidex and its sub-components.

It can be seen from Graph-D that the relative low level of prices of basic and intermediate goods was not confined to end-of period position but a sustained one. The accentuation became more conspicuous from 1997 and finally in 1998 the two were far apart from the general index. However, there are sectors which withstood the downward pressure and performed quite well compared to the overall index. These are: consumer durables and consumer non-durables (Graph-E). While consumer durables remained above the Sidex and fluctuated violently, consumer non-durables started pulling away from it from the beginning of 1997. The process reached its culmination in September 1999. The picture emanating from the presentation of select industries at the disaggregated level further confirms the trends noticed at the use-based classification level as also the top sectors identified on the basis of market turnover. For instance, while the importance of cement declined in 1997 it continued to be near the top and re-entered the top 10 in 1999. On the other hand, metals and metal products which was in the third position in 1996 disappeared from the top 10 all together. Similar was the case with textiles.[40] Power, an important component of the infrastructure sector, suffered the worst from the point of share prices. After experiencing a steep fall in mid-1995, it never recovered. Pharmaceuticals which were moving closely with the overall index, started pulling away towards the end of 1997 (Graphs F and G). Incidentally, by 1998 it became part of the top 10 in terms of market turnover. The emergence of computer software among the top 10 in aggregate market turnover and its price index (Graph H) also tell a similar story. As we shall see in the accompanying paper on FII investments, there appears to be close relationship between FII investment exposure, large turnover sectors and movement of share prices.

The earlier study of ISID noticed that share prices of foreign-controlled companies (FCCs) increased faster than those of domestic companies. The later trends, especially during 1994-1998, further confirm the understanding that shareholders prefer FCCs. While the overall index fell to about 57 percent of the original value, the index for FCCs declined to only 90. Indeed, shares of foreign subsidiaries among the FCCs withstood the general decline better (Table 17). Foreign subsidiaries have been market favourites all through the period. In general, the divergence between FCCs and domestic companies started emerging from the middle of 1996 (Graph I). But for the decline in the indices for foreign companies after September 1999, when the shares of consumer non-durables did not appreciate much, the difference would have been far wider.

Monitoring Company Managements

Shareholding pattern and company law provisions have important implications for monitoring and disciplining company managements. Controlling interests will have little difficulty in having their way if major portion of the shareholding is distributed among large number of individual shareholders especially in the absences of significant non-managerial shareholders. If the government directly or through public financial institutions holds substantial stake it could monitor managements through appointment of nominee directors and participation in shareholder meetings. This could be beneficial for the dispersed individual shareholders as well. An attempt is made here to examine the share holding pattern of BSE listed companies from these stand points.

Table 17. Share Price Indices of FCCs and Other Companies

Company Category (1)	Beginning of 1994# (2)	End-1998$ (3)	End-1999$ (4)
Foreign-Controlled Cos.	356.33	89.95	111.14
- of which Foreign Subsidiaries	N.A.	96.36	121.94
Other Companies	217.33	41.64	90.61
All Companies	258.67	56.93	96.67

Notes: See Table 16. N.A. Not available.
Source: See Table 16.

Out of the 3,388 companies studied,[41] for as many as 1,611 government shareholding was less than 1 per cent (Table 18). This implies that in a little less than half of the companies, the government does not have any direct say. If for effective participation a minimum of 10 per cent of the shareholding is needed, then the government cannot do much in case of three-fourths of

Table 18. Shareholding Pattern of the Non-Government Companies Listed on BSE, 1998

Equity Range (Rs Crore)	Government Shareholding# Less Than					Individual Shareholding@ ≥ 40%		
	1 %	10 %	25 %	40 %	Total	Total	of which	
							Share of Corporate Bodies* + Directors & Relatives >25%	Government Shareholding# >25%
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Less than 5	628	859	954	990	999	523	383	9
5 - 10	716	1,075	1,247	1,300	1306	723	486	8
10 - 25	204	459	626	685	703	271	184	8
25 - 50	35	97	161	200	211	72	36	8
50 - 100	19	43	64	89	96	26	10	3
100 & above	9	31	56	72	73	26	8	4
All Companies	1,611	2,564	3,108	3,366	3,388	1,641	1,107	40

* Excluding the holdings categorised under foreign and government categories.
\# Includes Government companies, public financial institutions, mutual funds, etc.
@ Includes top 50 and other individual shareholdings but excludes shareholdings of directors and relatives.
Source: K.S. Chalapati Rao, K.V.K. Ranganathan and M.R. Murthy, 'Indian Company Law and Protection of Shareholders' Interest', in *Global Capital Flows and the Indian Stock Market*, a report prepared under the Indo-Dutch Programme on Alternatives in Development, November 1999.

the cases [Ramaiah, 1991].[42] This may be understandable because in the post-liberalisation period companies relied on raising resources directly from the public instead of depending upon public financial institutions. Most of these are relatively smaller companies with less than Rs 10 crore equity capital and constitute three-fourths of the total number of companies having less than 10 per cent of government equity. The smaller companies are also characterised by high level of individual shareholding. More than half of the companies with less than Rs 10 crore equity have 40 per cent or more of individual shareholding. In the larger companies share of individuals varied between 27 and 38 per cent. It is also noteworthy that in such companies, substantial shares are held by corporate bodies, directors and their relatives while the share of government was significant in only a few companies. It has been also seen that in the post-liberalisation period, shareholding of government companies declined in the larger companies. Foreign shareholding had an opposite experience. Corporate bodies, directors and their relatives also, in general, improved their position. Significantly, the shareholding of individuals declined in about three-fourths of the cases [Rao et al., 1999].[43] This could be due, apart from the general increase in the level of foreign equity, to the Indian managements' attempt at consolidating control to face take-over threats.

The ownership structure of listed companies thus leaves little scope for monitoring by the Individual shareholders in a large number of companies. Government-controlled shareholding in many small companies is too small to be able to influence managements' decisions in shareholder meetings. The efforts at revamping the *Companies Act, 1956* that would have helped in strengthening the monitoring mechanism, however, got severely bogged down. The phenomenon of contested take-overs of listed companies, an essential element of the disciplining aspect of stock markets, has not yet manifested itself in any meaningful manner in India. Moreover, the introduction of new provisions for share buy-backs, the liberalisation of the norms on inter-corporate investments in the *Companies Act, 1956* early in 1999 and the sanction that allows managements to increase their shares substantially without making public offer have further reduced the take-over threat. Thus, in a good number of cases the stock market does not provide a market for corporate control. A number of provisions of the Companies Bill, 1997, such as setting up of Audit Committee and expanding the scope of 'officer-in-default' aim at better governance by company managements. It is inexplicable why these were not made statutory along with share buy-back and relaxation of the limits on inter-corporate investments. SEBI has recently directed the stock exchanges to amend the Listing Agreement to provide for certain provisions of corporate governance.[44] It should be seen how these could be enforced and in actual practice work in the absence of corresponding changes in the *Companies Act.*

Summing Up

In the endeavour to encourage companies to raise resources directly from the investors and dismantle administrative barriers, in spite of the known shortcomings, the Indian stock market was encouraged alongside liberalisation. The necessary regulatory framework was, however, slow to evolve. The *Capital Issues Control Act* was repealed even in the face of the securities scam as if one was following a pre-set timetable. From hindsight, it appears that the process of liberalisation could have been more gradual. The inexperience of the regulatory body, namely, SEBI coupled with the government's failure to arm it with adequate powers in time, enabled the private promoters to misuse the new freedom and generated a series of scams of varying magnitudes and types. Sudden deregulation created chaotic conditions as private promoters tried to take advantage of the situation. The fact is that not only perpetrators of scams but even large houses and transnational corporations took advantage of policy vacuum and issued shares to themselves at ridiculously low prices. The official response to the scams unfortunately was characterised by long drawn investigations, procedural delays and a slow acting judiciary. The process understandably brought a lot of discredit to the stock market.

The abrupt change to a market-based system denied the general investor the time to adjust to the new situation where the public financial institutions, the industrial licensing system and finally, the capital issue control mechanism could no longer be relied on to assure the viability of investment projects. The typical investors were neither in a position to understand the nuances of investing in new issues having no long term track record nor were ready to appreciate the risk factors. As a matter of fact, SEBI observed that in the prevailing euphoric atmosphere, the investors ignored the risk factors revealed in the issue prospectuses of the so-called 'vanishing companies'.

After experiencing a boom in the early years of liberalisation, the primary market almost dried up as investors lost confidence and households shifted away from investing in shares and debentures. Companies had to once again opt for assistance from banks and financial institutions denying the stock market its resource allocation role. SEBI had to tighten issue norms to prevent further damage. The non-responsive primary market also affected public sector divestment targets and the plans had to be deferred repeatedly.

Since the confidence of the general investor in the market has been shaken, the response to the repetitive attempts by the government at reviving the market proved to be short-lived. Trading got increasingly concentrated and trading volumes were increased mainly through greater speculation. In the face of increasing turnover, the concentration in trading manifested itself in a number of ways: (i) nil or very infrequent trading in an overwhelming number of companies; (ii) increasing concentration both in value and number of trades terms; and (iii) dominance of a few sectors in trading. The heavy emphasis on a few companies and sectors has its reflection in the remaining ones being illiquid. Since in an overwhelming number of companies there was either nil or very little trading, investors hardly had a chance to learn the real value of their shares. Lack of liquidity also meant that the investor could not exit from a company even after realising that the prospects of capital appreciation or dividend earnings were very poor.

While the National Stock Exchange, which was to specialise in medium-sized companies, counts on a number of large companies which are also listed on the BSE, the Over the Counter Exchange of India (OTCEI), meant for smaller companies, has become virtually defunct, hurting the interests of small companies. OTCEI too has come to rely on companies listed on other stock exchanges and permitted to be traded on it for the trading volumes [OTCEI, 1999, p. 14].[45] This is contrary to the expectation that medium and small-sized companies would gain better access to capital market. The turnover activity is concentrated in only a few centres showing the base of the capital market to be highly un-even in the country. Even for the National Stock Exchange three-fourths of its turnover is accounted by just five cities, namely, Bombay, Delhi, Calcutta, Madras and Ahmedabad.

There is a possibility of interpreting the lack of interest shown by the ordinary investor following the primary market scam, as a sign of his maturity and that he would be more cautious in future. Even granting that this was a positive outcome, it should be recognised that this has been achieved at a substantial cost and brought the very concept of stock market regulation to disrepute. The recent developments when excessive attention is being paid to sectors like information technology, telecommunications, media and pharmaceuticals, however, throws serious doubts about the Indian investor gaining maturity. Seeing that investors were flocking to companies carrying software and information technology tags, SEBI had to caution them. Without proper education, the ordinary investors are bound to behave like a herd. Given the comparatively ill-informed investors and lack of liquidity in many shares, the investors would only concentrate on a few shares.

The market's reliance on a few scrips as reflected in the increasing concentration in the number of transactions and market turnover is likely to worsen the volatility. The sudden jumps and steep falls periodically witnessed in the Indian stock market appear to be a result of this banking on the few by the investors - foreign as well as local, large and small. The first two months of 2000 have thrown further indications in this regard with large intra-day as well as day-to-day fluctuations of the Sensex.[46]

While computer software, telecommunications, electronic media, pharmaceuticals and consumer non-durables emerged as leaders, the extent of price declines in the case of important basic, capital and intermediate goods sectors unfortunately has never got reflected in the price indices referred to as barometers of the market mood. If the general lack of interest of the stock market in the latter sectors is due to the excessive attention paid to the former, serious thought should be given as to how their financing needs could be met.[47] If the stock market does not support these industries due to investors' preference for quick returns, as is clearly evident from the low delivery ratios, the efforts of the state in the form of development financial institutions should not be undermined. If the functioning of financial institutions has also to be decided by market forces they cannot obviously undertake ventures based on the projects' long term potential and in the interest of the economy. Given the investors' propensity to seek quick returns due the unsteady nature of the market, it is doubtful if the improvements in the form of dematerialisation of shares, rolling settlement, etc., would improve the situation. In this the role of foreign institutional investors and mutual funds need to be watched carefully.

The fact that 1999 proved to be different in terms of the relatively higher level of share prices and larger number of companies getting traded may give rise to a false sense of security. A number of problems remain. While the share prices of many companies increased in consonance with Sensex, not only the index for these companies remained far lower than its 1994 position, there are wide inter-sectoral differences. The concentration in trading continued to be quite high. The somewhat better distribution at the top appears more to do with investors flocking to select sectors. The shareholding pattern of the listed sector does not appear to be conducive to monitoring by shareholders. The efforts at revamping the *Companies Act, 1956* that would have helped in strengthening the monitoring mechanism are, however, bogged down severely. Since the shareholding pattern does not seem to support stock market discipline, and investor activism is yet to take an organised form, other institutional mechanisms in the form of amendments to the *Companies Act* should have been given precedence over the liberalisation provisions like buy-back, inter-corporate investments and enhanced shares for the promoters.

Stock markets have to function in a country's social, political and economic milieu. When encouraging stock markets it is necessary to give due attention to how rules are framed and how they are implemented by the authorities on the one hand and respected by the target groups on the other. Indian experience shows that evolution of such an institutional framework will most often be gradual and cannot be achieved in a swift manner and that without a suitable institutional framework in place, the cost of transition could be very high. The study, therefore, suggests the need for a deeper understanding of the functioning of developing country stock markets without which inferences based on aggregate data may lead to inappropriate policy prescriptions. Such an understanding would contribute to better appreciation of the role of stock markets in resource mobilisation and their contribution to economic development.

Annexure
Average and Relative Number of Companies Traded at BSE: 1994-1999

Month (1)	Average Number of Companies Traded (2)	No. Of Companies Listed (3)	% of Companies Traded (2)/(3) x 100 (4)
9401	1670	3353	49.81
9402	1802	3483	51.74
9403	1758	3585	49.04
9404	1842	3705	49.72
9405	1903	3813	49.91
9406	1989	3900	51.00
9407	2035	3987	51.04
9408	2153	4077	52.81
9409	2206	4172	52.88
9410	2327	4245	54.82
9411	2413	4345	55.54
9412	2479	4413	56.17
9501	2470	4495	54.95
9502	2545	4595	55.39
9503	2483	4702	52.81
9504	2718	4829	56.28
9505	2873	5063	56.75
9506	3146	5183	60.70
9507	3612	5303	68.11
9508	3582	5379	66.59
9509	3619	5435	66.59
9510	3579	5499	65.08
9511	3409	5568	61.22
9512	3639	5621	64.74
9601	3427	5451	62.87
9602	3658	5545	65.97
9603	3591	5603	64.09
9604	3589	5596	64.14
9605	3421	5719	59.82
9606	3610	5760	62.67
9607	3345	5799	57.68
9608	3283	5885	55.79
9609	2856	5933	48.14
9610	2557	5969	42.84
9611	2190	5988	36.57
9612	2184	5999	36.41
9701	2767	6008	46.06
9702	2271	5839	38.89
9703	2316	5832	39.71
9704	1914	5831	32.82

(Contd.)

Annexure (Concld.)

Month (1)	Average Number of Companies Traded (2)	No. Of Companies Listed (3)	% of Companies Traded (2)/(3) x 100 (4)
9705	1945	5840	33.30
9706	1849	5844	31.64
9707	1942	5844	33.23
9708	2038	5848	34.85
9709	1662	5839	28.46
9710	1684	5842	28.83
9711	1480	5842	25.33
9712	1435	5843	24.56
9801	1500	5850	25.64
9802	1384	5852	23.65
9803	1490	5853	25.46
9804	1884	5853	32.19
9805	1570	5852	26.83
9806	1265	5854	21.61
9807	1229	5850	21.01
9808	1143	5851	19.54
9809	1302	5854	22.24
9810	1135	5855	19.39
9811	1316	5857	22.47
9812	1300	5860	22.18
9901	1644	5861	28.05
9902	1819	5860	31.04
9903	1983	5848	33.91
9904	1482	5850	25.33
9905	1474	5850	25.20
9906	1420	5851	24.27
9907	1785	5851	30.51
9908	1967	5852	33.61
9909	2041	5854	34.87
9910	2318	5855	39.59
9911	1963	5858	33.51
9912	2516	5863	42.91

Previous month's figure was repeated in the absence of the corresponding month's figure.
Source: Col. (2) - CMIE, *Capital Markets*, October 1998 for the period January 1994 to March 1998. Estimated from the daily trade data for the remaining months. Data for some days in 1999 was not available. Col. (3) - BSE, *The Stock Exchange Review*, various issues.

NOTES

1. The World Bank noted that capital markets were needed in any mass privatisation programme especially for sale of state assets through direct share offerings. The UN noted that 'Besides the stock market's ability to mobilize domestic savings effectively, it also draws in foreign savings to augment investment. Clearly countries without a stock market will have severe difficulties competing with other countries having such an institution'.

2. The Narasimham Committee [1991] which recommended the discontinuation of the Controller of Capital Issues (CCI), felt that

> (I)n the scenario that we envisage it would be for the merchant bankers and the underwriters who should offer professional advice on a particular issue, on the nature of the instrument, its terms and pricing and for the issuer to decide on these matters. The Committee does not believe that CCI or, for that matter, SEBI should be involved in prior sanction of new capital issues in respect of companies whose scrips are listed on the stock exchange. In respect of unlisted shares however, where investor awareness of the prospects and background of the promoters may not be high and with a view to prevent any misuse by promoters, it may be stipulated that the Stock Exchanges should approve the prospectus.

3. Though the exchange is now called The Stock Exchange, Mumbai, we shall refer to it as Bombay Stock Exchange or BSE, its better known form.

4. As a follow up of the adoption of the FERA it became obligatory for all foreign branches operating in India to get registered as Indian companies under the *Companies Act, 1956* with up to 40 per cent foreign equity. Companies already registered in India and having more than 40 per cent foreign equity were also required to dilute the extent of foreign equity to 40 per cent.

5. The consequential wide dispersal of shareholding (a) provided insurance against likely attempt at cornering of shares by any groups or individuals and (b) created a situation in which a large number of shareholders can be mobilised to create public opinion in favour of the foreign company. For an empirical analysis of FERA dilution strategy.

6. For instance, the issue of Mcleod Russel was over-subscribed 41 times, that of Warren Tea by 27 times, Britannia 20 times and of Cadbury 16 times.

7. Since market capitalisation depends on prevailing share prices, its ratio to GDP must be read with caution. Market capitalisation is a stock concept, whereas the GDP represents flow. The use of this ratio to represent the size of a market has, however, been justified on the ground that market size is positively correlated with the ability to mobilise capital and diversify risk.

8. Besides being the oldest, most of the larger Indian companies are listed at the Bombay Stock Exchange. It is estimated that at the end of 1997, companies listed on BSE accounted for 92 per cent of market capitalisation of all-India listed companies. The share of traded volumes of BSE, however, got reduced in a substantial manner with commencement of the operations by the National Stock Exchange (NSE) in 1994. Subsequently, BSE introduced On-Line Screen Based Trading covering different cities to recover the lost ground.

9. These figures, however, have to be read with caution due of the uncertainty surrounding the estimation of the paid-up capital of the Indian corporate sector. Moreover, growth in the market capitalisation and the listed capital need not necessarily be due to new productive investments but due to the listing of *existing large companies*. For instance, in India many large public sector companies came to be listed on the stock exchanges in the post-liberalisation period due to partial divestment of government equity. These included Indian Oil Corporation, Steel Authority of India (SAIL), Mahanagar Telephone Nigam (MTNL) and Oil and Natural Gas Corp. (ONGC) apart from large banks like the State Bank of India (SBI) and financial institutions like the Industrial Development Bank of India (IDBI) and the Industrial Finance Corporation of India (IFCI). The importance of public sector companies can be seen from the fact that at the end of 1996 there were seven public sector companies among the top ten in terms of market capitalisation. Additionally, much of the market capitalisation of public sector companies is illusive because an overwhelming part of the equity of the companies is still with the government.

10. Capital can be raised from the primary market either through public issues or from rights issues to the existing shareholders. The amounts can either be in the form of equity, preference shares or debt. There are differences in the estimates provided by the *Economic Survey* and private monitoring organisations like the Centre for Monitoring Indian Economy (CMIE) and the Praxis Consultancy and Information Services Pvt. Ltd.'s Prime Database. While there are differences in number of issues and the amount raised, there is considerable similarity in the overall dimensions and the year-to-year movements. CMIE has been preferred here because it gives ownership-wise distribution of issues.

11. Though the two sources are not comparable, the fact that the situation worsened in 1998-99 is reflected from the data offered by SEBI. According to SEBI the number of issues declined from 111 in 1997-98 to 58 in 1998-99. Even among these, initial issues suffered the worst with just 18 in 1998-99 against 52 in the previous year.

12. Through irregularities in securities and banking transactions huge amounts were diverted to the stock market.

13. By sheer coincidence, we found that the observations of a Committee in 1948 describe aptly the situation that prevailed during those months. In the context of the steep rise in the shares of Indian Iron & Steel Co. between June 1936 and April 1937 from about Rs 9 to Rs 79 3/4 it was noted that: For the first time in its history, the stock market became the playground for all comers. Seized with an insatiable lust for money-making, uninitiated in the technique of stock speculation, ill-informed as to the relative position of and the value of the various speculative shares, the man-in-the-street was wildly dragged into the maelstrom of stock market boom. After reaching the above record price on 6^{th} April, Indian Irons fell abruptly to Rs 43-4-0 by the end of the month causing immense loss to numerous persons and benefiting only a few clever manipulators who had taken full advantage of the pitiable *laissez faire* policy then pursued by the Government.

14. Part of this was through issue of new shares and part through off-loading of government shares.

15. An additional safeguard was provided in the form of official scrutiny at the time of issuing an industrial licence.

16. Exceptions were, however, allowed for banks. SEBI subsequently modified the criteria. The latest guidelines indicate that instead of actually paying dividend the issuing company should have had *distributable* profits and minimum networth of Rs 1 crore during three out of the immediately preceding five years. In case of infrastructure projects it is sufficient if the projects have been appraised by public financial institutions and if any such institutions irrespective of whether they appraised the issue or not meet 5 per cent of the project cost. See SEBI Disclosure and investor Protection Guidelines 2000.

17. SEBI Chairman was reported to have said that '(T)he details of the mechanism (to find out the vanishing promoters) will be worked out soon. The total amount raised by these promoters is not known'. It was also reported that about half of the nearly 6,000 listed companies did not file annual results for March 1998.

18. According to RBI, the number of new non-government public limited companies which made new capital issues declined sharply from 577 in 1995-96 to just 27 in 1997-98 and to only 7 in 1998-99. Financing companies were affected severely in the process. The number of public issues of NBFCs declined from 477 in 1995-96 to 249 in 1996-97 and further to just 24 in 1997-98.

19. The case of CRB group whose diversion of funds raised from public issues led to the focus on non-banking financial companies provides a relevant example here. The group was associated with a number of public issues in the 'eighties. The kingpin of the group was even auditing the accounts of companies on which his father and mother were directors. Some other auditors associated with the group at that time later appeared as auditors to CRB Capital Markets Ltd., a merchant banking company, also engaged in leasing and other financial services. The company came to the public thrice in the early 'nineties - public issue August 1992, and public-cum-rights issues in August 1993 and January 1995 - the total issue amount being Rs 238 crore. Another company of the group CRP Crop Ltd., formerly Jaihind Granite Industries Ltd.) made two issues totalling Rs 81 crore. (See: Praxis Consulting and Information Services Pvt Ltd., Prime-MRL and Prime-MIL, covering All public Issues: 1.4.1989 - 31.3.1999 and All Rights Issues: 1.4.1990 - 31.3.1999, n.d.) The group received FDI approval for floating a financial services joint venture with Daewoo group of Korea and for setting up asset management companies in association with Daewoo Securities and Keystone Group Inc., USA. The group floated a mutual funds in August 1994 to raise about Rs 100 crore. The Group was on the verge of promoting a bank when the matter was exposed. In addition to the NBFCs, the operations of 'plantation companies' have also hurt the investor sentiment.

20. CMIE's observations are relevant in this context. CMIE noted that '(U)nlike the 1980s or the early 1990s, the business sectors are unable to directly draw upon the savings of the household sectors. IPOs are replaced by private placement issues. Banks and financial institutions have displaced manufacturing corporates and a significant part of fund mobilised is through debt instruments rather than equity'.

21. Liquidity enables investors to alter their portfolios quickly and cheaply and makes investments less risky. One measure of liquidity is total value traded as a proportion of GDP. Turnover ratio, *i.e.*, value of total shares traded as a proportion of market capitalisation is another important one. However, high level of trading in a few scrips may indicate unhealthy speculation.

22. When shares are purchased they will normally be taken delivery at the end of the settlement by making the necessary payment or the deals are squared off. The carry forward system enables the purchaser to postpone the delivery to the next settlement by paying *badla* or carry forward charges to a *badla* financier. The main difference between the margin system in USA is reported to be while in the Indian case there is no need for the seller to have shares and the buyer to have the money, in the margin trading the buyer has to put up at least 50 per cent of the purchase value of shares and also pledge the shares in actuality. For a detailed description of the carry forward system. In December 1993, SEBI directed the four major stock exchanges in Bombay, Delhi, Ahmedabad and Calcutta, where forward trading is permitted, to have all fresh trades only on cash basis. Banning of *badla* had severe adverse impact on trading volumes of Specified Group (also called the A Group) shares during 1994-95 in BSE. Average daily turnover in A group fell from Rs 285 crore in 1993-94 to Rs 67 crore in 1994-95. Due to this, the share of A group in total volume got reduced from 73.59 per cent in 1993-94 to only 22.81 per cent in 1994-95. Re-introduction of *badla* in January 1996 again led to the A Group's share increasing substantially in total volume transacted in the last quarter of 1995-96. During the first nine months of 1996-97, the share of A Group in total trading volume rose to 93 per cent.

23. Though data for certain days in 1999 was missing, the estimates may not have been affected seriously as only the number of days for which the data was available were taken for arriving at the average number of companies traded.

24. For purposes of this and the subsequent analysis of BSE trading data for the years 1996, 1997, 1998 and 1999, we have relied on the daily trade data supplied in machine readable format (called the QE files) along with the *Investment* Decision Support System (IDSS) by the Dalal Street Journal group. The database was later renamed as *Equity Research Station* (ERS) and is being maintained by the Asian CERC Information Services (India) Ltd. Though there are a few gap in the provided by the company, since most of the exercises analyse the relative shares of different sets of companies instead of the absolute amounts, this may not significantly affect the conclusions. The face value of each share is Rs 10 though there are some exceptions. Such companies are invariably the older ones with a face value of Rs 100. The assumption of uniform face value of Rs 10 made here does not, therefore, result in any over-estimation. The stock splits that have been introduced recently, however, make such assumptions unrealistic in future.

25. The percentage of premium issues was especially high during 1994-95 and 1995-96. During 1994-95 out of the 1,230 issues as many as 388 had a premium component. Out of 87 equity issues by already listed companies as many as 75 involved premium. Indeed, during 1995-96 all but one of the 59 public issues by the already listed companies were premium issues. During this year also the premium issues were high as out of 1,351 issues 300 had premium component (Based

on Prime Database Annual Reports).

26. The Bombay Stock Exchange has started giving data on trading values in 1996. We have confined to trading in equity shares of companies after excluding data relating to debt securities and transactions by mutual funds. For companies traded both in the regular and dematerialised forms with distinct scrip codes, the turnover has been combined and only one scrip code has been retained.

27. The concentration appears quite heavy when compared with the trading pattern at the New York Stock Exchange (NYSE). The turnover data of the NYSE for 1998 shows that at the 10 company mark, the share in turnover was only 12.64 per cent while it was 67.20 per cent for BSE. When the top 100 companies are considered the share at NYSE works out to about half of the share at BSE. Even at the 500 company level there is considerable difference between the shares: 83.13 per cent for NYSE against 99.82 per cent for BSE.

28. Initially BSE decided to remove 26 companies and introduce 27 new ones to maintain the strength of the Group was 149 at the time of revision). It, however, decided to bring in only 17 new companies thereby reducing the Group's strength to 140.

29. FIIs are obliged to take/give delivery of the shares traded by them.

30. The classification broadly follows the equity research (ERS) database pattern.

31. While the scrips in A Group can have carry forward deals with weekly settlements, those in B1 would have weekly settlements without the facility of carry forward. Those of B2 (also referred to as B Group) would be similar to B1 but with a fortnightly settlement.

32. These were: Aftek, Cybertech, DSQ Software, Kale Consultants, Mars Software, Mastek, Rolta (I), and Visualsoft in the software sector; Lupin Labs and Morepen Labs in the pharmaceutical.

33. Including Boss Industries (new name: Sriven Multitech) and Vakrangee Ltd. (new name: Vakrangee Software) which are reported to be under the scrutiny of BSE for changing their names to relate to software business.

34. A limited exercise at identifying public sector companies in 1999 revealed that its share declined further to about nine per cent.

35. The Sensex was revised in November 1998 by the inclusion of two FCCs (Castrol and Novartis) and two computer software companies (NIIT and Infosys Technologies). These replaced two public sector companies (SAIL and IPCL) and two large house companies (Arvind Mills and GE Shipping).

36. The mass media (Radio & T.V. networks) as also the newspapers invariably give prominence to the Sensex. Even the *Economic Survey* 1998-99, while presenting the monthly levels of Sensex (30 companies) and the NSE Nifty (50 companies) described the movements in BSE Sensex and referred to those in Nifty in a passing manner. Needless to say, there was no discussion on industry-wise price movements.

37. Though the FIIs started making purchases in early 1993, it was only during the last quarter, *i.e.*, October-December 1993 their net investments reached a substantial amount of US$ 600 million.

38. Private sector accounted for about two-thirds of the gross mobilisation and nearly three-fourths of the mobilisation in net terms. Resources mobilised by different types of mutual funds are discussed a little more in the accompanying paper on FII investments.

39. Out of the 70 companies in the capital goods category as many as 30 were FCCs. Their presence becomes more prominent if computer hardware companies are taken out: 28 out of 61.

40. See Table 7 in the accompanying paper: 'Foreign Institutional Investments and the Indian Stock Market'.

41. Out of about 5,600 companies listed on the BSE during 1998, we could get the shareholding pattern for 3,894 companies. After excluding public sector companies and companies promoted by them and the companies for which the information was not available for any of the years 1996, 1997 or 1998 we were left with 3,388 companies.

42. Under Section 169 of the *Companies Act, 1956* the minimum voting strength required for convening an extraordinary general meeting is 10 per cent of the paid-up capital of the company.

43. For this, a separate exercise was made to identify top 200 private sector companies in 1989-90 for which a shareholding pattern was available for both pre- and post-liberalisation periods. We assumed that shareholding data prior to mid-1992 represents the pre-liberalisation period and that for any time after 1995 reflects the impact of liberalisation. By eliminating companies for which shareholding data was not available for both the periods, companies which have got merged, the unlisted ones, those which have undergone extensive restructuring and the public sector companies, the final list of top 200 companies based on their ranking in 1989-90 was arrived at.

44. The Circular which followed the recommendations of a Committee constituted by SEBI under the Chairmanship of Mr. Kumar Mangalam Birla was issued in February 2000.

45. At the OTCEI, during 1999, turnover of equity shares of listed companies was Rs 4.47 crore against the corresponding figure of Rs 1,778.90 crore for the permitted ones.

46. On the 15 of the 41 days traded, daily highs of the Sensex were at least 3 per cent higher than the corresponding daily lows.

47. It is relevant to note here that investor preferences for select sectors have resulted in wide variations in the price-earning ratios. Out of the 304 product/activity groups for which price-earning (P/E) ratios are available, in case of six the ratio was more than 100 and in case of another five it was more than 50. For as many as 196, it was less than 10. The six with the highest P/E ratios are: Entertainment and Electronic media (765); Large Computer Software Companies (431); Magnetic Tapes and Cassettes (281); Computer Software Converts (161); Large Telecommunication Equipment (128); and computer Education (125). Figures in brackets are P/E ratios. Source: Industry Score Board at www.capitalmarket.com. Prices are for February 18, 2000.

ABBREVIATION

BHEL	Bharat Heavy Electricals
BSE	Bombay Stock Exchange
CCI	Controller of Capital Issues
CICA	Capital Issues Control Act, 1947
CMIE	Centre for Monitoring Indian Economy
ERS	Equity Research Station

FCCs	foreign-controlled companies
FDI	Foreign Direct Investment
FERA	Foreign Exchange Regulation Act, 1973
FIIs	Foreign Institutional Investors
FMCG	Fast Moving Consumer Goods
GDP	Gross Domestic Product
HPCL	Hindustan Petroleum Corp. Ltd.
ICICI	Industrial Credit & Investment Corp. of India
IDBI	Industrial Development Bank of India
IDPAD	Indo-Duch Programme on alternatives in Development
IDSS	Investment Decision Support System
IFCI	Industrial Finance Corporation of India
IPCL	Indian Petrochemical Corp.
ISID	Institute for Studies in Industrial Development.
MRTP	Monopoly and Restrictive Trade Practices Act
MTNL	Mahanagar Telephone Nigam
MTNL	Mahanagar Telephone Nigam
NBFCs	Non-Banking Financial Companies
NSE	National Stock Exchange
NYSE	New York Stock Exchange
ONGC	Oil and Natural Gas Corporation
OTCEI	Over the Counter Exchange of India
PUC	Paid-Up Capital
RBI	Reserve Bank of India
SAIL	Steel Authority of India
SBI	State Bank of India
SEBI	Securities and Exchange Board of India

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FOREIGN INSTITUTIONAL INVESTMENTS AND THE INDIAN STOCK MARKET

K.S. Chalapati Rao, K.V.K. Ranganathan and M.R. Murthy

To facilitate foreign private capital flows in the form of portfolio investments, developing countries have been advised to develop their stock markets. It was suggested that these investments would help the stock markets directly through widening investor base and indirectly by compelling local authorities to improve the trading systems. While the volatility associated with portfolio capital flows is well known, there is also a concern that foreign institutional investors might introduce distortions in the host country markets due to the pressure on them to secure capital gains. In this context, this paper seeks to assess the importance of foreign portfolio investments in India relative to other major forms and to study the relationship between foreign portfolio investments and trends in the Indian stock market during the past four years.

Introduction

The character of global capital flows to developing countries underwent significant changes on many counts during the 'nineties. By the time the East Asian financial crisis surfaced, the overall size of the flows more than tripled. It stood at US$ 100.8 bn. in 1990 and rose to US$ 308.1 bn. by 1996. The increase was entirely due to the sharp rise in the flows under private account that rose from US$ 43.9 bn. to 275.9 billion during the same period. In relative terms the percentage of private account capital flows increased from 43.55 to 89.55 per cent (Table 1). *Simultaneously*, the Official Development Assistance (ODA), declined both in relative and absolute terms. All the main components of the private account capital transfers, namely, (a) commercial loans, (b) foreign direct investments (FDI), and (c) foreign portfolio investments (equity and bonds) (FPI) recorded significant increases. Portfolio flows increased at a faster rate than direct investments on private account. As a result, starting with a low level of 11.16 per cent, the share of capital flows in the form of portfolio investments quadrupled to reach 37.22 per cent in 1996 reflecting the enhanced emphasis on private capital flows with portfolio investments forming the second important constituent of the flows during the 'nineties. In this process multilateral bodies led by the International Finance Corporation (IFC) played a major role.[1]

Following the East Asian financial crisis, initially there was a slow down followed, by a decline in private capital flows. While bonds and portfolio equity flows reacted quickly and declined in 1997 itself, loans from commercial banks dropped a year later in 1998. Decline in FDI was also delayed. But the fall in FDI was quite small compared to the other three major forms of private capital flows. While flows on official account increased, following the crisis, they continue to constitute only a small portion of the total flows. Thus, starting with the resolve by the developed countries to provide one per cent of their GNP as developmental aid, the industrialised world preferred to encourage private capital transfers through direct investments instead of official assistance [Goyal, 1980, Pp. 843-50; Goyal, 1982].[2] The declining importance of official development finance is attributed to budgetary constraints in donor countries and the optimism of private investors in the viability of the developing countries [World Bank, 1998, p. 5].

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[Since this October-December, 1999, issue of the Journal has been delayed by a quarter, the revised version of this paper could incorporate some of the information beyond December, 1999. - Editor]

Table 1. Aggregate Net Long-term Resource Flows to Developing Countries

(US$ bn.)

Type of flow (1)	1990 (2)	1991 (3)	1992 (4)	1993 (5)	1994 (6)	1995 (7)	1996 (8)	1997 (9)	1998 (10)
A. Official Flows	56.9	62.6	54.0	53.3	45.5	53.4	32.2	39.1	47.9
B. Total Private Flows	43.9	60.5	98.3	167.0	178.1	201.5	275.9	299.0	227.1
Of which.									
International Capital Markets	19.4	26.2	52.2	100.0	89.6	96.1	149.5	135.5	72.1
- Private Debt Flows	15.7	18.6	38.1	49.0	54.4	60.0	100.3	105.3	58.0
- Commercial Banks	3.2	4.8	16.3	3.3	13.9	32.4	43.7	60.1	25.1
- Bonds	1.2	10.8	11.1	37.0	36.7	26.6	53.5	42.6	30.2
- Others	11.4	3.0	10.7	8.6	3.7	1.0	3.0	2.6	2.7
- Portfolio Equity Flows	3.7	7.6	14.1	51.0	35.2	36.1	49.2	30.2	14.1
Foreign Direct Investment	24.5	34.4	46.1	67.0	88.5	105.4	126.4	163.4	155.0
C. Aggregate Net Resource Flows (A+B)	100.8	123.1	152.3	220.2	223.6	254.9	308.1	338.1	275.0
Share of Private flows in Total Flows (C)	43.55	49.15	64.54	75.84	79.65	79.05	89.55	88.44	82.58
Share of Portfolio Capital Flows (equity+bonds) in Private Flows (B)	11.16	30.41	25.64	52.69	40.37	31.12	37.22	24.35	19.51

Source: Based on World Bank, *Global Development Finance*, 1999, Table 2.1.

Portfolio investments spread risk for foreign investors, and provide an opportunity to share the fruits of growth of developing countries which are expected to grow faster. Investing in emerging markets is expected to provide a better return on investments for pension funds and private investors of the developed countries. For developing countries, foreign portfolio equity investment has different characteristics and implications compared to FDI. Besides supplementing domestic savings, FDI is expected to facilitate transfer of technology, introduce new management and marketing skills, and helps expand host country markets and foreign trade [World Bank, 1997, p. 31]. Portfolio investments supplement foreign exchange availability and domestic savings but are most often not project specific. FPI, are welcomed by developing countries since these are non-debt creating. FPI, if involved in primary issues, provides critical risk capital for new projects. Since FPI takes the form of investment in the secondary stock market, it does not directly contribute to creation of new production capabilities. To enable FPI flows which prefer easy liquidity, multilateral bodies, led by the International Finance Corporation (IFC), have been encouraging establishment and strengthening of stock markets in developing countries as a medium that will enable flow of savings from developed countries to developing countries.

FPI, it is expected, could help achieve a higher degree of liquidity at stock markets, increase price-earning (PE) ratios and consequently reduce cost of capital for investment. FPI is also expected to lead to improvement in the functioning of the stock market as foreign portfolio investors are believed to invest on the basis of well-researched strategies and a realistic stock valuation. The portfolio investors are known to have highly competent analysts and access to a host of information, data and experience of operating in widely differing economic and political environments. Host countries seeking foreign portfolio investments are obliged to improve their trading and delivery systems which would also benefit the local investors. To retain confidence of portfolio investors host countries are expected to follow consistent and business-friendly liberal policies. Having access to large funds, foreign portfolio investors can influence developing country capital markets in a significant manner especially in the absence of large domestic investors.

Portfolio investments have some macroeconomic implications. While contributing to build-up of foreign exchange reserves, portfolio investments would influence the exchange rate and could lead to artificial appreciation of local currency. This could hurt competitiveness. Portfolio investments are amenable to sudden withdrawals and therefore these have the potential for destabilising an economy. The volatility of FPI is considerably influenced by global opportunities and flows from one country to another. Though it is sometime argued that FDI and FPI are both equally volatile [Claessens et al, 1993], the Mexican and East Asian crises brought into focus the higher risk involved in portfolio investments.

The present paper has two objectives. One, to assess the importance of different types of foreign portfolio investments in capital flows to India. And two, to understand the investment behaviour of foreign portfolio investors through an analysis of the portfolios of five US-based India specific funds. Such an exercise, it is hoped, would explain the relationship between foreign institutional investments and trading pattern in the Indian stock market better than aggregate level analysis.

FPI and India

While foreign portfolio investments are not new to the Indian corporate sector, the importance of portfolio investments received special impetus towards the end of 1992 when the Foreign Institutional Investors (FIIs) such as Pension Funds, Mutual Funds, Investment Trusts, Asset Management Companies, Nominee Companies and incorporated/institutional Portfolio Managers were permitted to invest directly in the Indian stock markets. The entry of FIIs seems to be a follow up of the recommendation of the Narasimham Committee Report on Financial System. While recommending their entry, the Committee, however, did not elaborate on the objectives of the suggested policy. The Committee only stated:

> The Committee would also suggest that the capital market should be gradually opened up to foreign portfolio investments and simultaneously efforts should be initiated to improve the depth of the market by facilitating issue of new types of equities and innovative debt instruments [*Narasimham Committee Report*, p. 121].

Press reports of early 1993 indicate that the Asian Department Bank (ADB) influenced the Committee's recommendations [Patriot, 1993; Hindustan Times, 1993; Dataline Business, 1993]. The then ADB President's *Report on India's Request for a Financial Sector Program Loan*, mentioned that:

> The Bank (ADB) had also called for capital market reforms including allowing private mutual funds to operate, *allowing investment in Indian firms by foreign investors* and allowing increased access to world capital markets for Indians (emphasis added).[3]

Attracting foreign capital appears to be the main reason for opening up of the stock markets for FIIs [Lalitha, 1992]. The Government of India issued the relevant Guidelines for FII investment on September 14, 1992. Only a few days prior to this, a statement attributed to IFC suggested that India would have to wait for some years before the expected large foreign investment materialises [Financial Express, 1992]. Regarding the entry of FIIs the then Finance Minister said at a meeting organised by the Royal Institute of International Affairs (London) that the decision to open up the stock market to investments by foreign companies would be good for the country as India needed international capital. He further said that a non-debt creating instrument such as this was superior to raising loans of the classical type so that an unsustainable debt burden was not piled up. The Finance Minister also said that the liberalisation of the economy would bring in international capital of about $10 bn a year rising to $12-13 bn. over the following 2-3 years [*Economic Times*, 1992]. It may also not be a mere coincidence that India decided to open its stock markets to FII investments in the aftermath of the stock scam. The Sensex, BSE Sensitive Index, fell to 2,529 on August 6, 1992 from the unprecedented high level of 4,467 reached on April 22, 1992. As an incentive, FIIs were allowed lower rates for capital gains tax. This was justified on the basis that '(T)his will guard against volatility in fund flows' [*Economic Survey*, 1993-94, p. 54].[4] Indian industry did protest against this and called for a level playing field [Pai Panandiker].

During the period 1992-93 to 1998-99 out of the total capital inflow to India of about US$ 28.6 billion, a little more than US$ 15 billion or nearly 54 per cent of the total, was on account of foreign portfolio investments. These aggregate capital flows were a little less than the foreign currency assets at the end of 1998-99. During the period, external debt did increased from US$ 85 bn. to 98 bn. [*Economic Survey*, 1999-2000]. Much of the increase, however, took place by 1995. Thus, the strategy of relying on non-debt creating instruments seems to have yielded results. The flows, however, did not match the initial expectation that capital flows will aggregate US$ 12-13 bn. a year, *i.e.*, nearly US$ 50-60 bn. for the five year period 1993 to 1997. Within portfolio investments, FIIs had a share of nearly 50 per cent and GDRs 44 per cent (Table 2). From the point of capital flows and managing balance of payments, it does appear that an active pursuance of GDRs could be a viable alternative to FII investments. Unlike portfolio investments, GDRs are generally project specific and hence the benefits from such issues are more tangible.

Table 2. Inflow of Foreign Investments in the Post-liberalisation Period

(Amount in US$ mn.)

Year (1)	Total Inflows (Direct+ Portfolio) (2)	Of which, Portfolio Investments: Total (3)	Of which FIIs# (4)	GDRs@ (5)
1992-93	559	244	1	240
1993-94	4,153	3,567	1,665	1,520
1994-95	5,138	3,824	1,503	2,082
1995-96	4,892	2,748	2,009	683
1996-97	6,133	3,312	1,926	1,366
1997-98	5,385	1,828	979	645
1998-99	2,401	-61	-390	270
Total	28,661	15,462	7,693	6,806

\# Represent fresh inflow/outflow of funds by FIIs.
@ Figures represent GDR amounts raised abroad by the Indian companies.
Source: India, Ministry of Finance, *Economic Survey: 1999-2000*.

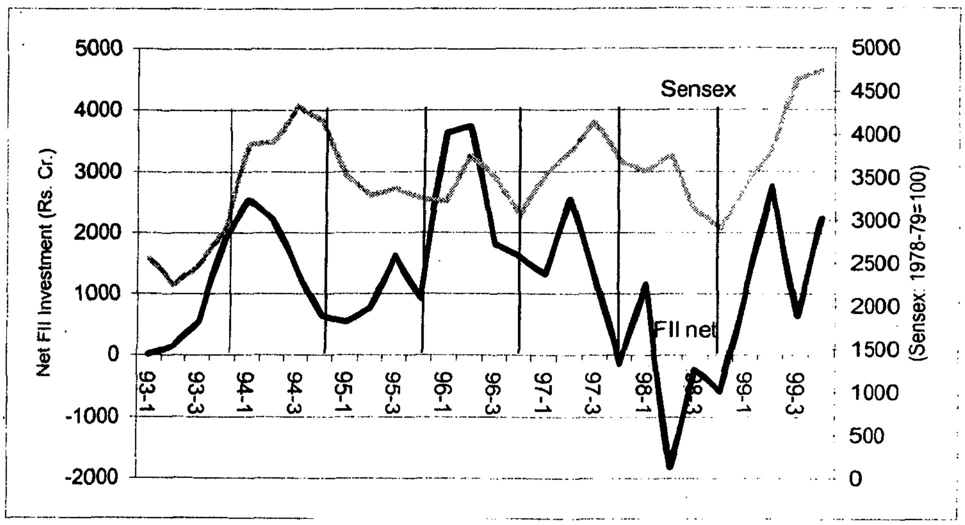
FII Investments on the Indian Stock Exchanges

In November 1995, SEBI notified the Foreign Institutional Investors Regulations which were largely based on the earlier guidelines issued in 1992. The regulations require FIIs to register with SEBI and to obtain approval from the Reserve Bank of India under the *Foreign Exchange Regulation Act, 1973* to enable them buy and sell securities, open foreign currency and rupee bank accounts and remit and repatriate funds. For all practical purposes, full convertibility of rupee is applicable to FII investments. Gradually, the scope of FII operations has been expanded by permitting (a) additional categories of investors, (b) recognising other instruments in which they can invest, and (c) altering the individual and aggregate FII shares in any one Indian company. The latest position is that an FII (investing on its own behalf) or a sub-account can hold up to 10 per cent of paid-up equity capital (PUC) of a company. The total investment by all FIIs and sub-accounts in any one company cannot exceed 24 per cent of the total PUC. In companies which pass a special resolution in this regard, the total FII investment can reach up to 30 per cent of the PUC. Imposition of investment ceilings, one expects, was aimed at: *one,* preventing cornering of shares that could result in take-over operations;[5] and *two,* to keep price fluctuations under limits. The 24 per cent limit does not include investments made by the foreign portfolio investors outside the portfolio investment route, *i.e.,* through the direct investment approval process. Investments made through purchases of GDRs and convertibles are also excluded. For calculating the FII investment limits, investments by NRIs and Overseas Corporate Bodies predominantly controlled by them, which were included earlier, are no longer included for purposes of monitoring the FII investment ceilings.[6] In the Budget Speech 2000-2001 it was proposed to raise the upper limit to 40 per cent.

In spite of the fact that FPI has been given an important place in India's financial sector under the liberalisation package, very few studies of the FII operations in India exist. One reason for this has been the paucity of data. Empirical studies have remained confined to aggregate level studies [Joshi, 1995; Pal, 1998, Pp. 589-98; Samal, 1997, Pp. 2,729-32]. The studies generally point to the positive relationship between FII investments and movement of the Bombay Stock Exchange share price index. We looked at the relationship in a somewhat different way. It has been noticed that net FII investments were lower in the fourth quarter in all the years except 1993, their first year of operations, and 1999. The average of BSE Sensex also fell in the last quarter except in 1993 and 1999. Contrary to the expectations FII investments picked up during the last quarter itself after a dip in the third quarter of 1999. Average level of Sensex also did not decline during the last quarter. It does, however, appear that FIIs buy in the first and second quarters following the depression created by their low activity or relative selling pressure in the last quarter. The decline, which starts in the third quarter, reaches the maximum in the last quarter[7] (Graph). One of the possible explanations for the BSE Sensex also declining during the last quarter could be that the local market players look towards FIIs for leads. In such a situation, even with relatively small turnovers, FIIs can swing the market by their actions. The extent of FII influence on market players can probably be gauged from the fact that SEBI asked the stock exchanges not to release FII trading details [*Hindu Business Line,* 1999][8] as SEBI decided to release the data with a one day lag and after due confirmation with the FIIs' custodians.

To give better empirical content to the general understanding that FIIs influence the Indian equity markets we tried to get detailed data on FII transactions. Our efforts at getting FII-wise information from the RBI and SEBI, however, did not meet with any success.[9] In view of this, we had to rely on other sources. At the beginning of March 2000, the number of FIIs registered with SEBI stood at 502. The sheer number of FIIs does not give a full picture of the FII operations in India since each of the FIIs can represent unlimited number of sub-accounts. On the number of sub-accounts, however, no information is available. With the importance attached to sub-account-wise investment limits one would have expected SEBI to provide information on these. Also, a good number of FIIs are under common control (as indicated by their names, addresses and telephone numbers) and render individual FII limits less relevant.

Graph
Quarterly Movements in Net FII Investments and Average Sensex Levels: 1993: 1999



Note: Quarterly averages of Sensex closing values.
Source: Net FII investments are taken from CMIE, *Capital Markets*, October 1998 and SEBI.

After 1993-94, SEBI stopped giving a category-wise break up of the registered FIIs in India. From an examination of the registration numbers, available from the SEBI web site, it appears that most FIIs fall under two categories: 'FA' and 'FD' (Table 3). FA appears to stand for fund advisers and asset management companies implying that most FIIs (56.57 per cent) work as representatives of others. From a similar deduction it appears that FD stands for investment funds.[10] These two categories account for 93 per cent of the FIIs. There are 9 FIIs under the category 'FC' which are most likely pension funds. The other important category is 'FE' which includes an assortment of insurance companies, investment trusts and government bodies.

Out of the 502 FIIs, as many as 200 were from USA and another 121 have UK addresses. A few FIIs are reported to be from Hong Kong, Singapore, Luxembourg, etc., but some of them, it is our assessment, had their origin in USA and UK. For instance, those registered from Singapore include: Citicorp Investment Bank (Singapore) Ltd., Templeton Asset Management Ltd., and J.P. Morgan Securities Asia Pvt. Ltd. The registrants from Hong Kong include Jardine Fleming Intl. Mgt. Inc., Merril Lynch Far East Ltd., and ABN Amro Asia Ltd. One of the registrants from Bahrain is Citicorp Banking Corp. Very few FIIs had their addresses in tax havens like Bahamas and Cayman Islands. Only one FII has given a Mauritius address. It thus appears that the phenomenon of FIIs is essentially a domain of funds from USA and UK.

The larger FIIs have multiple associates in India including locally incorporated companies which operate either as brokers, managers or mutual fund operators.[11] Some of the FIIs floated joint ventures with Indian companies: either belonging to the broking community or India's business groups. Coupled with the fact that the FIIs can invest through the GDR route, it appears that the operations of FIIs cannot be understood if investments by FIIs registered with SEBI are examined in isolation. The network of entities belonging to the Jardine Fleming Group may provide a concrete example in this regard (Box 1). We shall discuss the involvement of FIIs in the Indian mutual funds industry a little latter to further provide evidence in this regard.

Table 3. Country-wise Distribution of FIIs Registered with SEBI

Country	Asset Management Cos./Fund Advisers$ [FA]	Investment Funds/ Trustees on Behalf of Such Funds [FD]	Insurance Cos. Investment Trusts, Government Bodies, etc. [FE]	Pension Funds [FC]	Others	Total
(1)	(2)	(3)	(4)	(5)	(6)	(7)
USA	102	86	5	7	-	200
UK	68	42	10	1	-	121
Hong Kong	31	2	1	-	-	34
Singapore	19	1	2	-	1	23
Luxembourg	8	22	-	-	-	30
Australia	5	10	1	-	-	16
Switzerland	12	2	1	-	-	15
Canada	8	4	-	1	-	13
Netherlands#	7	6	-	-	-	13
Italy	6	1	-	-	-	7
Japan	4	1	-	-	-	5
Others (Incl. unclassified)	14	6	5	-	-	25
Total	284	183	25	9	1	502

$ This classification is based on relating registration numbers with the names of FIIs.
# Including one from Netherlands Antilles.
Source: Based on the registration details given at SEBI's website.

From the available information it appears that FIIs do not play a major role in the primary market. According to SEBI, in 1995-96, out of the 1,426 public issues involving an issue amount of Rs 14,240 crore, in 79 issues Rs 212 crore were reserved for FIIs. In the following year Rs 549 crore were reserved in 23 issues out of a total amount of Rs 11,557 crore issued by 751 companies. In 1997-98 the amount reserved was Rs 12 crore in 3 issues [SEBI, 1996-97 and 1997-98; 1998-99, Pp. 50-51].[12] The following exercise will, therefore, be concentrating on the FII operations in the secondary market. In the secondary market also, going by the values, FIIs are more active on the equity market than in the debt segment [BSE, 2000, Pp. 13-18].[13] At the Bombay Stock Exchange, which accounts for about half of the FII sales and purchases, against the total market turnover of Rs 5,27,960 crore in 1999, FII purchases were Rs 17,165 crore and sales, Rs 13,174 crore.[14] The total turnover for 1998 stood at Rs 2,65,995 crore; FII purchases at Rs 6,684 crore and their sales, Rs 6,940 crore. Thus, in comparison to total trading values on the BSE, FII sales and purchases appear to be quite small.

For understanding the investment pattern of FIIs we tried to examine the N-30D filings of investment funds with the US capital market regulatory body, namely, the Securities and Exchange Commission (SEC). Form N-30D is required to be filed by registered investment companies and contains semi-annual and annual reports mailed to the shareholders.[15] The SEC data are available for different years. One can, therefore, make useful comparisons over a period. The filings also offer details on the investment strategies of FIIs. A study of American funds could be quite representative of the FIIs investment behaviour in India because most FIIs registered in India are from the USA.

BOX - 1
JARDINE FLEMING# & INDIA

Jardine Fleming India Fund Inc.,	Maryland, USA
Investment Adviser:	Jardine Fleming International Management Inc. (JFIM), British Virginia Islands. Regd. with SEBI as an FII from HK.
Broker:	Jardine Fleming India Broking Pvt. Ltd., India *(Affiliate of JFIM)*
Revolving Credit Agreement WITH:	Jardine Fleming Bank Ltd. *(Affiliate of JFIM)*
Administrator:	Mitchell Hutchins Asset Management Inc. Wholly-owned subsidiary of Paine Webber
Mauritius Administrator:	Multiconsult Ltd., Mauritius
Custodian:	Citibank, US & India
JF India Trust	
Trustee & Registrar:	HSBC Trustee (Mauritius) Ltd., Mauritius
Investment Manager:	JF Unit Trust Management Ltd., British Virgin Islands
Manager:	JF India Fund Management Ltd., British Virgin Islands
Investment Adviser:	Jardine Fleming Investment Management Ltd.
Registrar's Agent: & HK Representative:	Jardine Fleming Unit Trusts Ltd.

Jardine Fleming India Asset Management Pvt. Ltd., India Asset Management Co. of Jardine Fleming Mutual Fund

Fledgeling Nominees Intl. Ltd., Cayman Islands. Regd. as FII with SEBI. C/o Jardine Fleming India Securities Pvt. Ltd., India, Mumbai.

Robert Fleming Nominees Ltd., London, Regd. as FII with SEBI. C/o Jardine Fleming India Securities Pvt. Ltd., India, Mumbai.

Jardine Fleming India Securities Pvt. Ltd.
Approved by the FIPB in June 1994 for undertaking merchant banking, corporate finance, stock broking and asset management. The approval was for Jardine Fleming, Mauritius.

Jardine Matheson's Joint Venture with Tata Industries with Bermuda as the home country Approved by FIPB in April 1996 for undertaking retailing, distribution, financial services, property, hotels, engineering and construction.

Fleming Fund Management (Luxembourg) S.A., Luxembourg, Regd. as FII with SEBI

Jardine Fleming was established in 1970 in Hong Kong and is jointly owned by Jardine Matheson Holdings Limited and Robert Fleming Holdings Limited. Early last year Flemings fully acquired Jardine Fleming.
Note: Prepared in early 1999 by way of illustration and is by no means exhaustive.

By a process of string search in the text, we could identify 53 funds which invested in India in 1998.[16] Only five of them were specific to India.[17] The others invested in GDRs of Indian companies, India specific funds of USA or UK or directly in a few Indian companies. Apart from the five India specific funds, only six other funds invested in more than ten Indian companies in 1998. This may indicate that the focus of FIIs on India is quite narrow.

Investment Pattern of Five India Specific Funds

The five India specific funds whose investment details for 1996 and 1998 we will be presenting in the following are: (i) India Growth Fund Inc.; (ii) India Fund Inc.; (iii) Jardine Fleming India Fund Inc.; (iv) Morgan Stanley India Investment Fund Inc.; and (v) Pioneer India Fund.[18] All the five have different investment advisers and the total value of investment in 535 Indian companies in mid-1996 was US$ 915 mn.[19] The number of companies compares well with the official estimates for 1996-97 that FIIs have been active in over 600 scrips out of more than 6,000 listed ones. It has also been indicated that out of the 427 registered at that time, on an average 130 were active in any given month and about two-thirds of the purchases and sales were accounted for by only 25 FIIs [*Economic Survey*, 1996-97, p. 61]. But by 1998, presumably as a fall out of the East Asian crisis, the sanctions following India exploding nuclear devices in May 1998 and the general slow down of the Indian economy, the number of companies in which the funds invested declined and stood at 375 (Table 4).[20] The market value of the assets held by the funds declined to US$ 762 mn. Decline in the number of companies is common to four of the five funds.

The accompanying study of trading at BSE[21] showed that out of the nearly 6,000 companies listed at the exchange, the largest 500 companies in terms of market turnover account for over 99 per cent of the turnover. FII investments have generally confined to this set of high turnover companies as the share of such companies in the market value of investments increased from 86 to 98 per cent between 1996 and 1998 (Table 5). This suggests that FII operations are progressively confining to liquid shares.[22] By 1998, it is also observed that A Group (Specified) companies, in which carry forward deals are

Table 4. Basic Details of Five India Specific Funds

Name of the Fund	Investment Adviser	No. of Companies Invested in		Value of Investment (Mn. US$)	
		1996	1998	1996	1998
(1)	(2)	(3)	(4)	(5)	(6)
1. Morgan Stanley India Investment Fund Inc.#	Morgan Stanley Asset Management Inc.	255	165	387.59	291.34
2. India Growth Fund Inc.	UTI Investment Advisory Services Ltd., India	224	174	134.31	276.02
3. India Fund Inc.#	(i) Advantage Advisers, a subsidiary of CIBC Oppenheimer Corp. (ii) Infrastructure & Financial Services Ltd., India	188	27	282.08	95.21
4. Jardine Fleming India Fund Inc.#	Jardine Fleming Intel. Management Inc., British Virginia Island	77	77	79.97	84.24
5. Pioneer India Fund	(i) Pioneer Management Corp. (ii) Kothari Pioneer AMC Ltd., India	93	52	31.02	14.78
All the Five Funds		535	375	914.97	761.59

Claimed tax residency status in Mauritius.
Note: The number of companies do not add up to the total as more than one fund invested in some of the companies.
Source: Based on the Funds' N30-D filings with the U.S. Securities and Exchange Commission (SEC). For the first three funds the data refers to June-end of the respective years. For Jardine Fleming it is May-end and for Pioneer it is April-end.

Table 5. Shares of Different Categories of Companies in the Market Value of Investments

Company Category	Market Value (US$ mn.)		Percentage in Total	
	1996	1998	1996	1998
(1)	(2)	(3)	(4)	(5)
Top Market Turnover Companies$	791.64	746.84	86.52	98.06
A Group#	623.70 (521.76)	619.58	68.17 (57.03)	81.35
Sensex Companies	326.27	256.33	35.66	33.66
Foreign-Controlled Cos.(FCCs)	190.29	214.04	20.80	28.10
Public Sector Companies	151.98	157.29	16.61	20.65
Large Indian Houses	339.85	108.63	37.14	14.28
All Companies	914.97	761.59	100.00	100.00

Percentages do not add up to 100 because of over-lapping of the groups.
$ Ranked according to the total market turnover at BSE in the corresponding year.
# The A-group was expanded in February 1998 to include 50 companies. Figures in brackets indicate the aggregate and percentage with regard to the composition of the Group prior to its expansion.

permitted, increased their share from 68 per cent to 81 per cent.[23] The share of Sensex (pre-November 1998) companies remained at about one-third of the total value. However, it is significant that the five funds invested in practically all the Sensex companies, implying that their operations could potentially influence the index. Names and other particulars of the top 25 companies in terms of value for each of the five funds are given in the Annexure. While the share of foreign-controlled companies (FCCs) in the value of investment increased from about 21 to 28 per cent. The share of public sector companies increased from about 17 to 21 per cent. Along with the decline in the number of companies in which the funds invested, the share of top companies in terms of market value of investment increased substantially. The share of top ten companies increased from about 26 per cent to 45 and that of top 100 from 77 per cent to 94 per cent. In all, the value of the investment of the five funds is concentrated in about 150 companies (Table 6).

Table 6. Share of Top Companies in the Market Value of Investments by Five India Specific Funds

Top Companies#	Percentage in Total Value of Investment	
	1996	1998
(1)	(2)	(3)
10	25.90	44.77
50	61.01	82.82
100	77.33	93.87
150	86.54	98.06
All Companies	100.00 (535)	100.00 (375)
Total Amount (Mn. US$)	914.97	761.59

Based on value of investment and includes investment in GDRs.
Figures in brackets are the number of companies invested in the respective years.

A sector-wise classification of the companies, in which the funds have invested shows that there was a major shift in the investment exposure within two years.[24] Computer software (development and training) group of companies which was not among the top 10 in 1996, reached the top-most position in 1998. Pharmaceuticals sector improved its position from the fifth to the third position. Food & Beverages and Personal Care products made their entry into the top 10. Major industries that moved down below the 10th position were: metals and metal products, textiles, cement and electrical machinery (Table 7).

It may be noted that at the Bombay Stock Exchange also computer software, food and beverages, pharmaceuticals and personal care products improved their position in 1998 compared to 1996. Similarly, trading values showed increased concentration and the number of companies traded declined during the same period. While share of FCCs in the turnover increased, that of Indian large companies declined. The resemblance between the distribution of trading values at BSE and exposure of FII investments seem to suggest a strong positive relationship between the two and possible influence of FII investment pattern on trading at BSE. This goes to strengthen the general conclusion drawn on the basis of comparison of quarterly net FII investments and movement of the Bombay Stock Exchange Sensitive.

Table 7. Investment Exposure of Five India Specific US Funds: Changing Sectoral Importance between 1996 and 1998

Ranking		Industry	Market Value of Investments (US$ mn.)		Percentage to Total	
1996	1998	(1)	1996 (2)	1998 (3)	1996 (4)	1998 (5)
1	2	Automobiles	93.77	85.21	10.25	11.19
2	14	Metals and Metal Products	65.72	19.54	7.18	2.57
3	4	Non-Electrical Machinery	60.85	55.85	6.65	7.33
4	6	Diversified	59.43	44.28	6.50	5.81
5	3	Pharmaceuticals	53.07	67.16	5.80	8.82
6	13	Auto-Ancillaries	50.84	20.82	5.56	2.73
7	19	Textiles	42.38	6.03	4.63	0.79
8	17	Electrical Machinery	41.56	11.73	4.54	1.54
9	18	Cement	39.02	10.99	4.26	1.44
10	16	Entertainment/Multimedia	33.33	16.22	3.64	2.13
14	1	Computer Software (Devt&Trg)	25.68	133.94	2.81	17.59
19	5	Food, Beverages & Tobacco Pr.	19.06	47.14	2.08	6.19
16	7	Personal Care Products	20.61	44.02	2.25	5.78
11	8	Telecommunications	37.92	27.94	4.14	3.67
15	9	Refineries	22.83	25.53	2.50	3.35
12	10	Public Sector Banks	30.64	24.73	3.35	3.25
		Total (including others)	914.96	761.58	100.00	100.00

Source: Complied on the basis of the Funds' N-30D filings with the US SEC.

A factor which emerged from the funds' filings is that three[25] out of the five funds claimed tax residency status in Mauritius with which India has entered into double taxation treaty. That this was a mere strategy of tax planning is evident from the fact that one of the funds (India Fund Inc.) reported that

> (T)he Fund has established a branch in the Republic of Mauritius. ... Multiconsult Ltd. (the 'Mauritius Administrator') provides certain administrative services relating to the operation and maintenance of the Fund in Mauritius. The Mauritius Administrator receives a monthly fee of $1,500 and is reimbursed for certain additional expenses.[26]

The other two funds also paid similar amounts to Multiconsult.[27] The Mauritius company should only be lending its address, as, for such small amounts, one cannot think of any other professional service. In this background, from the taxation of profits and capital gains, point of view, the country status described earlier has little relevance.[28] Incidentally, the address of Multiconsult Ltd., is used, apart from India Fund Inc. and Morgan Stanley India Investment Fund Inc., the two other funds claiming Mauritius residency status, also by such other foreign investors that invested in India and as varied as US West Cellular Investment Co., Chatterjee Petrochem (an NRI company which received approval to invest in Haldia Petrochem) and Marconi Telecommunications.

FIIs and Emergence of Computer Software, Consumer Non-Durables and Pharmaceutical Sectors

There appears to be a good deal of co-ordination and similarity in business approach among the five Funds in spite of each having different investment advisers. All of them started looking at the computer software, pharmaceutical as also fast moving consumer goods sectors while reducing their exposure to commodities and chemicals (Box 2).

The FII preferred sectors seem to have caught the attention of others too. The emergence of software, pharmaceuticals and personal care products in BSE market turnover could be a reaction of the local investors, especially the mutual funds promoted in association with FIIs, to the FIIs' investment strategy. For instance, Prudential ICICI Growth Plan managed by Prudential-ICICI Asset Management Co. (AMC), a joint venture of Prudential Corp. Plc., of UK and ICICI, by the end of 1998, had a quarter of its net asset value (excluding cash) in consumer goods companies, 17.01 per cent in pharmaceutical companies and 15.91 per cent in software companies. The combined share of the three sectors worked out to as high as 58.56 per cent. The electronic newsletter of the company dated March 17, 1999 informed that the share in the three sectors increased further to 72 per cent. Similarly, in the case of Birla Advantage Fund, managed by Birla Capital International Ltd.,[29] as on November 30, 1998, the share of the three sectors stood at nearly half of the overall value of investments.[30] It may be noted that after the mid-November revision, the three sectors have an overall weightage of 43.52 in the Sensex. Taking advantage of the popularity of software scrips, a few companies are reported to have even changed their names indicating their involvement in information technology, probably, to mislead the investors [*Hindu Business Line*, 1999; SEBI, 1999].[31]

BOX - 2

Investment Choices of US-Based India Specific Funds

India Growth Fund Inc: June 30, 1998

In January 1997, it was decided to *decrease* the Fund's investment exposure in industries such as *cement, iron and steel, commercial vehicles, chemicals, and heavy engineering.* ... exposure was *increased in information technology, pharmaceuticals/ healthcare and food and agro products.* ... The decision to restructure the portfolio by *reducing exposure to a small number of companies* and reducing exposure in declining and cyclical sectors has started to show results. The decision to *divest of stocks in small and midcap companies*, eliminate smaller holding where potential for appreciation was limited, ... has helped ... (emphasis added)

Pioneer India Fund: April 30, 1998

We *added pharmaceutical stocks*, with the belief that these companies should be able to advance regardless of the region's economic condition. ... In our strongest move of the period, we *significantly increased investments in the Indian software and computer industry.* (emphasis added).

India Fund Inc: June 30, 1998

The Fund continued its strategy of *overweighting the software sector* which is considered to be a longterm secular growth industry for India. This sector remains an inherent hedge in the case of a weakening currency due to high export earnings ... the Fund *steadily increased its exposure to ... consumer companies in areas of healthcare, food, detergents and other household goods* as people shift to using high quality branded products. The Fund *increased its holdings of both Hindustan Lever and ITC* ... The Fund *further reduced its holdings in commodities such as petrochemicals and textiles* where growth prospects continued to deteriorate due to delayed economic recovery in India ... (emphasis added).

Morgan Stanley India Investment Fund Inc: June 30, 1998

Given the political outlook and the poor visibility on the economy we remain defensive on the market and our Fund is being structured on these lines. We *remain positive on software, media, pharmaceuticals and the FMCG sectors* and we are *holding on to our large weightings in these sectors.* (emphasis added).

Jardine Fleming India Fund Inc: May 31, 1998

The Fund's portfolio is comprised of high quality counters with the manager's investment focus both on return equities and on those sectors where India has proven skills. Consequently, *the consumer, technology and pharmaceutical sectors are noticeably featured* together with utility stocks in an environment of some caution. (emphasis added).

Prudential-ICICI introduced a new fund specialising in what are now being popularly referred to as FMCG (fast moving consumer goods) scrips [*Hindu Business Line*, 1999].[32] According to Prudential-ICICI, FMCGs include:

> ... tea, coffee, bread, butter, cheese, biscuits, soaps, detergents and various other products that you use every day.

Regarding the favoured companies the AMC stated that:

> ... (T)he list speaks for itself: Hindustan Lever, Cadbury, Britannia, Procter & Gamble, Nestle, Reckitt & Colman, Henkel Spic, Indian Shaving Products, Marico & Smith Kline Beecham.
>
> ... All these are companies which feature great brands, a strong distribution network across the country, professional management and financial soundness, apart from consistent performance year after years. As a testimony to this fact, the stocks of these companies have performed better than the market in the last three years, giving an annualised return of 34.3 per cent as compared to an annualised return of only 4 per cent in the BSE 200 and the Sensex.[33]

The emphasis on FMCG thus actually implied emphasis on transnational corporations (TNCs) because of their well-known brand names, large advertisement expenditures and distribution networks. The importance of TNCs in market turnover of BSE may be a reflection of this phenomenon. This, seen in the context of new FCCs avoiding the stock market may mean that the existing listed ones will continue to be the favourites of investors as they have limited options. Paradoxically, these are the companies that may not need to raise resources from the Indian investors.

FIIs and the Indian Mutual Funds Industry

It was seen in the above that two of the FII associated local mutual funds also followed the pattern set by FIIs. In this context, it may be useful to examine the relative importance of FII affiliates in the Indian Mutual Funds industry. Following SEBI guidelines of 1993, which defined the structure of mutual funds (MFs) and asset management companies, mutual funds were launched in the private sector for the first time. A few years earlier in 1987, public banks and insurance companies, were allowed to enter the mutual funds sector which was till then the preserve of Unit Trust of India. While initially they raised considerable amounts, the mobilisation suffered with the general industry performance. Of late, private sector mutual funds have started becoming important once again [RBI, 1999]. An important contributory factor is the tax break allowed in the Budget 1999-2000 when the income distributed under the US-64 and other open-ended equity-oriented schemes of UTI and other Mutual Funds was exempted from dividend tax and income received by individuals from MFs was fully exempted from income tax. As a result, during April-December 1999, MFs raised Rs 35,915 crores in gross terms compared to Rs 16,288 crore in the corresponding period of 1998. The performance in net in net terms is more impressive: Rs 12,194 crore against a net outflow of Rs 950 crore in the previous period. During April-December 1999, share of private sector was 68.4 per cent in gross mobilisations and 74.33 per cent in net terms [*Economic Survey*, 1999-2000, p. 67]. Private sector MFs accounted for nearly ten per cent of the net assets of all mutual funds at the end of March 1999 [SEBI, 1998-99, p. 68]. By the end of the year the share doubled to nearly 21 per cent [SEBI, 1999, p. 26]. From independent compilations on mutual funds, it does appear that within the private sector MFs, funds with foreign associates have come to occupy an important position (Table 8).[34]

While it can be expected that foreign affiliated mutual funds would follow the investment pattern of FIIs, it is important to note that many domestic ones also followed FIIs. The sectors favoured by FIIs account for a substantial portion of the net assets under control of many MFs. Even the UTI started focussing on certain of these sectors. UTI Chairman is reported to have said in February 2000 that US-64's (flag ship fund of UTI) exposure to the information technology sector rose to 19.13 per cent at the end of December 1999 from 5.68 per cent a year earlier.[35] UTI's involvement with IT and pharmaceutical sectors is further revealed in its floatation of sector specific funds. UTI has floated five funds called UTI Growth Sector Funds. These are: Brand Value fund (FMCG), Pharma and Healthcare fund, Software Fund, Petro Fund, and Services Sector Fund. While understandably the Software fund is exclusively for computer software companies, the services Sector Fund also concentrates on computer related companies [*Economic Times*, 1999].[36] Among the others who promoted sector specific funds are: Birla Mutual, IL & FS, Kothari Pioneer, Prudential ICICI, SBI Mutual and Tata Mutual. Interestingly, it is reported that though it is not a sector specific fund, JM Equity Fund's reliance on the software sector increased from 34 per cent in September 1999 per cent at the end of December 1999 [Gulati, 2000].[37]

Table 8. Assets Under the Management of Different Categories of Mutual funds

(Rs Crore)

Category	At the end of		Increase	
	1998	1999	amount	Per cent
(1)	(2)	(3)	(4)	(5)
A Unit Trust of India	54,339	67,207	12,868	23.68
B Bank Sponsored MFs (6)	4,504	7,290	2,786	61.86
C. Institutions (4)	1,993	2,999	1,006	50.48
D. Private Sector incl. (22)	4,924	19,532	14,608	296.67
- Indian Companies (6)	776	2,225	1,449	186.73
- JVs: Predominantly Indian (7)	2,163	7,977	5,814	268.79
- JVs: Predominantly Foreign (9)	1,985	9,330	7,345	370.03
Total (A+B+C+D)	65,760	97,028	31,268	47.55

Source: Based on the data provided by the Association of Mutual Funds in India (AMFI) at it website www.amfiindia.com.
Figures in brackets indicate the number of funds.
Assets under the management of UTI are at book value.
JVs: Joint Ventures.

From the above it emerges that mutual funds are gaining prominence in the Indian Stock market and that (i) the share of foreign affiliated MFs is growing, (ii) a number of Indian funds are following the investment strategies of the foreign ones, (iii) there are sector specific funds for IT, Pharmaceuticals and FMCG, (iv) schemes of many funds focus on these sectors without actually claiming themselves to be one such. This provides further explanation to the sectoral developments in the Indian stock market during 1999. Such concerted effort may have further underplayed the importance of the other sectors and widened the differences in P/E ratios between the so-called new economy sectors and the others.[38] The latest change in Sensex announced by BSE further acknowledges the increasing importance of IT, media and pharmaceutical companies. From April 10, 2000 Satyam Computer Services, Zee Telefilms, Reddy Labs and Reliance Petroleum would replace Tata Chemicals, Tata Power, IDBI and Indian Hotels Co. in the Sensex [*Economic Times*, 2000].[39]

It may be noted further that while there was net outflow on account of foreign portfolio investors during 1998-99, private sector mutual funds in India mobilised Rs 1,453 crore on net terms. During the first nine months of 1999-2000 the net collections were Rs 9,064 crores which compare well with net inflows of foreign portfolio capital of Rs 6,766 and Rs 11,735 crore during 1997-98 and 1996-97, respectively [Economic Survey, 2000, p. S-77]. It can thus be expected that progressively stock prices would be affected not only by net FII investments but also the size of funds under control of their local counterparts. While FIIs can remit capital and profits back to their home countries, the local affiliates will have to invest in the domestic market only [SEBI, 1999].[40] Yet another development during 1999 which affected share price movement in India is the listing of Infosys Technologies and Satyam Infoway, a subsidiary of Satyam Computers, on Nasdaq of USA. It is now believed in stock market circles that prices of information technology companies in India are influenced by the Nasdaq

[*Economic Times*, 2000].[41] This phenomenon is going to be increasingly prominent as more and more Indian companies get traded abroad.

Summing Up

There has been a significant shift in the character of global capital flows to the developing countries in recent years in that the predominance of private account capital transfer and especially portfolio investments (FPI) increased considerably. In order to attract portfolio investments which prefer liquidity, it has been advocated to develop stock markets. The general perception about the foreign portfolio investments is that, not only do they expand the demand base of the stock market, but they can also stabilise the market through investor diversification [UN, 1996, p. 151]. Towards the end of 1992, the Government of India allowed FIIs to buy and sell securities directly on the country's stock markets, primarily to attract foreign capital. Concessional rates of tax on capital gains and to some extent the limits on the extent of foreign equity were expected to reduce the volatility and possibly to protect managements from hostile take-overs.

From the point of attracting foreign capital, the initial expectations have not been realised. Investment by FIIs directly in the Indian stock market did not bring significantly large amount compared to the GDR issues. GDR issues, unlike FII investments, have the additional advantage of being project specific and thus can contribute directly to productive investments. FII investments, seem to have influenced the Indian stock market to a considerable extent.

Though 502 FIIs are reported to be registered with SEBI at the beginning of March, 2000, due to inter-linkages among many FIIs, the effective number of entities would be much smaller. These factors render the limits on shareholding in a company by a particular FII serve only a limited purpose. While the country-wise distribution of FIIs suggests the predominant place of USA and UK in FII registrations in India, these inter-linkages make the two countries' dominance more prominent. It has also been noticed that only a few FIIs are active on the Indian stock market. While portfolio investments are known to be volatile, the fact that only a few FIIs and that too mainly from two countries namely USA and UK are interested in the Indian stock market increases its vulnerability to fluctuations.

Analysis of the investment exposure of five US-based India specific funds suggested a close resemblance between FII investment profile and trading pattern at the BSE. This finding takes quite further the general understanding that net FII investments influences stock prices in India as it traces the relationship to the sectoral level. The heavy emphasis on computer software, consumer goods in the Indian stock markets seems to have much to do with the process initiated by the FIIs after 1996 as a defensive mechanism.[42] Compared to 1996, in 1998, they reduced their exposure in terms of the number of companies and the amount involved. One implication that can be drawn from the similarity between FII investments and trading on the Indian stock market is that the Indian Investors, since they perceive FIIs to trade on the basis of well-researched strategies, may have followed the FIIs like a 'herd' and in the process accentuated the selective process introduced by the FIIs. FIIs having a strong presence in the Indian Mutual Funds segment meant that the funds have also started following a similar investment pattern. Many Mutual Funds floated specific funds for the sectors favoured by the FIIs. As a result, the differences have got so accentuated that food and beverages and computer software reached the top in 1998 and accounted for nearly two-fifths of the turnover at BSE during the same year. In line with the changing emphasis of FIIs, by 1999 consumer non-durables receded and computer software took the lead.

An implication of MFs gaining strength in the Indian stock market could be that unlike individual investors, whose monies they manage, MFs can create market trends whereas the small individual investors can only follow the trends. The situation becomes quite difficult if the funds gain a vested interest in certain sectors by floating sector specific funds. One can even venture to say that the behaviour of MFs in India has turned the very logic that mutual funds invest wisely on the basis of well-researched strategies and individual investors do not have the time and resources to study and monitor corporate performance, upside down. Thus, the entry of FIIs has not resulted in greater depth in Indian stock market; instead it led to focussing on only a few sectors.

Growing concentration of trading in a few sectors could reduce the stability base of the stock markets. The expectation that by adding liquidity to local markets, foreign investments would reduce the volatility which results from the thinness of the markets in developing economies may thus prove unfounded. So far as the incentive of lower tax is concerned, FIIs have apparently tried to circumvent even the low taxes by using Mauritius as a shelter. Ultimately to provide a level playing field, even the domestic investors had to be offered lower rates of capital gains tax.

From the point of monitoring company managements, it can be argued that the FIIs and large domestic financial institutions together can play a useful role to force company managements improve their performance and refrain from indulging in mal-practices and investor-unfriendly decisions as together they hold substantial shares in many large Indian companies. This argument has the inherent weakness that the FIIs cannot remain attached to a single company. They are expected to exert pressure on managements by their selling or buying activity. On the other hand, government through holdings controlled by it, in the long term interest of Indian industry can, if there is political will, take a firm stand. There are also other problems with utilising foreign portfolio equity for monitoring domestic companies. One is not sure how much of the such equity is in fact return of the flight capital. In such a case, the so-called FII investment will only support the existing managements. Even if it is accepted that FII investment could be helpful in monitoring, due to their propensity to invest in a few liquid shares, the problem of monitoring a large number of companies still remains.

The need for a proper regulatory system is reflected from the fact that due to severe regulatory failure even the presence of FIIs did not help the revival of India's primary market for a long time. A strong domestic base is a prerequisite for providing depth and spread to the stock market and to enable it to counter any precipitative action by the FIIs not based on fundamentals. The only safeguard can be Indian financial institutions (FIs) holding large shares and in their capacity for direct intervention. The size of the holdings and internal resources with Indian FIs will be an important factor in containing the volatility induced by FIIs. Attracting FIIs cannot be a substitute for domestic policy formulation and institutional development.

While it is said that to attract portfolio investments and retain their confidence, the host countries have to follow stable macro-economic policies, the fact is that developing countries have their own compulsions arising out of the very state of their social, political and economic development. How FIIs view the domestic situation can be seen from the following extract from a semi-annual report of Jardine Fleming India Fund Inc.

> *Politics, as usual, remains the joker for investors* in the Indian market. The decision of Kesri, President of the Congress Party, to withdraw his Party's support from the United Front Government, came as a complete surprise to almost all and caused the market to fall approximately 10 per cent in a short period. This simultaneously jeopardised not only the passage of the Budget *but also Chidambaram's tenure at the Finance Ministry. Kesri's actions are regrettable since they destroy shareholder value,* tarnish India's global reputation, and exacerbate the hardship of the 350 million Indians who continue to live in poverty [Jardine Fleming India Fund Inc., 1997, p. 4] (emphasis added).

Obviously, political personalities or fundamentalist and extremist organisations would have a logic of their own in whatever they do. Fall-out of their actions on foreign investment and Indian stock markets will be the last thing on their minds when they act. This is the reality of developing countries. Whether or not they indulge in local politics, they seem to impress upon (even pressurise) the host governments to follow liberal policies in order to attract large inflows.[43]

To trends suggest that the Indian stock market may weaken its relationship with the rest of the economy. As it focuses excessively on certain sectors [Economic Times, 2000].[44] Can the developing countries rely on the wisdom of the stock market, particularly if it reacts to external factors, for industrialising their economies is a question that needs to be examined in greater detail. To the extent that this phenomenon has been introduced and accentuated by FII operations gives rise to a doubt whether foreign portfolio investments would serve the objective of local stock market development or the tangible benefit from them would only confine to getting the balance of payment support along with its attendant risks.

Annexure Fund-wise List of Top 25 Companies in terms of Value of Investment

Sr. No.	Company (1)	Industry/Activity (2)	FCC (3)	Sensex (4)	GDR Issue (5)	Top Turnover Company$ (6)	A Group (7)	Percentage Share in Total Value# (8)
INDIA FUND INC.								
1	NIIT Ltd.	Computer Software		Y		Y	A1	12.52
2.	Infosys Technologies Ltd.	Computer Software		Y		Y	A1	7.38
3.	Punjab Tractors Ltd.	Automobile				Y	A1	6.89
4.	Hindustan Lever Ltd.	Personal Care	Y	Y		Y	A	6.64
5	Reliance Industries Ltd.	Diversified		Y	Y	Y	A	5.43
6.	ITC Ltd.	Food & Beverages	Y	Y	Y	Y	A	4.43
7.	Hindustan Petroleum Corp Ltd.	Refineries		Y		Y	A	4.01
8.	Dr Reddy's Laboratories Ltd.	Pharmaceuticals			Y	Y	A	3.90
9.	Satyam Computer Ltd.	Computer Software				Y	A1	3.70
10.	Ranbaxy Laboratories Ltd.	Pharmaceuticals		Y	Y	Y	A	3.45
11	Mahanagar Telephone Nigam	Telecommunications		Y	Y	Y	A	3.32
12.	Larsen & Toubro Ltd.	Diversified		Y	Y	Y	A	2.97
13.	Hindalco Industries Ltd.	Metals		Y	Y	Y	A	2.29
14.	Videsh Sanchar Nigam Ltd.	Telecommunications			Y	Y		1.74
15.	ABB Ltd.	Machinery - Elect.	Y			Y	A	1.59
16.	DSQ Software Ltd.	Computer Software				Y		1.44
17.	Tata Iron & Steel Co Ltd.	Metals		Y		Y	A	1.37
18.	Oriental Bank of Commerce	Banks - Public Sector				Y	A	1.34
19.	TVS Suzuki Ltd.	Automobile	Y			Y	A1	1.33
20.	Bank of Baroda	Banks Public Sector				Y	A1	1.27
21.	Associated Cement Companies	Cement		Y		Y	A	1.06
22.	E Merck Ltd.	Pharmaceuticals	Y			Y	A1	1.04
23.	Bharat Heavy Electricals Ltd.	Machinery - Non.Elect		Y		Y	A	0.99
24.	Madras Refineries Ltd.	Refineries				Y	A1	0.98
25.	Indian Rayon & Industries Ltd.	Diversified			Y	Y	A	0.96
	Total							82.04

(Contd.)

Annexure (Contd.)

Sr. No.	Company (1)	Industry/Activity (2)	FCC (3)	Sensex (4)	GDR Issue (5)	Top Turnover Company$ (6)	A Group (7)	Percentage Share in Total Value# (8)
INDIA GROWTH FUND INC								
1	ITC Ltd	Food & Beverages	Y	Y	Y	Y	A	9.75
2.	Hindustan Lever Ltd.	Personal Care	Y	Y		Y	A	7.36
3.	NIIT Ltd.	Computer Software		Y		Y	A1	5.71
4.	TVS Suzuki Ltd.	Automobile	Y			Y	A1	5.52
5.	Bajaj Auto Ltd.	Automobile		Y	Y	Y	A	4.65
6.	Smithkline Beecham Cons Health	Food & Beverages	Y			Y	A	4.46
7.	Punjab Tractors Ltd.	Automobile				Y	A1	3.86
8.	Reliance Industries Ltd.	Diversified		Y	Y	Y	A	3.66
9	Hindustan Petroleum Corp Ltd.	Refineries		Y		Y	A	3.39
10.	Hero Honda Motors Ltd.	Automobile	Y			Y	A	3.28
11.	Mahindra & Mahindra Ltd.	Automobile		Y	Y	Y	A	2.78
12.	Mahanagar Telephone Nigam	Telecommunications		Y	Y	Y	A	2.30
13.	Satyam Computer Ltd.	Computer Software				Y	A1	2.26
14.	Nestle India Ltd.	Food & Beverages	Y	Y		Y	A	2.11
15.	EIH Ltd.	Hotels & Resorts			Y	Y	A	2.00
16.	DSQ Software Ltd.	Computer Software				Y		1.95
17.	Colgate Palmolive (India) Ltd.	Personal Care	Y	Y		Y	A	1.88
18.	Hindalco Industries Ltd.	Metals		Y	Y	Y	A	1.55
19.	Credit Rating Information Service	Finance - General				Y		1.55
20.	Vashishti Detergents Ltd.	Cons. Non-Durable	Y			Y		1.48
21.	National Aluminium Co Ltd.	Metals				Y		1.43
22.	Housing Development Fin Corp	Finance - Housing				Y	A	1.22
23.	Castrol India Ltd.	Auto-Ancillaries	Y	Y		Y	A	1.17
24.	Carrier Aircon Ltd.	Consumer - Durable	Y			Y	A1	1.07
25.	Tata Tea Ltd.	Food & Beverages				Y	A	1.00
	Total							77.39

(Contd.)

Annexure (Contd.)

Sr. No.	Company (1)	Industry/Activity (2)	FCC (3)	Sensex (4)	GDR Issue (5)	Top Turnover Company$ (6)	A Group (7)	Percentage Share in Total Value# (8)
JARDINE FLEMING INDIA FUND								
1.	Hindustan Lever Ltd.	Personal Care	Y	Y		Y	A	12.14
2.	ITC Ltd.	Food & Beverages	Y	Y	Y	Y	A	8.04
3.	Bajaj Auto Ltd.	Automobile		Y	Y	Y	A	4.41
4.	Hindustan Petroleum Corp Ltd.	Refineries		Y		Y	A	4.27
5.	Videsh Sanchar Nigam Ltd.	Telecommunications			Y	Y		4.23
6.	Satyam Computer Services Ltd.	Computer Software				Y	A1	4.21
7.	State Bank of India	Banks - Public Sector		Y	Y	Y	A	3.53
8.	Mahanagar Telephone Nigam	Telecommunications		Y	Y	Y	A	3.26
9.	Bank of Baroda	Banks - Public Sector				Y	A1	3.19
10.	TVS Suzuki Ltd.	Automobile	Y			Y	A1	3.00
11.	Punjab Tractors Ltd.	Automobile				Y	A1	2.92
12.	BSES Ltd.	Power Gen./ Distn.		Y	Y	Y	A	2.67
13.	Housing Development Fin Corp.	Finance - Housing				Y	A	2.51
14.	Reliance Industries Ltd.	Diversified		Y	Y	Y	A	2.26
15.	Reliance Industries Ltd.	Diversified		Y	Y	Y	A	2.25
16.	ICICI Banking Corporation Ltd.	Banks Public Sector				Y	A1	2.12
17.	Mahanagar Telephone Nigam	Telecommunications		Y	Y	Y	A	2.03
18.	Videsh Sanchar Nigam Ltd.	Telecommunications			Y	Y		1.97
19.	NIIT Ltd.	Computer Software		Y		Y	A1	1.77
20.	Reliance Petroleum Ltd.	Refineries				Y		1.52
21.	Indian Hotels Co Ltd.	Hotels & Resorts		Y	Y	Y	A	1.42
22.	Aptech Ltd.	Computer Software				Y		1.39
23.	Infosys Technologies Ltd.	Computer Software		Y		Y	A1	1.39
24.	Carrier Aircon Ltd.	Consumer - Durable	Y			Y	A1	1.29
25.	ICI (India) Ltd.	Diversified	Y			Y	A1	1.29
	Total							79.08

(Contd.)

Annexure (Contd.)

Sr. No.	Company	Industry/Activity	FCC	Sensex	GDR Issue	Top Turnover Company$	A Group	Percentage Share in Total Value#
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
MORGAN STANLEY INDIA INVESTMENT FUND								
1.	Bharat Heavy Electricals Ltd.	Machinery - Non.Elect		Y		Y	A	13.87
2.	Infosys Technologies Ltd.	Computer Software		Y		Y	A1	11.69
3.	Container Corp. of India Ltd.	Service - Transport				Y		8.12
4.	Housing Development Fin. Corp.	Finance - Housing				Y	A	7.01
5.	Zee Telefilms Ltd.	Entertainment				Y	A1	5.25
6.	Punjab Tractors Ltd.	Automobile				Y	A1	3.66
7.	Smithkline Beecham Pharm.	Pharmaceuticals	Y			Y	A	3.28
8.	Hero Honda Motors Ltd.	Automobile	Y			Y	A	3.20
9.	State Bank of India	Banks - Public Sector		Y	Y	Y	A	2.65
10.	Hoechst Schering Agrevo	Pesticides/Agro Chem	Y			Y		2.25
11.	Novartis India Ltd.	Pesticides/Agro Chem	Y	Y		Y	A1	2.22
12.	TVS Suzuki Ltd.	Automobile	Y			Y	A1	2.21
13.	ITC Ltd.	Food & Beverages	Y	Y	Y	Y	A	2.09
14.	Hoechst Marion Roussel Ltd.	Pharmaceuticals	Y			Y		1.88
15.	Cipla Ltd.	Pharmaceuticals				Y		1.78
16.	MRF Ltd.	Auto-Ancillaries				Y	A	1.71
17.	Supreme Industries Ltd.	Plastic Products				Y	A	1.51
18.	NIIT Ltd.	Computer Software		Y		Y	A1	1.47
19.	Sandarac Fasteners Ltd.	Auto-Ancillaries				Y		1.30
20.	Sun Pharmaceutical Industries	Pharmaceuticals				Y	A1	1.23
21.	Cummins India Ltd.	Machinery - Non.Elect	Y			Y	A1	1.14
22.	Colour-Chem Ltd.	Chemicals - Dyes	Y			Y		1.07
23.	ICI (India) Ltd.	Diversified	Y			Y	A1	1.00
24.	Motor Industries Co. Ltd.	Auto-Ancillaries	Y			Y		0.98
25.	Revathi-CP Equipment Ltd.	Machinery - Non.Elect	Y			Y		0.88
	Total							83.45

(Contd.)

Annexure (Concld.)

Sr. No.	Company	Industry/Activity	FCC	Sensex	GDR Issue	Top Turnover Company$	A Group	Percentage Share in Total Value#
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
PIONEER INDIA FUND								
1.	Bharat Petroleum Corp Ltd.	Refineries				Y	A	5.32
2.	Satyam Computer Services Ltd.	Computer Software				Y	A1	4.73
3.	Hindustan Petroleum Corp Ltd.	Refineries		Y		Y	A	4.54
4.	Larsen & Toubro Ltd.	Diversified		Y	Y	Y	A	4.22
5.	Tata Infotech Ltd.	Computer Hardware				Y		3.87
6.	Videsh Sanchar Nigam Ltd.	Telecommunications			Y	Y		3.76
7.	Pentafour Software & Exports	Computer Software				Y	A1	3.30
8.	Mahanagar Telephone Nigam	Telecommunications		Y	Y	Y	A	3.24
9.	Ranbaxy Laboratories Ltd.	Pharmaceuticals		Y	Y	Y	A	3.21
10.	Oil & Natural Gas Commission	Petrochemicals				Y		3.10
11.	Bajaj Auto Ltd.	Automobile		Y	Y	Y	A	3.00
12.	NIIT Ltd.	Computer Software		Y		Y	A1	3.00
13.	Infosys Technologies Ltd.	Computer Software		Y		Y	A1	2.94
14.	Industrial Credit & Invt. Corp. (I) Ltd.	Term Lending Inst.		Y	Y	Y	A	2.88
15.	Pentafour Software & Exports	Computer Software				Y	A1	2.77
16.	TVS Suzuki Ltd.	Automobile	Y			Y	A1	2.45
17.	State Bank of India	Banks - Public Sector		Y	Y	Y	A	2.28
18.	Housing Development Fin. Corp.	Finance - Housing				Y	A	2.20
19.	ABB Ltd.	Machinery - Elect.	Y			Y	A	2.19
20.	National Aluminium Co. Ltd.	Metals				Y		1.84
21.	Reliance Industries Ltd.	Diversified		Y	Y	Y	A	1.83
22.	Novartis India Ltd.	Pesticides/Agro Chem	Y	Y		Y	A1	1.72
23.	Pfizer Ltd.	Pharmaceuticals	Y			Y	A	1.69
24.	Bank of India	Banks - Public Sector				Y	A1	1.66
25.	Cochin Refineries Ltd.	Refineries				Y	A1	1.58
	Total							73.32

A1: Companies which were included in the A-Group in February 1998.
With respect to total value of investments of the fund.
$ Among the top 500 companies in terms of market turnover in 1998.

NOTES

1 IFC promoted foreign portfolio investment in developing countries by helping to establish 'country funds', venture capital funds and debt funds that invest in emerging market securities issues. IFC also claims that by pioneering and actively promoting such funds for developing countries, IFC introduced many international portfolio investors to emerging markets. See: http://www.ifc.org/depts/html/capmkts.htm.

2. Brandt Commission Report: *North-South - A Programme for Survival*, Pan Books, 1980.

3. From the letter written in April 1993 by Shri Chandra Shekhar, former Prime Minister, to the then Finance Minister.

4. The then Finance Minister said: 'Under the scheme of permitting Foreign Institutional Investors (FIIs) in our capital market, we had indicated that such investors would be liable to tax at 20 per cent on investment income and 10 per cent on long term capital gains. I also propose to extend a concessional rate of tax of 30 per cent in respect of short term capital gains for such investments'. Budget Speech 1993-94, para 63. The Union Budget 1999-2000 removed this discrimination and the Indian investors are also eligible for the lower long term capital gains tax of 10 per cent.

5. This may be in response to the earlier experience when in the early 'eighties an NRI tried to take over two major companies of that time, namely, Escorts & DCM.

6. Experience shows that ceilings are generally reached in case of smaller companies only.

7. The general decline in the fourth quarter is attributed to book closure during November by most American fund managing houses. It is stated that there 'will be lack of trading activity in November and a 'buyers' strike till at least 15 November, with FIIs not being involved in any markets at all'. See: Ridham Desai, 'FII selling is not India-specific', http://www.capitalmarket.com/capitalmarket/mag/cm1418/face.htm.

8. It was reported that some brokers were giving inflated figures of purchases or sales of FIIs to give a false impression of FII activity in the market.

9. It was emphasised that not only the detailed trading information, but also total trade/investment by individual FIIs and the names of the companies along with the extent of FII investment is price sensitive and thus cannot be disclosed. One got a feeling that one should not be too much concerned with FII investments as the money as well as the risk was after all of FIIs.

10. This deduction is based on the names of the FIIs and was ascertained from SEBI sources. We have been informed that at present only two categories namely, FA & FD are being followed.

11. Morgan Stanley was among the earliest to tap the local market with its mutual fund in 1993-94 after the sector was thrown open to private sector.

12. Though SEBI does not report the corresponding figures for 1998-99, the fact that FIIs would not have contributed in any significant manner is evident from the fact that out of the total capital raised during the year, the amount reserved for banks and financial institutions was only Rs 33.83 crore.

13. Out of the net investment of Rs 6,697 crore at the all-India level during 1999, Debt accounted for only Rs. 119 crore.

14. Total reported FII purchases at the all-India level in 1999 were reported to be Rs 36,394 crore and sales Rs 29,816 crore. (See: Bombay Stock Exchange, *Stock - Exchange Review*, January 2000). BSE turnover measures one-sided transactions, *i.e.*, sales or purchases. In case of FIIs, they can either sell or purchase from others or from other FIIs. The transactions of FIIs cannot, therefore, be strictly compared with the total net turnover of the Exchange. If one averages sales and purchases, the share of FIIs in 1998 works out to about 2.5 per cent of total net turnover of BSE. The corresponding share in 1999 was 2.9 per cent.

15. Companies that have fewer than 500 investors and less than $10 million in net assets are not required to file annual and quarterly reports with the SEC.

16. Out of the total list of N-30D filings during 1996 and 1998, we searched for the words, India, International, Global, Asia, Emerging, etc., in the funds' names. The filings of the funds thus identified were downloaded. Out of these, those having 'India' within the body of the file were further identified.

17. The funds' investments in the neighbouring countries are negligible both in terms of numbers and value.

18. The 1998 data generally refers to the post-sanctions period. The exercise was not extended to 1999 because Pioneer India fund ceased to be India specific and renamed itself as Pioneer Indo-Asia Fund, the N-30D filing of Jardine Fleming was available only for March 1999 and India Fund Inc. is no longer traceable at the SEC website. In any case, the years chosen cover an important period during which the substantial shifts occurred in the industry-wise trading pattern.

19. Excluding small investments in Pakistan.

20. For instance, India Fund Inc. stated: Several events during the first six months influenced the market. The Asian economic crisis continued to negatively impact the markets. The elections in India resulted in yet another coalition government, continuing the political instability in the country. Most significant, however, was the testing of nuclear weapons by the BJP government, which triggered economic sanctions by the U.S. and other countries. And, Pioneer India Fund informed: As the rest of the world looked for a competitive advantage so too did India. Economic reform continued, even in the face of political change. Unfortunately, as this report goes to press, India also initiated a series of nuclear tests that put the world and the region on edge.

21. 'Some Aspects of the Indian Stock Market in the Post-Liberalisation period'.

22. For instance, explaining their investment strategy, Sun F&C Mutual Fund said, 'Contrary to belief, some smaller companies do offer tremendous value opportunities. However, they often bring with them lack of liquidity. Companies with reasonable levels of liquidity, on the other hand, allow us the freedom of buying and selling the value shares as and when we want. *Investment in small companies is, therefore, restricted to a small percentage of the fund*' (emphasis added). The fund is managed by Sun F&C Asset Management (India) Pvt. Ltd., a joint venture of Foreign and Colonial Emerging Markets Ltd., UK with Sun Securities (India) Pvt. Ltd. See: www.sunfc.com/invest/factsheet.html. On its part ING Savings Trust said '(T)he portfolio is designed to have concentrated holding within reasonable risk limits, rather than an unproductive and excessive diversification'. See: the Monthly

Update for December 1999 at: www.ingsavings-trust.com/technical_fin/sub/mark2.html.

23. For the classification of companies and description of the Specified Group, see the accompanying paper: 'Indian Stock Market in the Post-Liberalisation Period: Some Insights' in this issue of this Journal.

24. Since value of investment varies with share prices, interpretation in terms of exposure may be more appropriate rather than treating the amounts as investment.

25. These are India Fund Inc.; Jardine Fleming India Fund Inc.; and Morgan Stanley India Investment Fund Inc.

26. The relevant file at SEC is : 0000891554-98-00105.txt.

27. In the case of Jardine Fleming India Fund Inc. it was $1,500 a month and for Morgan Stanley it was $22,000 a year, or $1,833 per month.

28. This is in sharp contrast to the country-wise distribution presented earlier, and which indicated that only one out of the 472 FIIs furnished a Mauritius address. Indeed, we came across other funds which were using the Mauritius route. For instance, Fleming India Fund of Luxembourg operates through a wholly-owned Mauritius subsidiary.

29. Joint venture of Aditya Birla Group and Capital Group of Companies Inc. USA.

30. Based on the information downloaded from the respective fund managers' web sites. Further evidence to this phenomenon can be seen from the sectoral composition of investments by FFF-Fleming India Fund at the end of February 1999. IT accounted for 27.7 per cent of the investments followed by Consumer Non-durables with 19.6 per cent and Pharmaceuticals with 12.1 per cent. Similarly, the top five holdings of JF India Trust as on February 26, 1999 were Hindustan Lever (9.8 per cent), Satyam Computer Services (8.6 per cent), ITC Ltd. (6.6 per cent), Infosys Tech. (5.8 per cent) and VSNL (4.9 per cent).

31. SEBI is reported to be concerned that shares of some of the companies which changed their names showed high volatility and had advised the stock exchanges to examine the matter. SEBI tightened the issue norms for companies in the IT sector later in October 1999. In case the company going for an initial public offer does not have distributable profits in three out of five preceding years from out of IT activities. In case the company fails to fulfil this criterion, it can access the market if the issue is appraised and financed by a bank or financial institution. The same conditions apply to a listed company which changed its name to reflect activities in the IT sector.

32. The idea seems to be catching on fast. Kothari Pioneer was reported to have planned two funds *Kothari Pioneer FMCG Fund* and *Kothari Pioneer Pharma Fund*.

33. Extracted from the description of the Prudential ICICI FMCG Fund downloaded from web site of the Prudential ICICI Asset Management.

34. Some of the foreign affiliated MFs are: Alliance Mutual (Alliance Capital Asset Management, USA); Birla Mutual Fund (Sun Life Assurance Co., Canada); Cholamandalam Cazenove (Cazenove Fund Management, UK); Credit (Lazard Group, UK and Edinburg Fund Management); DSP Merrill Lynch (Merril Lynch, USA); Dundee MF (Dundee group, Canada); Kothari Pioneer (Pioneer Group Inc., USA); Morgan Stanley MF (Morgan Stanley, US); Prudential ICICI (Prudential Corp, UK); Sun F&C (Foreign & Colonial Foreign & colonial, UK); Sundaram MF (Newton Investment Management, UK); Tata MF (Dresdner RCM Global Investor Holdings, UK); and Zurich India MF (Zurich Financial Services, Switzerland).

35. See: www.indiainfoline.com/mufu/news/29html.

36. For details see: UTI's website www.unittrusriofindia.com. It was estimated IT, Pharmaceuticals and FMCG accounted for close to 30 per cent of US-64 exposure to equity in December 1999. Exposure of other schemes of UTI to information technology is also quite high at 12 per cent (in December 1999). It is relevant to note in this respect the statement of UTi Chairman that '(W)e might have entered a bit late, but we have entered big'.

37. Some other funds with 40 per cent or more of their net assets in computer software and hardware companies during Dec/Nov 99-Feb. 2000 are Tata Tax Saving Fund; ING Growth Portfolio; Alliance 95; IL&FS Growth & Value; Kotak Mahindra - K30; and SBI Magnum Tax Gain '93

38. See the accompanying paper 'Some Aspects of the Indian Stock Market in the Post-Liberalisation Period'. foot note 70.

39. It was suggested that just four companies Infosys, NIIT, Satyam computers and Zee Telefilms would claim a fifty per cent weightage in the Sensex.

40. Indian MFs have, however, been allowed in September 1999 to invest in ADR/GDR issues of Indian companies. MFs are permitted to invest in ADRs/GDRs initially within overall limit of US$ 500 mn. An individual MF should not exceed 10 per cent of the net assets managed by them subject to a minimum of US$ 20 mn. and a maximum of US$ 50 mn.

41. Chief Investment Officer of SBI Mutual Fund was reported to have Said: 'Running with the Nasdaq is a fact, but I see it as a short-term phenomenon'.

42. For instance, India Fund Inc., in its report for the period ending June 30, 1998 informed that '(T)he Fund's strategy of maintaining positions in defensive sectors of the economy such as consumer non-durables and pharmaceuticals as well as its strong overweighting in the technology sector continued to generate out performance'. See 0000891554-98-001105.txt, the relevant filing with the SEC.

43. President of Morgan Stanley India Investment Fund Inc., said in his letter to the shareholders than the investors base both local and international is looking to this government to kick-start the reform process, which should serve as a pointer to the direction where the policy framework of the government is headed. If the current government can establish its reformist credentials, then the markets will improve quickly. If, for any reason, this government falls short and fails to deliver on the reforms agenda or on issues such as reforms in insurance industry, legislation on patents or accelerating investment in infrastructure, then India as a country runs the risk of having wasted another year. See: The Fund's filing with the SEC, namely, 0001047469-99-008656.txt.

44. It was indeed claimed that the IT sector on whom the Indian stock market is placing heavy emphasis has little to do with the local conditions. The Chief Investment Officer of Jardine Fleming was reported to have said that '(I)t's fairly obvious. IT companies are different: they don't borrow from local banks, their customers are international and their sales

don't at all depend on what happens in India'. Similar was the view attributed to HCL group head. According to him: '(O)ur future has little to do with the Indian market'.

ABBREVIATION

ADB	Asian Development Bank
AMC	Asset Management Co.
AMFI	Association of Mutual Funds in India
BJP	Bhartiya Janata Party
BSE	Bombay Stock Exchange
FMCG	fast moving consumer goods
FIs	Financial Institutions
FCCs	foreign-controlled companies
FCC	Foreign Collaboration Company
FDI	Foreign direct investments
FIIs	Foreign Institutional Investors
FPI	Foreign portfolio investments
FA	fund advisers
GDRs	Global/American Depository Receipts
GNP	Gross National Product
IDPAD	Indo-Duch Programme on Alternatives in Development
IFC	International Finance Corporation
FD	investment funds
JFIM	Jardine Fleming International Management Inc.
NRIs	Non-residential Indian
ODA	Official Development Assistance
PUC	paid-up equity capital
FC	pension funds
PE	price-earning
RBI	Reserve Bank of India
SEBI	Securities and Exchange Board of India
SEC	Securities and Exchange Commission
TNCs	Transnational corporations
UTI	Unit Trust of India
VSNL	Videsh Sanchar Nigam Ltd.

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FISCAL STRESS AND FISCAL DEPENDENCY OF INDIAN STATES

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This paper analyses finances of the state governments in India with the objective of assessing the nature, causes and extent of their dependency. It tries to compute the states' Fiscal Dependency and Fiscal Stress Ratios that highlight the need for the fiscal correction at the state level, in order to maintain the fiscal discipline in the Indian economy. The calculated Fiscal Stress and Dependency Ratios reveal that there has been no perceptible change in the dependency of states on the centre to finance their needs during the past one and half decades. Among the non-special category states, the backward states like, Bihar, Madhya Pradesh, Uttar Pradesh and Orissa continue to lag behind and have higher dependence on the central assistance. Unless the central government diverts its capital investments in to these backward states, the dependence of these states on central assistance would continue. Similarly, states also need to take proper measures to attract foreign capital inflows by creating suitable environment in the states, privatizing state-owned loss making units, increase in the user charges of state provided public utilities. This would help them to step up the growth rates (SDP) in the states and increase the internal resources in the forms of tax and non-tax revenues for the states.

I. Introduction

The fiscal consolidation at the central government and the reduction of Fiscal Deficit had been initiated in India as a part of the liberalisation programme initiated in 1991. The federal issues that have been unresolved in the economy and also some of the special structural features of the nation need to be taken into account before implementing the IMF-proposed model of fiscal correction. The state government finances pose a difficult problem to carry out smooth exercise of fiscal consolidation. The general features of Indian states' finances are: large deficits in populous (and backward) states and poor revenue collection in some states, the continuous dependence of the special category states on central funds (nearly 10 states and UTs) and the regional disparities in terms of per capita State Domestic Product (rich and poor states), political lobbying of states with that of central government (political economy of finances), etc. In spite of the functioning of two Commissions, namely Planning and Finance Commissions, to undertake the exercise of recommending for allocation and distribution of resources from centre to the states and among the states (vertical and horizontal transfers), there have been a persistence of grievances among states. Given all these facts, the present study tries to follow a positive approach to analyse the state-level finances and provide some suggestions for the policy formulations.

The paper is organised in the following way: Section II explains the method used to compute the Fiscal Dependency Ratios (FDRs), and the interpretation of the FDRs and Fiscal Stress Ratios (FSR). Section III interprets the tables and the computed FDRs and FSRs, and section IV draws conclusion.

II. Method of Computing FDR and FSR

The Reserve Bank of India has been publishing the data relating to various measures of resource gaps of both central and state governments. These pertain to revenue, capital and overall gaps. The gaps are the Net Fiscal Deficits and the modes of financing them, Primary Revenue Balance and own deficit both adjusted and unadjusted for the statutory transfers. The Gross Fiscal Deficit (GFD) indicates the total borrowing requirements of the states. The GFD however, fails to highlight

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restrictions imposed by the Constitution on the states and also the central assistance, which imposes a ceiling on their expenditure.

There have been a number of measures used in the accounting the resource gaps of the states. The overall gap and its decomposition into the revenue and capital account deficits give an idea about the states' resource position. The GFD is the difference between aggregate disbursements net of debt repayments and recovery of loans, revenue receipts and non-debt capital receipts. The Net Fiscal Deficit (NFD) is the difference between the GFD less loans and advances. Net Primary Deficit is computed as the difference between the NFD net of interest receipts. The own deficit of states is of two types, viz., unadjusted and adjusted for statutory transfers from the centre.

Due to the inherent weaknesses of some of the existing measures-both conceptual as well as practical (due to changing RBI' policies relating to overdraft, pursuance of the Fiscal Stabilization Programme as advised by the IMF), there is a need to add a few more measures. The present exercise computes additional measures like. Basic Resource Gaps, Fiscal Dependency and Fiscal Stress Ratios of the state governments in order to assess the correct fiscal status of the State governments.[1]

The Basic Resource Gap (BRG) is a measure, which indicates the estimation of the volume of expenditure of the states subject to the sources of finance. This measure is further extended into three variants as BRG1, BRG2 and BRG3 by including more components of revenue and other receipts. That gives an idea about the dependency of a state on the centre, the RBI and other institutions.[2] BRG1 is the difference between the total expenditure (revenue and capital) and total own resources (both tax and non-tax). The BRG2 is computed as the difference between total expenditure less (a) total own revenues (b) internal debt net of market loans (c) provident fund, reserve funds and deposits and other capital receipts. The BRG3 is obtained as the difference between the total expenditure and (i) total own revenue and states' share in central taxes and statutory grants from the centre (ii) internal debt net of market loans and (iii) provident fund and reserve funds, deposits and other capital receipts.

After computing these resource gaps of states, the next aspect is to find the financing of them by the union government and other institutions. The BRG1 is financed by the states' share in central taxes; total grants from centre (both statutory and non-statutory), capital receipts and Ways and Means Advances (WMA) (in the *ex post* sense). BRG2 is financed by the states' share in central taxes, total grants from centre, market loans, loans and advances from centre. The BRG3 is financed by the non-statutory grants from centre, market loans, the loans and advances from the centre. Among these three measures, BRG3 has a greater analytical importance, as all the four components involved happen to be exogenous to a state, since they are at the discretion of the centre or are largely influenced by the centre as the institutions involved in financing the BRG3 happen to be owned and managed by the central government.

The Fiscal Stress Ratio (FSR) is obtained as the ratio of BRG3 to BRG1. The State Domestic Product is used in the analysis for computing the FDRs.

The Fiscal Stress Ratio analysis carried out here follows the work of Patnaik et al [1994, Pp. 315-367]. However, there are two distinct improvements. First is to make a state-wise analysis for major Indian states instead of all states' dependency, which enables one to understand the state-specific dependency and problems. The bifurcation of states into Special and Non-special categories helps to observe the relative dependency of each group on centre and external funding. Second is that the present analysis gives an insight into the extent of regional imbalances as an alternative to SDP analysis.

The following variables are used in the analysis.

RR = Revenue Receipts
OTAR = Own Tax Receipts
SCT = States' share in Central Taxes
ONTR = Own Non Tax Revenue
SGFC = Statutory Grants from Centre
NSGFC = Non-statutory Grants from Centre
RR = Revenue Receipts
RE = Revenue Expenditure
IPC = Interest Payments to Centre
MB = Market Borrowings
CR = Capital Receipts
ID = Internal Debt
LAC = Loans and Advances from Centre
RLA = Recovery of Loans and Advances
ML = Market Loans
PFS = Provident Funds
RFD = Reserve Funds
OCR = Other Capital Receipts
TE = Total Expenditure
CD = Capital Disbursements
LAS = Loans and Advances by States
DID = Discharge of Internal Debt
RLC = Recovery of Loans to Centre
IP = Interest Payments
IR = Interest Receipts
GRARBI = Grants from RBI
WMA = Ways and Means Advances
TR = Total Receipts
GFD = Gross Fiscal Deficit
NL = Net Lending
NIP = Net Interest Payments
PD = Primary Deficit
PD1 = Primary Deficit 1
PD2 = Primary Deficit 2
NPD = Net Primary Deficit
PRB = Primary Revenue Balance
NPSTRS = Non plan Statutory Transfers
ML = Market Loans
NSTG = Non Statutory Grants
OCR = Other Capital receipts

Using different identities the BRG 1, 2, 3 are computed. The FDR and FSR are then calculated.

BRG1 = (RE+CD) -(OTAR+ONTR)
BRG2 = (RE+CD) - [(OTAR+ONTR) +(ID-ML)+(PFs+RFD+OCR)]
BRG3 = (RE+CD)-[(OTAR+ONTR+SCT +SFGC)+(ID-ML)+(PFs +RFD+OCR)]
FSR = BRG3/BRG1
FDR1 = BRG1/SDP
FDR2 = BRG2/SDP
FDR3 = BRG3/SDP

III. Interpretation of Computed Values

All states' revenue receipts and revenue expenditures have increased enormously during the period covering 1981-1991. While an insignificant revenue surplus was obtained prior to 1985, the later period is marked by revenue deficits. The deficit started growing sharply after the mid 1990s. The states' own tax revenue as a proportion of total receipts have risen during the period; while there is no perceptible change in the other variables. In case of grants, the statutory grants have become insignificant and the non-statutory grants have been forming bulk of the grants transferred to the states. In case of the capital account, the states as a whole, had deficits during the early 1980s. Since then, their capital receipts exceeded disbursements showing an ever-increasing surplus. In case of the internal debt of states, the market loans component has been the most dominant source, which accounted for about 65 per cent of the internal debt. For the year 1987, the states' market loans accounted for over 98 per cent of their internal debt. The capital disbursements, as a percentage of total expenditure, fell considerably from over 34 per cent during 1981 to about 17 per cent by 1998.

Table 1 gives the Fiscal Dependency Ratios (FDRs), which are computed as the ratio of the corresponding BRGs and the State Domestic Product (SDP). FDR1 shows the extent of reliance on external sources of states' financing. FDR2 measures the extent of market borrowing to finance the gap. FDR3 captures the extent of non-statutory transfers on which the states would rely after external and market borrowings. The table indicates that FDR1 for 1982-83 for states like Bihar, Orissa and Rajasthan are significantly higher compared to others. The FDR2 and FDR3 values, are lower than that of FDR1 uniformly for all states, which is expected. But these three states continue to have relatively higher values, which indicate the higher dependency. The fiscal stress ratio, which is the ratio of BRG3 and BRG1, is in the range of 45.45 to 79.63.

Table 1. State-Wise BRGs and FDRs for 1982-83

STATE (1)	BRG1 (2)	BRG2 (3)	BRG3 (4)	FDR1 (5)	FDR2 (6)	FDR3 (7)	FSR (8)
A.P.	895	863	502	9.22	6.43	1.61	56.09
BHR	1,487	1,393	871	18.99	11.60	3.82	58.57
GUJ	955	917	706	10.92	7.97	2.91	73.93
HAR	388	360	287	9.69	6.38	2.35	73.97
KAR	562	521	281	7.58	4.96	1.37	50.00
KER	473	401	215	10.15	6.23	1.77	45.45
M.P.	1,029	917	545	13.31	8.23	2.05	52.96
MHR	1,381	1,300	878	7.56	4.90	1.52	63.58
ORS	935	895	679	24.83	15.08	7.03	72.62
PNJ	486	486	387	8.37	5.84	2.31	79.63
RJN	815	753	537	14.74	9.82	2.94	65.89
T.N.	1,120	1,062	705	12.70	7.76	2.50	62.95
U.P.	2,207	2,162	1,359	12.43	8.73	2.75	61.58
W.B.	1,303	1,269	889	12.21	8.02	2.80	68.23

Note: BRGs in rs cr and FDRs and FSR in percentages.
Source: *RBI Bulletin*, various issues.

Tables 2 consists of BRGs and FDRs for the year 1985-86. A similar trend prevailed, with MP and UP joining the above three states showing a higher dependence. The reduction in FDR3 is less compared to the earlier year. Table 3 for the year 1990-91 reveals that FDRs for the states of Bihar, Orissa, UP and Rajasthan possess relatively higher values implying a higher dependence.

Table 2. State-Wise BRGs and FDRs for 1985-86

STATE (1)	BRG1 (2)	BRG2 (3)	BRG3 (4)	FDR1 (5)	FDR2 (6)	FDR3 (7)	FSR (8)
A.P	1.707	1.648	1.353	12.29	12.29	10.09	79.26
BHR	2.264	2.090	1.190	17.41	17.41	9.91	52.56
GUJ	1,212	1.161	882	10.09	10.09	7.66	72.77
HAR	561	505	417	8.95	8.95	7.39	74.33
KAR	1.548	1,487	1,049	14.15	14.15	9.98	67.76
KER	1.217	1.097	879	17.04	17.04	13.66	72.23
M.P.	1.793	1.679	1,100	15.08	15.08	9.88	61.35
MHR	2.404	2,335	2.235	8.80	8.80	8.42	92.97
ORS	1.057	991	659	16.69	16.69	11.10	62.35
PNJ	1.163	1,112	979	13.37	13.37	11.77	84.18
RJN	1.320	1,236	911	16.12	16.12	11.88	69.02
T.N.	1.585	1,526	996	11.15	11.15	7.28	62.84
U.P.	3.587	3.484	2.215	14.07	14.07	8.94	61.75
W.B.	1.809	1.769	960	11.18	11.18	6.07	53.07

Note: BRGs in rs cr and FDRs and FSR in percentages.
Source: *RBI Bulletin*, various issues.

Table 3. State-Wise BRGs and FDRs for 1990-91

STATE (1)	BRG1 (2)	BRG2 (3)	BRG3 (4)	FDR1 (5)	FDR2 (6)	FDR3 (7)	FSR (8)
A.P.	3,047	3,022	1,714	9.78	9.70	5.50	56.25
BHR	4,310	4,009	2,139	18.88	17.56	9.37	49.63
GUJ	2,672	2,586	2,279	11.00	10.65	9.38	85.29
HAR	814	652	464	6.65	5.33	3.79	57.00
KAR	2,132	1,980	1,315	10.36	9.62	6.39	61.68
KER	1,836	1,502	952	15.08	12.34	7.82	51.85
M.P.	3,341	3,038	1,949	12.59	11.44	7.34	58.34
MHR	3,907	3,582	2,508	6.79	6.22	4.36	64.19
ORS	2,176	2,028	1,330	22.52	20.99	13.76	61.12
PNJ	1,821	1,698	1,450	10.85	10.12	8.64	79.63
RJN	2,693	2,481	1,592	14.73	13.57	8.71	59.12
T.N.	3,102	2,848	1,831	11.02	10.11	6.50	59.03
U.P.	8,366	7,800	5,238	16.90	15.76	10.58	62.61
W.B.	3,667	3,418	2,309	11.55	10.76	7.27	62.97

Note: BRGs in rs cr and FDRs and FSR in percentages.
Source: *RBI Bulletin*, various issues.

IV. Conclusion

The calculated Fiscal Stress and Dependency Ratios reveal that there has been no perceptible change in the dependency of states on the centre to finance their needs. Among the non-special category states, the backward states like, Bihar, Madhya Pradesh, Uttar Pradesh, Orissa continue to lag behind and depend on the central assistance. Unless the central government diverts its capital investments into these backward states, the dependence of these states on central assistance continues. Similarly, states also need to take proper measures to attract foreign capital inflows by creating suitable environment in the states. This would help them to step up the growth rates (SDP) in them and increase the internal resources in the forms of tax and non-tax revenues for the states.

NOTES

1. See for detailed discussion of the deficits and ratios. Patnaik et al [1994].
2. These include the RBI, LIC, HUDCO, etc.

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CORPORATE STATISTICS: THE MISSING NUMBERS

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This paper reviews the current status of Indian corporate statistics. It makes a critical evaluation of the various sources of data such as ASI, RBI, ICICI, IDBI, BSE, CMIE and DCA in terms of comprehensiveness, reliability and timeliness. In this process it identifies the gaps in the data and gives suggestions for improvement taking into account the increasing demand for data following globalisation. It emphasizes the role of firm level / industry-wise / state-wise / size-wise data on a census basis.

Introduction

Liberalisation measures introduced gradually since the mid 1980s have far-reaching implications for the growth and behaviour of the private corporate sector in India. For any meaningful analysis of their implications, the most important pre-requisite is a sound database. Unfortunately, statistics in the area are quite confusing and wanting in several respects. Besides, statistics for the corporate sector as such do not exist,[1] so much so, that much of the work on the corporate sector has been on methodological issues relating to and building up of population estimates for this sector with lesser attention to the substantive issues. This state of affairs needs to be changed particularly in the context of the growing significance of the corporate sector in the economy.[2] It therefore seems relevant to make a critical assessment of the database of the private corporate sector with particular reference to its comprehensiveness and usefulness so that the gaps in the data can be identified. What is the nature of the data available? What are its problems? How can they be improved to make them more useful? This paper addresses these issues.

We confine ourselves to the non-government non-financial private corporate sector. In this category, we include public limited companies private limited companies, foreign controlled rupee companies, and branches of foreign companies.[3] The survey of different sources of data for these sub-sectors of the private corporate sector is confined to the important sources of published data.

This paper is divided into three sections. Section 1 deals with the major sources of data and identifies the gaps in them. Section 2 outlines how these data sources have been used. Section 3 gives suggestions for improving the database.

SECTION 1

Major Sources of Data:

The corporate sector can be analysed at, firm level, size-wise, industry level, aggregate level and state-wise. The study of significant issues at each of these levels requires detailed data. The main published sources of data for analysing the private corporate sector are the data published by

1. Central Statistical Organisation (CSO),
2. Reserve Bank of India (RBI),
3. Industrial Credit and Investment Corporation of India (ICICI),
4. Industrial Development Bank of India (IDBI),
5. Bombay Stock Exchange (BSE),
6. Centre for Monitoring Indian Economy (CMIE), and
7. Department of Company Affairs (DCA).

The level of aggregation, the variables for which information are given, and the period for which it is available varies across these sources.

Central Statistical Organisation:

At the outset, it must be mentioned that most of the databases of the private corporate sector are in the form of financial statements and give data only in value terms. This in turn has determined

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the type of studies undertaken in this area. Perhaps, the oldest data relating to private corporate sector was an exception to this. The oldest data source on the private corporate sector was published in *Census of Manufacturing Industries* (CMI). The CMI gave information by type of ownership[4] at the aggregate level, that is, for the entire manufacturing sector for the years 1951 to 1958. Variables for which information was available included productive capital, persons employed, salaries, wages and benefits to employees, gross output, materials consumed, and value added. Since 1954, this information was given at the industry level. This was, however, available only up to the year 1958. One major drawback of this data source was that it did not distinguish between government and non-government companies. It also did not distinguish between workers and salaried-class. The *Annual Survey of Industries* (ASI) replaced CMI in 1959 and brought changes in the format and coverage. These changes were useful in several ways but affected corporate statistics adversely. To be explicit, the provision of information by type of ownership ceased to be published and, thereby, a major source of information to analyse corporate sector ceased to exist.

To a certain extent, this was compensated by the publishing of the document titled, *Summary Results for the Factory Sector*. It gives information by type of ownership and organisation since 1973-74. The information provided includes the number of factories, fixed capital, productive capital, invested capital (since 1980-81), workers (since 1979-80), employees, wages to workers (since 1979-80), total emoluments, total input (since 1978-79), gross output, depreciation (since 1979-80), net value added, rent paid (since 1993-94) and interest paid (since 1993-94). The major problem with this source of data is that it does not directly give information on the private corporate sector as such. Estimates for private corporate sector have to be prepared by combining information given by type of organisation and by type of ownership [Appendix 1]. This is fraught with number of difficulties [Shanta, 1994a, Pp. 1,874-76]. In particular, the results could be overestimates or underestimates depending upon the method used for arriving at the estimates. Another problem with the use of this data is that the details of each are not made explicit. For instance, since 1988-89 some changes have been made in the presentation of the data. A separate category, namely, Joint Family [Hindu Undivided Family] has been separately enlisted. No mention is made, however, as to where this category had been included hitherto. This makes comparability over time difficult. Again, neither industry-wise nor state-wise analysis is possible with this data source.

Reserve Bank of India [RBI]:

Another source of data for aggregate analysis is the data published by the RBI. It is also the most commonly used source of data for corporate analysis.[5] Data published by RBI is essentially sample data. The RBI provides data on company finances consistently from 1950-51 onwards. It is essentially based on the financial statements of companies, that is, Balance sheets and Profit and Loss accounts and, therefore, gives information only in value terms. It provides information for the various sub-sectors of the corporate sector such as Medium and Large Public Limited Companies, Large Public Limited Companies (from 1965-66),[6] Small Public Limited Companies,[7] Medium and Large Private Limited Companies (from 1955-56), Small Private Limited Companies,[8] Foreign Controlled Rupee Companies and Branches of Foreign Companies,[9] and Financial Performance of Private Corporate Business (from 1993-94).[10]

Data was provided on a quinquennial basis until 1980-81,[11] since then it is provided for three years. From the financial year 1982-83 [*RBI Bulletin*, 1987], the survey of Medium and Large Public Limited Companies and that of small companies were merged and was published under the title 'Finances of Public Limited Companies'. So also is the case with private limited companies. Although the specificity of companies included in the sample and the changes in them over time are not clearly known;[12] this data is useful for time series studies based on ratio analysis. Aggregate time series analysis can be carried out after blowing up. The RBI also gives industry-wise[13] and size-wise data.[14] Public and Private Limited Companies are classified under six broad industry groups.[15] Data are also available at a more disaggregated level of industry classification for Public Limited Companies, but not for Private Limited Companies. Size-wise or industry-wise data is available with RBI but not published.

Since RBI data source is essentially based on sample data, estimation is involved for studying the whole of the corporate sector. Also, all the problems associated with using data set do arise. One important and most commonly accepted method of estimating for the whole is the blow up method. For this, information for the corporate sector as a whole aggregate data with respect to any variable becomes very important. The DCA provides aggregate data with respect to number of companies and paid-up capital for public and private limited companies.[16] By suitably adjusting for government and financial companies, it is possible to work out the aggregate paid up capital for non-government non-financial public and private limited companies. It also makes available industry-wise. For making any aggregate estimates, we will have to rely on this information.

The variable commonly used for blowing up is the paid up capital. The method of blow up is as follows: first work out a blow up factor, which is the ratio of total paid up capital of all companies to paid up capital of sample companies. And then multiply the variables with this factor to arrive at aggregate figure.[17] For example,

$GFA_T = GFA_S * [PUC_T/PUC_S]$ or
$GFA_T = [GFA_S/PUC_S] * PUC_T$

Where
GFA_T = Gross fixed assets of total population
GFA_S = Gross fixed assets of the sample
PUC_T = Paid up capital of total population
PUC_S = Paid up capital of the sample

In the case of foreign companies, information on total assets held by all branches in India is available and this could be used to work out blow up factor.[18] Coverage for this set of companies is in terms of net assets.

As industry-wise total paid up capital is available, it is possible to blow up the sample data at the level of major industry groups. This will take care of the inter-industry differences, while building estimates for the corporate sector as a whole.[19] This process can be expressed in a formula as follows:

$$GFA_i = \sum_{j=1}^{n} GFA_{ji}(PUC_{pji}/PUC_{sji})$$

Where
GFA_{ji} = Gross fixed assets j^{th} industry in i^{th} year;
PUC_{pji} = Total paid up capital of j^{th} industry in i^{th} year;
PUC_{sji} = Sample paid up capital of j^{th} industry in i^{th} year

As mentioned above, the blow up method requires information on the coverage of the sample in terms of the paid up capital or the blow up factor. While RBI provides the coverage[20] for the sample as a whole, it does not give such information for industry-groups or size-classes. This precludes any sectoral and structural analysis at the aggregate level. Alternate sources like the DCA and CCI may perhaps be used for arriving at blow up factor but they have their limitations.

Shanta [1991] had evolved an alternate to the blow up method. She proposed a method of estimation by taking the ratio of the variable to be estimated of newer companies (normally enlarged samples) to the older samples of overlapping year and multiplying it with the corresponding variable of previous years of the sample period.[21] After a series is constructed using this procedure, she linked it to the actual value of each variable for all companies available from RBI census data.[22] This method though overcomes the limitation of using paid up capital, as a blow up factor for all variables, is dependent on the availability of Census data.[23]

The main problem with this data source is that it is based on sample data and the sample size is changed every 5 or 3 years. So there are breaks in the series. Since it is sample data it is more suited for ratio analysis than for aggregate analysis. Ratio analysis deals with proportions and cannot reflect the magnitudes involved. It also precludes one from making a comparison of the relative position of the private corporate sector *vis-à-vis* other sectors of the economy. We have already explained the problems involved in building estimates for the whole. Secondly, the source of information for RBI is the Registrar of Companies and, in some cases, it takes direct recourse. This has not only rendered it difficult to do scientific sampling [DCA, 1998] but caused delay in the publication of results of the study at least by three years.[24] Data is also published for different subsectors at different times, which implies more delay for aggregate analysis.

ICICI and IDBI:

The Industrial Credit and Investment Corporation of India (ICICI) brings out an annual series titled *Financial performance of companies: ICICI portfolio.*[25] The companies covered are essentially those on its portfolio. The first of this series began for 1970-71 covering 543 companies including both public and private limited companies. Since 1976-77, only public limited companies are covered. The samples are distributed according to industry, size, and state. There are broadly 17 industry groups based on the United Nations 'International Standard Industrial Classification of all Economic Activity'. Gross fixed assets were the basis for size-wise classification.[26] The state wise classification is based on the location of units.[27]

The Industrial Development Bank of India (IDBI) also compiles accounts of its client companies in an annual volume titled *Performance of IDBI assisted companies in private sector.* Like ICICI, only those companies on its portfolio form its sample. These companies are public limited companies including joint sector companies directly assisted by IDBI.[28] The financial statistics are available industry-wise and state-wise. The basis for industry-wise classification is not clear. State-wise classification is based on location of the manufacturing units.[29]

While both sources have some similarities in terms of nature of information furnished, ICICI provides some more useful information, in particular, on industry-wise employment such as number of employees [skilled and unskilled] and man-days worked. This information, which is not available elsewhere, is very useful but the manner in which the data are given, does not allow one to use them fruitfully. Further, ICICI gives the coverage of their sample, but it is not given for all years. A bigger problem is encountered when one tries to make use of the information on employment. The data are collected for a sub-sample, part of, which is included in the larger ICICI sample, but not the whole.[30] For some years, information on these companies, which form part of the larger ICICI sample, are given separately, so that one could again make approximation to the larger sample and subsequently to the whole. But even this information is not given uniformly. The biggest problem arises when one comes to the data on man-days employed. No information on any other variable for this sample of companies that can be linked to other available information for the corporate sector is available.

Besides, the coverage of these two sets of data is limited since it relates to only those companies that have borrowed from them. It is also biased in favour of larger companies. The drawbacks of sample data for differing cohorts of companies for different years applies to this data set also. As in the case of RBI data this data set can be used for estimating aggregates only if appropriate blow up factors are available and, hence, more suited for ratio analysis.

Bombay Stock Exchange [BSE]:

In contrast to CMI/ASI, RBI, ICICI and IDBI data, BSE deals with company level data and can, therefore, be used for firm level analysis. The

BSE publishes financial statistics of individual companies in its *Stock Exchange Official Directory*. Every issue contains data for 10 financial years. The financial statistics provided also include Balance Sheets and Profit and Loss Accounts, and equity share, closing quotation on selected date, and highs and lows of equity share. Trend analysis of some worked out financial ratios is also presented.

Besides financial statistics, the directory also provides for each company information on the objectives and activities of the company, place of its incorporation, registered office and address, directors' name and some important dates and a description of the companie's activities over the years. To study at firm level, this is one of the best available sources of data, which can be obtained from the early 1960's. The main drawback of this data is that it is confined to quoted public limited companies only.

Centre for Monitoring Indian Economy [CMIE]:

The CMIE's provision of corporate statistics is larger in scope. It gives financial statistics and market shares. The publications of CMIE relevant for corporate analysis are *Key financial data on larger business units, Trends in company finance: industry aggregate, Statistical profile of 500 private corporate giants.* What is missing in the CMIE's publications is that information on any particular category is not brought out consistently. To illustrate, since June 1978, CMIE had been compiling financial statistics of companies in a volume entitled *Key financial data on larger business units.* Initially, they started with 750 companies of both private and public sector having sales of more than Rs 5 crore. This gives company-wise income and expenditure account, profit and their appropriation accounts, assets and liabilities, and total exports and imports. Besides, it also gives particulars such as name of the company and ownership, the major products of the company including their installed capacity and production,[31] the location of plants, the major projects on hand, and, board of directors. In January 1993, information was presented separately for top 500 giants covering five financial years (1985-86 to 1989-90) and other companies numbering 1986 covering three years (1987-88 to 1989-90). In January 1994, they brought out a separate volume titled *Statistical profile of 500 private corporate giants*, covering companies in the private sector only for five years (1988-89 to 1992-93). The last of this series was published in January 1995.

Since 1986, the CMIE also provided statistics at the industry aggregate level under the title *Trends in Corporate finance: aggregate results*, presenting results for five financial years. The data was culled out from *Key financial data of larger business units*. Initially they covered 48 industry groups, which was later on expanded to include 60 groups.[32] Aggregate results were presented for different types of ownership.[33] Selection of companies was based on the criteria that more than half of their sales/income was derived from mining and manufactured products. Since November 1992, only companies in private sector were covered under the title, *Company finance: industry aggregates*. This series included companies engaged in services and utility besides mining and manufacturing. The last one was published in November 1994.

Since April 1996, only one volume was brought out under the name *The Indian Corporate Sector,* which was later on changed to *The Corporate Sector* in July 1997. The latest one is available for April 1998. They cover eight years and provide statistics, mostly in the form of ratios by types of industry, ownership, age, and size.

The CMIE also gives data for about six thousand companies listed in BSE in its computerised database known as PROWESS (formerly CIMM). The great advantage of this data set is that it is computerised and is timely updated. It is useful for cross section analysis. Its utility for time series analysis now is limited because it is available only from 1988-89 onwards. From this data source, it is possible to gain a lot of qualitative understanding of a firm regarding the movements of its share prices, press releases, reports of board of directors, shareholding pattern, year of incorporation, capacity utilisation, and so on. Another advantage of PROWESS is that the companies could be classified according to predetermined criteria such as types of ownership, products, industry groups, year of incorporation and financial performance. Aggregate analysis is also possible. As PROWESS is the most currently diffused data set, some of the anomalies are being pointed out here to caution the users.

For instance, the R&D expenditures of firms in PROWESS (updated up to 06-04/99) are collected from the report of board of directors of respective companies. The R&D of TELCO are reported 0 in the PROWESS. The company, however, had R&D of Rs 68 crore for the financial year 1994-95.[34] Studies using R&D figure, as reported by PROWESS, would not consider TELCO for analysis because its R&D expenditure is reported to be 0. Given its importance in the segment of transport equipment,[35] results obtained using samples, which excludes TELCO, can be partial and misleading. Yet, another problem is with regard to classification. For instance, Maruti Udyog Limited is classified under Foreign Private Sector, but foreign equity share holding is given as 0. This has not only 50 per cent foreign participation but also an important player in the segment of passenger cars and jeeps.[36] The foreign participation is, however, mentioned in the background report. This requires that users have to read background report of each and every firm under consideration and is expected to have prior information as to which companies are the major constituents in an industry so as to avoid exclusion of that company from the samples. Thus, one has to be extremely careful while employing the data extracted from this types of data set without fully understanding not only limitations of the data set but definitions of variables. And also, it is suggested that the conclusion be generalised along with the caveats wherever necessary.

Finally, all these data sets based on financial statements of companies, wherein the variables are expressed in value terms, have certain limitations in common. While particulars of income and expenditure are at current prices, assets are reported at their historical prices and do not reflect the current value of the assets. This requires revaluing of assets, if they have to be related to any variable that is being expressed in current value. Balance Sheet information pertains to a particular point of time of a particular year (i.e., March 31) and is subject to window dressing. Again, financial statements are prepared based on Generally Accepted Accounting Principles (GAAP), conventions and some personal judgements. Users should be aware of the items liable to window dressing. Some of these items are inventories, trade credit, depreciation, intangible assets, and provisions. Methods used, while preparing financial statements, for valuing inventories, calculating depreciation etc. can have serious implications for fixed assets, working capital, and cost of production, profits, and rate of return. These have to be borne in mind by the users of these statistics. The users should, hence, be cautious in deriving conclusions from such data. It is suggested to confirm such conclusions by taking into account the performance of the industry in general or of other firms in the industry over time. Above all, the information given in the Balance Sheet and Profit and Loss Accounts is with reference to a unit of organisation and not with reference to a unit of production. This reduces its utility for studying production function or related issues.

Department of Company Affairs (DCA):

The main sources of data published by DCA are

1. *Directory of Joint Stock Companies published annually,*
2. *Quinquennial Directory of Joint Stock Companies,*
3. *Registration & Liquidation of Joint Stock Companies in India published annually,*
4. *Annual Report on the Working and Administration of Companies Act 1956, and*
5. *Company News and Notes published monthly.*

The Directory of Joint Stock Companies gives information on important financial variables such as paid up capital, reserves and surplus, total assets, net fixed assets, borrowing, turnover, profit before tax. It also distinguishes between government companies, MRTP companies, industry groups and state. Since this gives firm level information, identification of companies is possible. However, the utility of this information is lost because it is arranged in the alphabetical order of the name of the companies. It would have been much more fruitful if it was arranged state wise and would have facilitated preliminary level analysis at the state level before one could go in for detailed analysis of their respective balance sheets and profit and loss account. Of course, inclusion of more information on other variable is always welcome. It also gives a list of branches of foreign companies. The last series published was in 1990. The data are now available only on CD-ROM and can be obtained on request [DCA, 1988]. This can take care of the some of the problems with the printed data.

The annual publication *Registration & Liquidation of Joint Stock Companies in India* contains complete list of companies registered and liquidated during the respective financial years. Like the Directory, it also gives various particulars of the companies registered, including their names, registered address, State in which registered, industrial classification code, date of registration and authorised capital. List of companies which went into liquidation or whose names were struck off under section 560 of the Companies Act 1956 is also provided.

The Annual Report gives very useful information. Data relating to registration of companies are provided in terms of number of companies and authorised capital. And, they are by region, by public or private, activity-wise[37] and size-wise.[38] The main limitation of this data is that since activity-wise state-wise registration of companies is not available, one cannot distinguish between financial and non-financial companies for state level analysis. Although, the *Statistical Abstract* published by CSO provides data on Joint Stock Companies newly registered according to activity and state,[39] it does not distinguish between government companies and non-government companies. The *Company News and Notes* gives registration of companies state-wise.

As regards companies at work, the Annual Report gives state-wise and activity-wise information relating to number of companies and paid up capital. But size-wise data is not given. Unlike newly registered companies, information is not available activity-wise state-wise. A state-wise analysis of distribution of companies according to activity is, thus, not possible.

Other Sources:

Besides these, there are other sources of data, which give information on matters relating to the private corporate sector. For example, the *Kothari's Industrial Directory of India* [Kothari Enterprises, 1996] is available since 1936 and serves as a useful document to understand the growth of the private corporate sector in a historical perspective. It gives the various regulations promulgated from time to time with regard to industry, company taxation, stock exchanges, etc. In addition, it gives detailed write up of several industries along with brief statistics relating to individual companies. While the statistics for each company is limited and not suitable for detailed analysis, the facts regarding the industry are very useful and serve to supplement firm-wise analysis based on other sources.

The *Industrial Databook* of Centre for Industrial & Economic Research [1998] New Delhi, provides information relating to installed capacity, annual production, sales, equity, and gross profit of a large number of individual firms. While this databook classifies firms according to the industry group they belong to, it does not distinguish between private and public sector companies.

It is also possible to get information from various chambers of commerce and industry and trade associations. For instance, the *ASSOCHAM Parliamentary Digest* published by Associated Chambers of Commerce and Industry in India (ASSOCHAM) is a vital source of information about policy changes related to trade, industry and other spheres affecting corporate sector, industrial growth, foreign investment, and so on. This is based on the questions and answer of

Parliament sessions. Researchers interested in industry case studies can obtain information related to a particular industry from the associations concerned and use them to supplement the analysis based on other sources of data.[40] The EPW Research Foundation, Mumbai collects company data and periodically publishes them in the *Economic and Political Weekly* [EPW Research Foundation, 1988, Pp. 1,271-84]. The Institute for Studies in Industrial Development [ISID] in New Delhi collects companies' data from their respective annual reports. It is made available on request and is used for firm-level analysis [Basant and Fikkert, 1996, Pp. 187-99].

SECTION 2

How has each of these data sources been used?

The above mentioned sources of data formed the basis for a number of studies of both private corporate and non-private corporate characteristics of Indian industry. Studies have used ASI data for understanding the growth trends, relative performance, and relative position of the private corporate sector in India [Bardhan, 1984; Chandra, 1991, Pp. 685-687; Majumdar, 1995, Pp. M-25 -M-32; Shanta, 1991]. But, studies based on this source have been very few. The RBI database is the most widely used and has been employed to analyse trends in capital formation, savings, sales, value added, profitability, corporate financing and investment behaviour, import intensity and export performance, and so on.[41] It has been used for building up aggregates as well as for ratio analysis. The RBI also makes available unpublished firm-wise data on request, which have been used to examine various issues like market structure, productivity, profitability, and performance [Kambhampati, 1996; Kumar, 1994; Srivastava, 1996]. The ICICI and IDBI data have largely been used by the respective institutions to analyse trends in capacity utilisation, export performance, and productivity. The BSE data have been used to analyse growth, factor productivity's, and investment behaviour of specific industries at firm level [Anandaraj, 1987; Krishnamurthy and Sastry, 1975; Shanta, 1994b]. The CMIE PROWESS data is currently widely used more for firm level analysis to study issues like factor productivity's, export and import intensity, R&D intensity, foreign collaborations, impact of FDI on R&D, technology and productivity, and so on. The DCA data, while used in combination with other sources of data, has been mostly used for departmental analysis. The issues studied include registration and liquidation of companies, amalgamations, take-overs and mergers, operation of MRTP Act, cases of restrictive trade practices, capital issues and so on. These studies generally appear in *Company News and Notes* of DCA and are mostly authored by Officials of DCA.

With liberalisation, Indian industrial sector is likely to undergo structural changes. In this context, issues which become important are capital structure, investment behaviour, cost structure, wage structure (wages *vis-à-vis* managerial remuneration), R&D intensity, advertising intensity, FDI, technology spillover, foreign exchange earnings, import and export intensity, mergers, amalgamations, take-overs and acquisition, profitability, competition, employment, and so on. These issues can be studied separately or in conjunction with one another. Choice of a particular data source depends both on its suitability to answer the questions analysed and on its availability. Firm-wise data are often found more used in this context. As it has already been pointed out, the users have to understand the limitations of these types of data in drawing generalised conclusions.

SECTION 3

Suggestions for improving the database:

Much more structural analysis of the private corporate sector is possible using these sets of data in isolation or in combination. This could be gainfully and more easily achieved if the limitations of the data are overcome and the gaps filled. In the light of this, we have the following suggestions to make.

The ASI's statistics by type of ownership / organisation could be made available industry-wise and state-wise to facilitate state-wise and industry-wise studies. The CSO could widen the pool of information in ASI to include capital structure, export, import, foreign exchange earnings, etc taking into consideration the new demands for data. It would be useful if data are given along with definitions of each category of organisation and ownership.

As regard the RBI database, it is necessary to have systematic information on blow up factor for different subsector, industry groups and size classes. Size class could be defined in terms of net assets, as it is a better indicator of size than paid up capital. Size-wise and industry-wise information for private limited companies that are available with RBI could be published. As census provides benchmarks, RBI should continue to conduct census of public limited companies at least once in 5 years and extend its coverage to private limited companies and foreign companies. The studies of branches of foreign companies should be revived, considering the importance of this sub-sector under globalisation. Detailed industry-wise data for both foreign controlled and branches of foreign companies are equally important in this context.

In addition to the existing information, RBI could give more information on employment, man-days, and capacity utilisation, and distribution of samples by state and year of incorporation. We understand that these information are available with RBI. In the wake of financial liberalisation, it is important to make the sources of funds as explicit as possible. It would be useful to have institution-wise instruments-wise sources of funds. Further, study of foreign assets and liabilities and transactions in foreign currency of Indian companies becomes equally important to analyse the performance of Indian companies under globalisation. Attempts could also be made to reduce the time lags involved in the publication of the RBI studies.

Some rare information on employment, man-days worked, etc. is provided in ICICI, but only for sub samples. It would be useful to give blow up factors clearly for all the samples and for the sub samples in relation to the large samples. This would improve the utility of the information provided. The IDBI could also provide such information of those companies assisted by them.

The BSE Official Directory gives data for some companies relating to capacity, quantities produced, shareholding pattern, business group to which they belong to, and so on. Once this information is made available uniformly and for all companies, inter-firm and inter-industry comparisons could be made. Attempts could also be made to add information on exports, imports and employment, and to provide more details of financial particulars.

The information presented by CMIE in PROWESS should be complete across all companies. The missing values should be pointed out by some method in stead of the current practice of putting '0s' and anomalies taken care of. Again it would be useful to give a detailed break up of the foreign share holding pattern of a company.

The DCA could provide paid up capital of companies at work, activity-wise by size and by state. The size class of above Rs 1 crore could further be divided into various sub-groups. This would enable building up of aggregate estimates based on other sources of data like RBI and to carry out structural analysis. The revised figures of paid up capital activity-wise, state-wise and size-wise should be given. Now we get only the provisional figures for this break up, whereas paid up capital as a whole is revised.

Our survey of the database has made it clear that analysis of certain crucial aspects of corporate sector is handicapped due to non-availability of firm-wise data on certain aspects. In particular, mention may be made of the lack of data on shareholding pattern, employment details and firm estimates of revaluation of fixed assets. It may be mentioned that divulgence of these types of data need not necessarily affect the inter-firm competitive position. It is, therefore, legitimate for a researcher to feel that firms should be willing to provide such micro level data, which can be used for analysing the corporate performance, behaviour, etc. that will have policy implications for corporate development. The authors would venture to suggest that the government might even consider amendments to Companies Act or other relevant legislation making it mandatory for companies to divulge these particulars as additional information in the report of board of directors.

Further, it is also useful if a central agency compiles and presents annual accounts of companies following a uniform method. Shetty [1998b] had suggested constituting a Statistical Authority of India. If constituting a new institution is expensive, we would even suggest that RBI, being the apex body of the financial system, could require all financial institutions including Development Financial Institutions and Commercial Banks to supply information relating to companies assisted by them. Almost all companies have a link with financial institutions and, hence, obtaining information through these institutions is possible. Once this method of obtaining information is followed and codified, it would not only be possible to gather other-wise rare information like employment, capacity utilisation, share holding pattern and so on for a larger number of companies but helps to reduce the delay in the compilation of data. State level information on the corporate sector with implications for regional development assumes significance. Attempt could be made to collect state level information through State Level Financial Corporations.

Summing Up:

In the context of liberalisation, study of the private corporate sector has assumed significance. This requires a sound database. Our review showed that the different data sources contain a variety of useful information, although sometimes wanting in comprehensiveness, timeliness and accuracy. A major lacuna is that firm-wise data are not available in respect of private limited companies, excepting with RBI. To strengthen the utility of the private corporate statistics on the whole, it is suggested to collect as much information as possible both physical and financial, taking into consideration the new requirements for information consequent to the globalisation of the economy. Firm level / state level / industry level / size-wise data is what one should aim at, complemented with periodic censes. The growing significance of comparative studies of foreign and domestic firms underlines the need to gather information on foreign companies and their activities, that is, industry-wise information on foreign companies will be useful. Given the extreme competition between states for wooing foreign investment, state level information on the corporate sector with implications for regional development has also become very important. In this context, it may be worthwhile to constitutionalise collection of data under a single agency.

Appendix 1

Principal Characteristics by Type of Organisation (since 1988-89):

1. Individual Proprietorship
2. Joint Family (HUF)
3. Partnership
4. Public Limited Companies
5. Private Limited Companies
6. Government Department Enterprises
7. Public Corporations
   Corporate Sector [4+5+6+7]
8. Co-operative Societies
9. Others

Principal Characteristics by Type of Ownership (since 1988-89):

1. Wholly Central Government
2. Wholly State/local Government
3. Central and State/local Government Public Sector [1+2+3]
4. Joint Sector - Public
5. Joint Sector - Private Joint Sector [4+5]
6. Wholly Private
7. Unclassified

Format Obtained by Combining Data by Type of Organisation and Ownership:

1. Wholly Private
2. Individual Proprietorship
3. Partnership
4. Co-operative Societies
   Private Corporate Sector [1-(2+3+4)]

NOTES

1. The data relating to savings and capital formation published by Central Statistical Organization (CSO) in the National Accounts Statistics is an exception.

2. While the data base relating to industrial statistics is, of late, receiving special attention of several researchers [EPW Research Foundation, 1998; Ghosh, 1998; Maulik, 1998; Nagaraj, 1999, Pp. 350-55; Pradhan and Saluja, 1998, Pp. 1,263-70], little attention has been paid to data by the type of industrial organization, particularly the private corporate sector. Studies which did concentrate on the data base of the corporate sector such as that of Barman [1998], Department of Company Affairs [1998], and Shetty [1998a] have not adequately brought out the limitations of the data or identified the gaps in the data.

3. The CSO, while providing information on savings and capital formation by types of institutions, defines private corporate sector to include non-government financial and non-financial public and private limited companies, and cooperative institutions. While presenting Flow of Funds account, the RBI defines private corporate sector as consisting of the private corporate business sector and the co-operative non-credit societies. The former includes non-government non-financial public and private limited companies (including foreign controlled rupee companies) registered under the Indian Companies Act 1956, and branches of foreign companies operating in India. See, the Supplement to RBI Bulletin, December 1988.

4. There were 5 types of ownership, namely, Individual Proprietors, Partnership Firms, Private Limited Companies, Public Limited Companies, and others. Although CMI uses the term 'by type of ownership', it would be more appropriate to use 'by type of Organization'.

5. The CSO uses RBI data for estimating capital formation and savings of private corporate sector. The Flow of Funds (FoF) account for private corporate sector is also based on RBI sample studies. The FoF account provides aggregate data on the sector-wise (including for the private corporate sector) and instruments-wise sources and uses of funds.

6. Large companies were those with paid up capital of more than Rs 1 crore. First of this survey appeared in RBI Bulletin October 1971, covering the second half of 1965-66 to 1969-70.

7. Small companies were those with paid up capital of less than Rs 5 lakh. This survey was available for financial years from 1956-57 to 1975-76.

8. This was available for financial years from 1963-64 to 1975-76 and covered companies with paid up capital of less than Rs 5 lakh.

9. Foreign Controlled Rupee Companies (FCRC) are Indian joint stock companies which are subsidiaries of foreign companies. These are companies in which 40 per cent or more of the equity capital is held outside India in any one country and companies in which a foreign company or its nominees hold 25 per cent or more of the equity capital. This survey excludes Banking, Insurance and Government companies. These companies also form samples of the regular studies on public and private limited companies. Branches of Foreign Companies (BFC) are those not registered under the local law. The statistics on FCRC and BFC used to appear together and was available for financial years from 1957-58 to 1980-81. Since then, only the Finances of FCRC are published. With the enforcement of FERA 1973, which required foreign companies to convert themselves into rupee companies [Kumar, 1994], number of BFC has reduced significantly and this consequently affected the coverage. May be because of this, the RBI has stopped survey of BFC [see RBI Bulletin, August 1984: p. 298]. The last of the series of FCRC has appeared for the year 1990-91, published in RBI Bulletin, November 1994. The latest study in this series is entitled 'Finances of FDI companies: 1993-94', published in RBI Bulletin, March 1999. Information on foreign investments can be collected from the survey of 'Indian Foreign Liabilities and Assets' as well. The last of this is available for the year 1994-95, published in RBI Bulletin, April 1998.

10. This series is rather a new one, the first of which was published in July 1995. The latest one is available for the financial year 1997-98 published in January 1999. This article is based on the abridged audited / unaudited financial results of companies collected from financial/news dailies and The Stock Exchange, Mumbai. The study covers non-governmental non-financial public limited companies. As limited information is provided, this series could be considered as a guidepost. This series is not discussed.

11. Unlike medium and large companies, studies on small companies did not have a quinquennial series. They were for two years.

12. For instance, distribution of sample according to year of incorporation is not known and, hence, the age composition of the sample cannot be gauged.

13. The industry-wise classification of sample companies was based on the Standard Industrial Classification of All Economic Activities as adopted by Government of India. Accordingly a company with more than one activity is classified under that industry from which it derived more than half of its sales or main income according to the latest information available at the time of its inclusion in the studies.

14. The size wise classification of sample companies was based on their paid up capital and was available from the accounting year 1959. Size-wise data is available only for Public Limited Companies. A quinquennial series following size-wise classification based on net asset is available for some years from the financial year 1965-66 [see RBI, 1975].

The size classes of paid up capital consists of Rs 5 lakh to Rs 10 lakh, Rs 10 lakh to Rs 25 lakh, Rs 25 lakh to Rs 50 lakh, Rs 50 lakh to Rs 1 crore, and Rs 1 crore and above. Since 1970-71, some new size classes were added. They are Rs 1 crore to Rs 2 crore, Rs 2 crore to Rs 5 crore, Rs 5 crore to Rs 10 crore, Rs 10 crore to Rs 25 crore and Rs 25 crore and above.

15. They are 1) Agriculture and allied activities; 2) Mining and quarrying; 3) Processing and manufacture - foodstuffs, textiles, tobacco, leather and products thereof; 4) Processing and manufacture - metals, chemicals and products thereof, 5) Processing and manufacture - not elsewhere classified; and 6) Other industries.

For Small Public/Private Limited Companies, industry level data is not available.

16. Controller of Capital Issues (CCI) used to furnish data on the capital raised by private sector. Between DCA and CCI, Rangarajan and Patel [1979, Pp. 153-164] rejected DCA data in favor of CCI because they observed some amount of inconsistencies of DCA with that of RBI. For example, the

total paid up capital for public limited companies for 1971-72, after making adjustment, was found to be almost equal to that of sample companies of RBI, whereas RBI claimed only 80 per cent coverage of paid up capital.

17. This method, thus, assumes a linear relationship between individual items of company accounts and paid up capital.

18. The RBI uses this in their Flow of Funds account.

19. Another method of blowing up used by Roy Choudhury [1992, Pp. 599-653] can also be followed. In the RBI sample survey, information is given for a common year for two consecutive samples. Roy Choudhury uses this common year and adjusts the sample results. The process followed is to take an adjusting factor which measures the difference in the sample results for the common year in consecutive surveys, that is, adjusting the sample data to larger samples and ultimately blowing up to the total. She argues that since sample size has been gradually increasing, if one starts with a recent survey, then such exercise involves a series of adjustment beginning with the most recent overlapping years. This adjustment factor has to be obtained separately for each variable and adjusted accordingly. This makes the whole series comparable over time having adjusted for gradual increase in sample size and having made use of data for common years. Having adjusted the data and constructed a series, she uses blow-up factor based on paid up capital to arrive at aggregate estimates.

20. The RBI gives its coverage in terms of paid up capital based on DCA's figures, which is likely to change along with DCA revision. Hence, care should be taken while comparing RBI's claim with the DCA's revised figures.

21. This method assumes that the variable of the enlarged sample change exactly in the same direction and at the same rate as that of the older sample through the year t-4 to t-1.

22. This method and the one suggested by Roy Choudhury crucially depend upon a condition that the newer series needs to be larger than the previous series. Once this condition is not satisfied, the numerator would be smaller than the denominator and, thereby, smaller adjusting factor which eventually deflates the series.

23 The RBI has published Census of Public Limited Companies for the account years 1970-71 and 1971-72, 1975-76, and 1980-81 and 1981-82. This was an extremely useful source of data. Detailed information, size-wise and industry-wise was also available. Since then, this has been discontinued. This needs to be revived, at least for providing a benchmark.

24. The latest study published in November 1998 covered the financial year 1995-96. The latest survey of public limited companies accounts for, in terms of paid up capital, 28.8 per cent of all non-Government non-financial public limited companies as at the end of March 1996 [RBI Bulletin, November 1998]. This coverage used to be above 80 per cent in the initial years.

25. The other important publications of ICICI include 'Capacity Utilization in the Private Corporate Sector' and Productivity in Indian manufacturing: Private Corporate Sector.

26. Till the 1982-83 series, the size class were as follows: Rs 1 crore and below; Rs 1 crore to Rs 5 crore; Rs 5 crore to Rs 10 crore; and Rs 10 crore and above. Since 1982-83, these size classes were changed and remain as follows: Rs 5 crore and below; Rs 5 crore to Rs 20 crore; Rs 20 crore to Rs 50 crore; Rs 50 crore and above.

27. In the case of multi-plant firm, having plants in various states, the state where a unit, having largest share in the total turnover is located is treated as the state, where the company belongs. For the service activities, the location of head office is considered. State-wise data are not available since 1990-91.

28. Assistance includes schemes for Project Finance, Soft Loan, and the Technology Development Fund.

29. In the case of multi-product companies with plants in different states, the location of unit assisted is taken into consideration and in case more than one unit is assisted, the location of the unit having largest share of assistance is taken into account.

30. Due to gaps in the category wise data or because of not getting enough or timely reply from sample companies, some companies which are normally included in the particular series are excluded. The number of companies for which this information is available is, thus, lesser than the number for which other financial statistics are available.

31. The engineering concept of capacity utilization, that is, production to installed capacity, can, thus, be worked out at the firm level.

32. If a product contributes more than half of the company's gross sales, it is clubbed into the industry group to which the product belongs. Those companies that could not be classified were grouped under a category called 'diversified groups'.

33. Two broad classifications include public sector and private sector. The latter is divided into Indian and Foreign. The Indian private sector is further divided into large houses and other companies.

34. See Department of Science and Technology, 1996, p. 88.

35. During the year 1994-95, TELCO's market share was 70 per cent in medium and heavy commercial vehicle, 59 per cent in light commercial vehicle, and 10 per cent in passenger cars [CMIE. 1998. Pp. 455-457]

36. During the period between 1991-92 and 1996-97, Maruti Udyod Limited accounted for 67.94 per cent (CV was .02) of market share in passenger car and 13.1 per cent (CV was .28) in jeeps [CMIE, 1998, Pp. 458-460].

37. The major activity groups are: 1) Agriculture and Allied Activities; 2) Mining & Quarrying; 3) Manufacturing: 3a) Foodstuffs, Textiles, Wood Products, Leather and Products thereof; 3b) Metals and Chemicals and Products thereof and Machinery and Equipment; 3c) Electricity, Gas and Water; 4) Construction; 5) Wholesale and Retail Trade and Restaurants and Hotels; 6) Transport, Storage and Communication; 7) Finance, Insurance, Real Estate and Business Services; 8) Community, Social and Personal Services.

Wholesale and Retail Trade and Restaurants and Hotels included finance until 1989-90 since when this was clubbed with Finance, Insurance, Real Estate and Business Services

38. The size classes are: 1) Below Rs 1 lakh; 2) Rs 1 lakh to under Rs 5 lakh; 3) Rs 5 lakh to under Rs 10 lakh; 4) Rs 10 lakh to under Rs 25 lakh; 5) Rs 25 lakh to under Rs 50 lakh; 6) Rs 50 lakh to under Rs 1 crore; and, 7) Rs 1 crore and above.

39. The information was based on the returns received from Registrars of Joint Stock Companies.

40. Addresses of these associations are available in Kothari's Industrial Directory of India [Kothari Enterprises, 1996]

41. See. Anand, 1995; CSO; Krishnamurthy and Sastry, 1975; Mani, 1991, Pp. 1,693-96; Misra, 1989; Raja Kumar, 1995, Pp. 647-60; RBI; Rangarajan and Patel, 1979, Pp. 153-64; Roy Choudhury, 1996; Shanta, 1991; Sharma, 1991, Pp. 59-109; Siddharthan, 1989, Pp. 103-11; Subrahmanian, 1987, Pp. 420-46.

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DOCUMENTATION

The purpose of this section is to make available to the readers official documents such as reports of committees, commissions, working groups, task forces, etc., appointed by various ministries, departments, and agencies of central and state governments which are not readily accessible either because they are old, or because of the usual problems of acquiring governmental publications, or because they were printed but not published, or because they were not printed and remained in mimeographed form. It will be difficult and probably not worthwhile to publish the documents entirely. We shall publish only such parts of them as we think will interest our readers. The readers are requested to send their suggestions regarding official documents or parts thereof for inclusion in this section.

In the present section we publish:

1. Report on The Regulation of The Stock Market in India, 1948, (One man Committee: P. J. Thomas), Government of India, Ministry of Finance.

2. Report of The Study Group on Financing of The Private Corporate Sector in The Sixth Five Year Plan (Chairman: C. Rangarajan), India, Planning Commission, 1982 (mimeo).

3. Report of The High-Powered Committee on Stock Exchange Reforms (Chairman: G.S. Patel), India, Ministry of Finance, 1986.

4. Report of The High-Powered Study Group on Establishment of New Stock Exchanges (Chairman: N. J. Pherwani), India, Ministry of Finance, June 1991.

5. Report of The Committee on Review of Disclosure Requirements in Offer Documents (Chairman: Y.H. Malegam), Mumbai, Securities and Exchange Board of India, June 1995.

6. Securities and Exchange Board of India (Foreign Institutional Investors), Regulations, 1995.

7. Report of The Committee on Corporate Governance, (Chairman: Kumar Mangalam Birla), Mumbai, Security and Exchange Board, India, 1999.

REPORT ON THE REGULATION OF THE STOCK MARKET IN INDIA (One man Committee: P. J. Thomas), 1948

[Extracts from this report, partly from the summary of chapters given in chapter XII of the report and partly from the text, are reproduced below]

CHAPTER I. HISTORY AND PRESENT POSITION OF THE STOCK MARKET (SUMMARY)

Although the first stock exchange in India was started in 1877, only three cities in India had stock exchanges in 1933. Since then Progress has been rapid, especially during World War II; today eight cities in Br. India have exchanges (and two in Indian States), and the number of stock exchanges in Br. India is 18, with a total membership of about 2,500 (Paras 3-24).

The stock market in India is at present in a confused condition. In many of the leading cities of India there is a strange medley of stock exchanges, street markets and independent firms all competing with one another for trade in the same securities - a situation which cannot arise and will not be tolerated in any civilised country today. Nor is each city confining itself to one stock exchange, as is the recognised custom in Europe and America; in two Indian cities there are as many as three or four stock exchanges working in the same street or mohulla, trading in the same securities and competing with one another. Another undesirable feature is that several of the stock exchanges permit trade not only in stock but also in bullion and commodities, thereby creating serious complications (Paras 25 to 46).

CHAPTER II. CONSTITUTION AND MANAGEMENT OF STOCK EXCHANGES (SUMMARY)

Stock exchanges in India are either unincorporated, private registered associations (as in Bombay and Ahmedabad) or, joint stock companies (like the Calcutta Stock Exchange). While the membership of the former is acquired by the purchase of a card, the holding of a share is essential for the membership of the latter. The liability of most of the company exchanges is limited by shares; of two by guarantee. There are certain peculiar features attaching to the shares of the stock exchange companies (Paras 3-8).

Although some of the member-firms in Bombay and Calcutta can hold their own with similar firms in London or New York, the great majority of members of the Indian stock exchanges are ill-equipped for discharging the heavy responsibility falling on them as brokers, and as investment advisers of the public (Para 17).

Members of Indian stock exchanges are not divided into brokers and jobbers, and efforts in the past to raise up a class of jobbers have not succeeded (Paras 21-23).

Some of the members on the Bombay Stock Exchange do tarawani work; their business is of parasitical nature and causes excessive speculation (Para 24).

The speculative practices of remisiers or 'half-commission' men have also brought the stock market into disrepute (Para 26).

The managing boards of stock exchanges are elected once a year from among the members of the general body. On the Calcutta Stock Exchange separate seats are set apart for Europeans, Marwaris, Bengalees, etc. There is no outside representation on the governing boards of stock exchanges (except Hyderabad Stock Exchange) (Paras 27 and 28).

Complicated problems have arisen in connection with the management of company stock exchanges, due chiefly to the directorate of the company being also managing board of the stock exchanges (Paras 29 and 30).

Only two stock exchanges in India have well defined and fully written rules approved by a Government. Others have rules drawn up by the directorate of joint stock companies. There are yet other exchanges with partly written and partly unwritten rules. Outside markets work entirely under convention and usages (Paras 32-37).

The listing regulations of the Bombay and Ahmedabad stock exchanges are fairly complete. The Calcutta Stock Exchange has also got some listing regulations. In the case of other exchanges the securities to be traded in are decided by the governing boards (Paras 38-41).

CHAPTER III.
THE SECURITIES, THEIR NUMBER, VALUE AND DISTRIBUTION (SUMMARY)

The data available regarding Indian securities are inadequate, as no organised effort has been made to collect and collate them systematically (Paras 1 and 2).

The public securities traded in the Indian stock market are the Central Government Loans (non-terminable and terminable), Provincial Government loans, Municipal loans, Port Trust loans, Improvement Trust loans, Indian State loans, etc. (Para 4).

Of the 14,859 companies working in March, 1945, with a paid-up capital of Rs 388.97 crore, only issues (ordinary, preference etc.) of about 1,125 companies are listed on one or the other stock exchange. Of these 1,057 companies (1,506 issues) have a paid-up capital of Rs 270.40 crore (Paras 6 and 7).

Of the 14,859 Joint stock companies in India, 7,851 were trading and manufacturing companies, 2,434 were banks, 1,253 were mills and presses, 896 were transports, 701 plantations and 518 were hotels, accounting in all for 92 per cent of the grand total. They accounted for 86 per cent of the total paid up capital of all joint stock companies.

8. Listing is given not only to ordinary shares but also to deferred and preference shares and debentures. The issue of preference shares is fairly common among Indian companies, but this is most pronounced in the case of jute and cotton companies. Most of the jute companies have issued preference shares and in the case of a large number of them such shares form nearly half the capital. On the other hand, only a few of the coal companies issue preference shares and in the case of banks and railway companies, issue of preference shares is very rare. Deferred shares, known also as founders' shares, receive no dividend until preference and ordinary shares have been paid their prescribed respective dividends. In India, as will be shown in a later chapter, deferred shares have lately been used to give too disproportionate a voting power to promoters or founders of companies or underwriters.

9. Of a different category are bonds and debentures, which are creditorship securities. When a specific property is mortgaged for a loan the security is termed 'bond' while if the security of the loan depends on the general credit of the issuing company it is called 'debenture'. Bonds are very common in the U.S.A. In India debentures are more used, but even these are not very popular.

Information on listed companies on stock exchanges was available for 969 out of the 1957 companies listed.

The total number of issues listed on the New York Stock Exchange at the end of February 1947 was only 1,343 (less than that on Indian stock exchanges), the total number of shares came to 1986 million and their total market value 68,839 million dollars (about Rs 20,700 crore). The total market value of all listed shares in India came to only Rs 971 crore in March 1947.

On the Calcutta Stock Exchange are listed 864 issues (of which 647 are ordinary issues) of 629 companies. In recent years increase has been seen chiefly in regard to sugar mills, electrical companies, miscellaneous, etc. (Paras 13 and 14).

Since the outbreak of World War II, security prices have risen about four times, the highest rise being in cotton textiles shares, jute shares engineering shares, coal shares and chemical shares.

The aggregate values of securities, which stood at 55 per cent above par value at the outbreak of war rose to 436 per cent above par values in the middle of 1946, but have since fallen greatly (Paras 16-19).

It is not possible to state how the ownership of securities is distributed between different sections of the population. But it is certain that they are held mostly in the larger cities and by business or professional classes (Paras 19 and 20).

No doubt, more men of limited incomes have come to own securities lately, but no accurate data can be gathered regarding this (Para 21).

CHAPTER IV.
OPERATION OF THE SECURITY MARKET

While the stock exchanges of Calcutta (except one), Lahore (5), Nagpur and Delhi confine themselves to cash dealings, exchanges in Bombay, Ahmedabad, Madras and Cawnpore and one company exchange in Calcutta permit both cash and forward dealings. The curb markets generally follow the system in the nearby stock exchange (Paras 3-9).

The Operation of Cash Dealings

12. As has already been shown, all stock exchanges in India as also the outside markets provide for cash dealings. The rules of the organised exchanges require that the settlement of cash transactions should be done by delivery of scrips and payment of price within a specified short period. If delivery or payment fails, the buying-in rule or selling-out rule as the case may be, is to be applied as will be explained later. The period for delivery and payment varies from exchange to exchange and even on the same exchange the practice differs according to the class of securities.

The Operation of Forward Dealings

18. Briefly the operation of forward transactions is as follows:- When the dealings are 'for the account' the contracts are to be fulfilled only on the settling day for which they are made. The settlement may be done either by delivery and payment or by differencing at the 'making up' price, on the reversal of the contract. If either of these methods is not resorted to the contract can be *budlied* by mutual agreement to the subsequent settlement. Settlement days for a year are prescribed, and fixed sufficiently apart to provide a long period. The long period is a vital facility for a future market. In the long period, the price may fluctuate and a dealer can take advantage to match a contract for purchase or sale, by a corresponding contract for a resale or repurchase, either to make a profit or to cut his loss. Therefore, these transactions are called 'time bargains'. Among the members the closing of the deal, through the clearing houses, can only be done at the settlement. But in dealings between a member and his client closing can be done before the settlement on the exchange, with a view to reducing the debit balance. It is these three facilities, namely, the long period, settlement by differencing, and *budla*, which lure people to indulge in excessive and unhealthy speculation.

(i) Contracts

20. Contract plays a prominent part in security transactions, especially in the speculative trade. As the losing parties are likely to dodge the fulfilment of transactions, it is necessary to render the agreement for transaction or bidding valid and bonafide, conferring claims or rights on both parties. Besides, any control of speculation has to start with a control of contracts.

21. On organised exchanges, the first step in a transaction, whether purchase or sale, is the contract between the parties concerned. No transaction can be recognised by an exchange without a contract in the prescribed form. This is essential whether the transaction is between member and member within the exchange or between member and non-member outside the exchange. The contract note should show the nature and terms of the transactions and should be duly stamped in accordance with the Law of Contract. A contract note given by a member-broker to a non-member client is always found to have a condition that it is subject to the rules of the exchange of which the former is a member. This practice is found prevalent even where the rules are not written and published.

22. In some cases like the Madras Stock Exchange, the rules of which are written, an additional condition that the contract is subject to the usages of the exchange is seen with a view to making the position of the member safer than that of the client. There are 4 forms of contract, either prescribed by rules or adopted by usages: (i) contracts for settlement issued by members acting for constituents as brokers; (ii) contracts for settlement issued by members acting with constituents as principals; (iii) ready delivery contracts, members acting as brokers; and (iv) ready delivery contracts, members acting as principals. In the latter three cases, whether between members or between members and non-members, brokerage, an important factor adding to the price, is never separately mentioned. Thus a knowledge of the brokerage added to the price, is denied to the public, as well as the authorities of the exchanges. Yet, such contracts are found officially prescribed even by exchanges whose rules are approved by a Provincial Government. In practice, contract between members, on exchanges, whether by usages or by rules (as in Madras), are always done as principals. Besides, contracts in genuine form are never passed between members. 'Memos' or 'notes' are substituted for formal contracts and the practice is recognised by every exchange. Such methods are adopted only to circumvent the rules regarding contract stamps. Concerned about the loss of revenue, the Bombay Government issued a notification directing that even the memos should be stamped *ad valorem* in accordance with the Contracts Act. But, the action does not appear to have been successful. As matters stand, genuine contracts duly stamped, are being passed only between members and their clients outside the stock exchange. Nevertheless, on two recognised stock exchanges of Bombay Province, for transactions passing through their Clearing Houses, the presidents used to help the Government in getting the stamp duties. It is doubtful if this service was rendered fully after the promulgation of D.I. Rule 94C. Thus almost all the transactions between members on stock exchanges and the entire volume of transaction on the curbs, are being done without proper contracts duly stamped.

(ii) Settlement and Clearance

23. Contracts, whether for cash or for the account, are fulfilled through settlement. The mode of settlement has an important bearing on the regulation of stock dealings. Settlement within time limits is essential to prevent accumulation of liabilities of dealers. If liabilities are allowed to accumulate dealers may find it difficult to discharge them later and thus may lead the market to a crisis. Settlement is to be made in some exchanges according to written rules, and in others according to rules and usages. In curb exchanges and unorganised share bazaars, there are only a few unwritten rules for this purpose. We have seen that the contracts between members and non-member clients are subject to the rules or usages of the exchange to which the former are attached. Hence the settlement between them too ought to be done according to the practice on the exchanges.

24. The way of settlement and the facilities afforded for the purpose are the most important factors which regulate the speculative activities of the members as well as the public. For example, if members are to take or make delivery in a short period of all their purchases or sales, large funds will be required and this may deter them from doing too many transactions. Whereas, if they are allowed to settle the bargains by some device, without taking or making delivery or full payment, it will encourage them to do excessive speculation. Similarly, if compromise between defaulters and creditors is permitted it is bound to encourage much undesirable speculation.

25. The arrangements and the procedure for settlement are found to vary among the exchanges. On some exchanges like the Native Stock and Share Brokers' Association, transactions in some securities are to be settled through the agency of the exchange, while the rest are to be settled only with the knowledge of the exchange. On the Calcutta Stock Exchange,

though a portion of the transactions are settled through the agency, the rest are fulfilled independently of the machinery and knowledge of the exchange. On others like that of Madras, the entire settlement is done independently of the machinery and knowledge of the exchanges. In the latter two cases, an exchange is only to intervene and enforce remedial measures in accordance with the rules of delivery and payment when failure is reported. Where the transactions are settled through the agency, the exchange has provided a clearing house. Of the 21 exchanges in the country only three are now provided with clearing houses-the Bombay Stock Exchange from 1921, Ahmedabad Share Brokers' Association from 1925 and Indian Stock Exchange (Bombay) from 1937. The Calcutta stock Exchange had made arrangements for clearing 4 or 5 securities from 1944 December, but this arrangement was discontinued in 1946. Even on the three exchanges, clearing is limited to a very few active counters as shown in para 9. Clearing arrangements in Calcutta have since been discontinued.

As the mode of settlement differs with the nature of the market, the subject may be dealt with separately under cash and forward markets.

Settlement of Cash Dealings

26. Ready Delivery Contracts enjoin that the parties should take or make delivery of the securities bought or sold, against payment. Settlement in any other way, according to the rules of the exchanges, is not permitted. If any one party fails either to make or take delivery, the securities will be bought-in or sold-out in the open market by the Secretary of the Exchange and the loss will be realised. In stock exchanges served by clearing houses, the securities in the cash list are divided into two groups, one group for settlement through the clearing house and the other for settlement by a process of 'hand delivery'. In the case of, the former, i.e., securities which are cleared, members are to submit to the clearing house one day before the 'delivery day' a statement in prescribed form stating their purchases and sales classified according to the securities. On the 'clearing day' members are to deliver scrips for the balance sale, after crossing out purchases and sales, along with the payment for the debit balance, if any, in the account. On the day after the clearance day, securities will be delivered to the purchasing members by the clearing house and payment to the selling members will be credited to their accounts. If any member is found to fail either to make or take delivery, the securities will be bought-in or sold-out against him, as the case may be, in the open market by the secretary of the exchange. The damages from such a procedure will be realised later from the defaulter. However, since the promulgation of D.I. Rule 94C, a new practice has come into vogue in the Bombay and Ahmedabad Exchanges in the settlement of contracts regarding cleared securities. A delivery rate for each security will be fixed by the exchange on the clearance day; and members are permitted to settle their contracts by the adjustment of accounts and payment of differences in prices. Thus, it has been made possible to effect settlements without the delivery of scrips and full payment of prices.

27. The settlement of contracts in the case of non-cleared securities is effected through a process of 'hand delivery', i.e., between the members themselves without the intervention of the clearing house. In the recognised exchanges of Bombay and Ahmedabad, though the settlement is through hand delivery it comes under the knowledge of the exchange. If delivery tickets are not delivered at the purchaser's office before 3 p.m. on the day fixed for it, the tickets are to be delivered to the purchasers in the settling room of the exchange in the presence of an officer of the exchange. If any purchaser is absent or found to refuse acceptance, the officer is to endorse such tickets. Similarly, if any seller is absent or found to refuse the delivery of the tickets, the buyer may get the 'memo' from the former endorsed by the officer. In case of absence of either party, the seller is permitted to deliver the tickets to the purchaser's office later. In the case of refusal either of delivery or of an acceptance, the securities will be bought-in or-sold-out, as the case may be, in accordance with the rules of delivery and payment. Similarly, on the settlement day, the

delivery of shares with transfer forms and payments are to be made in the settling room where an officer will be present. If any failure either to delivery or to accept is reported, the securities will be bought-in or sold-out as the case may be in accordance with the Rules. Thus the settlement comes into the knowledge of the exchange.

28. On the Calcutta Stock Exchange, however, the settlement of contracts in the case of non-cleared securities is not done under the supervision of the exchange; nor does it come to the knowledge of the exchange. Selling members are to settle their transactions by delivering the scrips to the purchasing members' offices against payment. Only if a failure is reported, is the exchange to intervene with remedial measures in accordance with the rules. As already mentioned, the usual practice is to deliver the securities on the 3rd day; and yet, the delivery on the 3rd day cannot be insisted on as, the contracts contain a clause, "that delivery shall be made on or after the 2nd day". The time that can be extended after the 2nd day has not been specifically defined. In practice, however, as in the case of cleared securities, members are found to wait for the delivery for a week. In case of failure either to deliver or accept the securities even after a week, the matter may be reported to the exchange for remedial action. But even for such complaints or reports for remedial action, no time limit is found either in the rules or in the practice of the exchange. Many instances have been noticed where the exchange has accepted complaints or reports for remedial action weeks after the dates of contracts (Many such cases are said to be pending in the Calcutta High Court against the Exchange). However, if failure is one of acceptance, the Exchange, after due notice to the party concerned, may sell-out the securities in the open market against the defaulter in accordance with the practice. But if the failure is one of delivery the procedure has been found cumbersome and remedial action by buying-in used to be delayed for a long time. Several instances have been noticed where remedial action has been taken months after contract dates.

29. As regards the settlement on other exchanges, two of them, namely, the Lahore Stock Exchange and the All-India Stock Exchange are found to follow the system for non-cleared securities on Calcutta Stock Exchange. Three exchanges under C group in Ahmedabad have no defined rules or settled conventions for the fulfilment of contracts. In practice, however, they are found to settle most of the transactions weekly, more by the payment of 'differences' than by actual delivery of scrips. Though the settling rate is fixed by the exchange, the settlement is done only independently of the machinery and knowledge of exchange. On other exchanges like that of Madras, though the settlement is done only independently of the machinery and knowledge of the exchange, the period for settlement is clearly defined and delivery of scrips and payments for them are compulsory. Also if a failure is reported, remedial action by buying-in or selling-out, as the case may be, is to be taken in a specified period.

Settlement of Forward Contracts

30. Both equities and Government securities are admitted for forward trade, and on every exchange contracts for transactions in the former are to be fulfilled monthly and the latter fortnightly. The street markets also follow the same practice. The mode of settlement too is the same. The settlement dates in a year for either class of securities are fixed in advance, before the commencement of the year. Legally, every contract enjoins that delivery should be made and paid for, on the dates fixed for the purpose. Yet in practice, settlement by making or taking delivery in forward contracts is very seldom done. Such transactions are taken up by speculators with a view to making profit out of time-bargains from purchases and sales during the course of the settling period. During every settlement, the period being long, there will be a number of contracts for purchases and sales between members. These contracts are crossed out on the last day and only the remaining are to be settled finally by one of the ways permitted by the exchange. It has already been mentioned that three ways are provided, namely, (1) by delivery and payment,

(2) by the reversal of contract and payment of differences in prices based on the make-up price. (3) by carrying-over or *budlying* to the next settlement. If any one party is not willing to square up by the latter two methods, the securities are to be delivered and paid for on the delivery day. Then, if any party fails either to make or take delivery, the securities will be bought-in or sold-out against him in the open market and damages will be realised. However, settlement by the method of making and taking delivery is done only on Madras Stock Exchange. On other exchanges forward contracts are generally settled only by the latter two methods with a view to avoiding delivery of scrips or payment of full price which would involve large amounts of money or credit. For this, a day before the delivery day, for every security the making-up price for settlement, and the *budla* rates for carry-over are fixed by the Managing Committee of the exchange after due consideration of the market trends and the technical position in purchases and sales. The outstanding transactions after the elimination of the crossed-out contracts are then settled either by the reversal of contracts and payment of differences in prices based on the make-up price on the pay day, or are carried over to the next settlement by the payment of the *budla* charge. If any member fails to fulfil his contracts either by the payment of differences or by carry-over before noon on the settling day, he will be declared a defaulter. Immediately after such declaration the managing committee will fix a 'hammer price' on each security and all members having contracts with the defaulter are to close their transactions either by selling or buying the securities to or from him, as the case may be, at the hammer price. But payments are to be claimed from the Defaulters' Committee to which the defaulter is to surrender all his assets and liabilities. Thereafter the member will be suspended from further trading on the stock exchange. On an exchange where there is a clearing house, all forward contracts are to be settled through the clearing house. On others the settlement is done between the members themselves and only failures are reported to the exchange for remedial action.

(iii) Buying-in and Selling-out

32. We have seen above that when a member does not tender or accept 'delivery', the shares are either bought-in or sold-out, as the case may be, on his account in the open market by the Stock Exchange and damages realised from him. These two are important functions of an organised exchange, and power for this is vested in its governing board. The object of these two rules is mainly to enforce the fulfilment of the contracts when a member does not discharge them voluntarily in accordance with the rules. Their rigorous enforcement may also deter members from over-trading and regulate his speculative activities. The timely enforcement of these rules is also essential in the interests of equity in the relations between members. If some members postpone making or taking 'delivery' till conditions turn favourable to them, it is bound to lead to capital depreciation and loss for other members as well as for investors. Therefore, these rules are essential for the orderly conduct of business in stock exchanges.

33. Yet the enforcement under abnormal circumstances may produce the contrary effect. For example, in an 'over-sold' market under a corner, if the buying-in is permitted the short sellers may be seriously affected and even ruined, thus producing a crisis in the entire market. Similarly in an over-bought position under a bear-raid, if selling-out is adopted the 'bulls' are bound to suffer severely.

34. Now we will see how these operations are being conducted in the different Stock Exchanges. In the recognized stock exchanges of Bombay and Ahmedabad, failure to fulfil the transactions is to be reported immediately. The buying-in or selling-out should be done on the day following the day of failure and no notice to the party concerned is necessary. Nevertheless, the Governing Board is empowered to extend the time up to 15 days beyond which the right cannot

be exercised and the Board is not competent to vary, this rule. Also, when an over-sold position under a corner is there or is likely to arise, the rule of buying-in, may be suspended for 24 hours after which an extension can only be made subject to the sanction of Government. But, in an over-bought position under a 'bear raid' the rules of selling-out cannot be suspended in these two exchanges. In the Indian Stock Exchange, Bombay, although the rules are similar, notice to the party is necessary and the Board is competent to vary the rules according to their discretion. In the Madras Stock Exchange, the failure need be reported only within one month and thereafter a period of 15 days is granted for the operation of buying-in or selling-out. The Board is also found to possess absolute powers to vary the rules according to its discretion. Besides, there are no defined rules in regard to the suspension of buying-in or selling-out under abnormal conditions, though the Board can do it under power of 'objects' in the Memorandum of Association of the Company.

35. The position in the Calcutta: Stock Exchange is not quite definite. The rules regarding such important operations, which should control over-trading by members, are not even defined. Neither any time-limit nor any definite procedure is laid down in the bye-laws, nor observed in practice. This Exchange has been found to accept reports of failure and application for action even weeks or months after the failure. After the acceptance of the application, the action is too often delayed for weeks. However, in respect of the 4 securities which are being cleared since 1945 (out of the 780 securities listed on the exchange), the failures at present are being reported weekly, though the buying-in or selling-out is often delayed. The position in regard to the suspension under corner or 'bear raid' is similar to that of Madras.

36. The U.P. Stock Exchange has a defined procedure and almost follows the system in vogue at the Bombay Stock Exchange. In addition, this Exchange has a rule by which the selling-out operation in an over-sold market under a bear-raid can be suspended so as to provide protection to the Bulls. As regards the other established exchanges, although they have precisely defined rules for the fulfilment of the contracts, some of them habitually delay the remedial actions of buying-in and selling-out. For the suspension of the rule under abnormal conditions, their powers and practice too are similar to those of Madras and Calcutta. In the C group of exchanges these rules are very seldom adopted.

(iv) *Budli* or Carry over

37. We have seen that forward contracts can be settled in some exchanges by *budli* or carry-over. This is done when parties, whether members or their clients, are unable or unwilling to fulfil the transactions by other methods. It generally happens when prices do not move according to the expectations of the parties concerned. Settlement by this method, in fact is not a fulfilment of the bargains. It is only a closure of the contract for the particular settlement for which it has been made. The obligation to make or take delivery on the existing terms is only postponed and continued up to the next settlement through a new contract. For, when such new contract is between a member and his client, a concession in the brokerage too is permitted. The brokerage for a *budla* contract is usually $\frac{1}{4}$th of that mentioned in the schedule of minimum brokerage. But, for the act of postponement of 'delivery' or payment, the party who wants the obligation is to make a payment to the other, known as the '*budla* charge' fixed by the exchange in proportion to the fluctuations in price after due consideration of the market trends and the technical position of purchases and sales. But if the prices remain static, carry-over is done only on even terms, *i.e.*, without payment of a *budla* charge.

38. In practice, *budla* at present is being done in two ways, (i) by parties accommodating each other, (ii) through an intermediary known as *Budlivala* who lends money or security, as the case may be.

(a) Parties Accommodating Each Other

39. Here *budli* is done by means of two new

contracts. A purchase or a bull transaction, is carried over by a corresponding sale for the current settlement at the 'making up' price and a re-purchase for the next settlement. At the re-purchase, either the *budla* charge maybe paid separately or may be added to or deducted from, the price. Similarly, a sale or a bear transaction is carried over by a corresponding purchase at the making-up price, and a resale for the next settlement. In the resale, as in the first case, the *budla* charge may be paid separately or may be added to, or subtracted from, price. Thus the original contract in either case is settled in equity, but the fulfilment of the bargain is postponed for the next settlement.

This in fact is only a grant of credit for the purchase of settlement to the party who wants the postponement of either delivery or payment, by the other. In the 'bull' transaction the 'bear' is extending a credit to the bull for an agreed interest, called *budla* charge, or *budligala* or contango, fixed by the exchange. In the 'bear' transaction, it is a lending of shares by the bull to the bear for the *budla* charge or backwardation. The rate of *budla* charge, whether contango or backwardation, is generally ruled by the technical position in purchases and sales. In a heavily over-bought market the contango will be very high as it creates scarce money conditions in the market. In a heavily 'bear-sold' market, though money condition is easy, the backwardation charge will he high due to scarcity of scrips.

(b) Budli through an intermediary or Budlivala

40. We have seen that *budli* is done by a Bull, because he is either unable due to 'over-bought' position, or unwilling to pay and take delivery at the settlement for which he has contracted the purchase. Thus he is in need of a loan or wants someone to take delivery for him. Similarly a bear who has 'short-sold' in the market is in need of a loan of securities or wants someone to deliver the securities for him at the settlement. To help these operators there are a number of rich *budlivalas* both inside the stock exchange among the members and outside among the non-members, who conduct the business of lending money as well as securities for the purpose of settlement. The party who wants the money, or the security as the case may be, is to make a contract with the *budlivala* for a time loan undertaking the return of the loan at the expiry of the period. The period usually is the period of settlement on the stock exchange. The rate of interest is charged per share, whether the loan is money to take delivery, or securities to make delivery. The interest is fixed according to the *budla* charge and may be slightly less than that to attract customers. The bull is to deposit the securities he takes delivery of with *Budlivala* against the loan and the Bear is to deposit the money he has received on making the delivery against the loan of securities, which will be returned to them on their respective returns of their loans. But neither the *Budlivala* nor the Bear is bound to return the identical securities, each party is to return only the same amount of securities. Here, though the original transaction between the members is settled on the exchange, it is simultaneously opened up for the next settlement with the *Budlivala*. Thus in fact it is only a postponement of the fulfilment or *budli* of the original bargains to the next settlement.

41. By the second method *budla* can be done even in cash market operations and the system is widely prevalent in Calcutta.

(v) Transfer of Securities

42. Stock exchanges, stock dealers, and speculators are greatly concerned about the mode and procedure of the transfer of ownership of securities. In fact, the extent of speculative dealings is directly related to the facility for transfer. Easy and quick, but safe, transfer of ownership is an essential requisite for speculative trade in securities. Dealings on the market are done in quick succession to take advantage of the fluctuations in price. Purchase and sale and repurchase and resale are often done several times even in the course of a few hours. In cash dealings we have seen that the maximum time for delivery on a stock exchange is one week. Thus even if dealings are done strictly in accordance with the rules, a particular set of scrips may have a chance of changing ownership nearly 46 times a year, as

there are 46 deliveries in a year. On exchanges like that of Calcutta where the ready delivery is to be done in two days, the scrips may change ownership more than 150 times in a year. But this can be managed only if facilities for quick and safe transfer of ownership are provided with. Thus, the mode and procedure of transfer has a great influence over the regulation of speculative trade in securities.

43. Transfer of securities whether of Government or of companies is governed by statutory laws. According to the method of transfer, securities are of three classes - (a) Bearer Bonds and Shares, (b) Inscribed Stock, and (c) Registered Stock and Shares. The ownership of Bearer Bonds and Shares is transferable by mere delivery from hand to hand and no other transfer formalities are to be complied with. The bearer is the owner and he is entitled to get the dividend or interest. Dividend coupons are attached to this sort of securities and are only to be cut out and presented to the paying office for the payment. In India such securities are few and despite their high negotiability are not popular on the stock exchanges as fraudulent transactions are easy in the case of them. Though inscribed Stock is the safest for investment, its negotiability is the least. Here actual certificates conferring title on the owners are not given; but their names and the amount of stock they hold are inscribed in a statutory register, kept for the purpose in the office of the issuing body. Inscribed stock can be transferred only by declaring and signing in the register by the owner showing that he has assigned his holdings in favour of another. For this, the transferor is to be identified at the transfer office and his signature in the register should be witnessed. The transferee too is to be introduced and identified to the office and sign the Acceptance of the stock. However, as this sort of security has the least negotiability they are not taken on the stock market for speculative dealings.

44. Registered stocks, and shares are the securities mostly dealt in on the stock exchanges. As their name signifies, they are registered in the share or stock register of the company or the Government that has issued them. The law, i.e., the Indian Companies Act, or the Indian Securities Act, as the case may be, imposes upon the issuing body, whether a corporation or a Government, the duty of keeping books or record and that of making transfers of stock when requests are received therefor. Almost all the joint stock companies have their capital only in the form of registered stock or shares. A considerable part of the public debt or Government loans too is in the form of registered stock. However, the certificates or scrips issued by a company or a Government under its seal is not a title deed in itself, but is only a statement showing the registered holder's name and the extent of his holding. From the point of view of the company or the Government, the change of ownership, therefore, cannot be effected by a holder by a mere assigning of the scrip in favour of another; but can be done only by transfer and registration in the company's or Government's books. For the transfer, a regular transfer deed duly signed by both the transferor and the transferee and witnessed, must be passed along with the scrips from the transferor to the transferee. The deed is to be stamped with an *ad valorem* stamp in accordance with the law, except in certain exempted Government securities. Then the transfer deed along with the scrips are to be lodged with the company or the Government, as the case may be, for transfer and registration in the register kept for the purpose, after which new scrips are issued to the transferee in his name. In the case of joint stock company securities, prior to 1936, there was no uniform and definite procedure in transfer. The method and procedure of transfer was left to the company to incorporate in its Articles of Association. As this practice has raised much protests and clamour from the shareholders as well as speculators, the Indian Companies Act was amended in 1936, laying down a uniform and definite procedure for the transfer of securities.

45. Thus, the transfer of registered securities involves expenditure at every change of ownership or transaction by way of stamp duty to the Government and transfer fee to the company. Besides, to complete a transaction by transfer and registration in the company's books takes a long

time, usually a month, and if there is any objection, transfer may take several months. The procedure, therefore, involves not only expenditure, but it reduces the negotiability of the securities considerably. If 'settlement' can be completed only by transfer in the company's books, transactions may often be limited to 12 times a year as the law and postal facilities stand to-day. But, we have seen that dealings in the stock market are done in quick succession and are settled as many as 150 times in certain securities on some exchanges and in all securities in certain exchanges. This negotiability is imparted to a registered security only by the recognition and use of Blank Transfer as valid delivery for settlement.

46. **Blank Transfer -** In a regular transfer deed we have seen that the seller and the buyer should fill in their names and signatures, and the deed should be duly witnessed and dated. When such a regular deed is executed the buyer cannot obtain a right to sell the security again, without transfer and registration in the books of the company. To overcome this difficulty in practice the seller gives only a 'blank' transfer to the buyer. In the blank transfer deed the seller only fills in his name and signature. Neither the buyer's name and signature nor the *date of sale* are filled in the transfer form. The advantage in giving such a blank deed is that the buyer will be at liberty either to sell it again without filling his name and signature to a subsequent buyer. In the latter case he can avoid the payment for the transfer stamp and new deed to the buyer. The process of purchase and sale can be repeated any number of times with the blank deed and ultimately when it reaches the hands of one who wants to retain the shares he can fill in his name and date and get it registered in the company's books. For this ultimate transfer and registration the first seller will be treated as the transferor even if it happens years after his death. On such registration the last buyer will be recognised as a shareholder by the company and the other intervening parties being not such shareholders, but only having had an equitable right in themselves if they had so desired to be registered as shareholders of the company. Besides Blank Transfer serves to pledge the shares as a security to get loans from Banks. In the absence of Blank Transfer the borrower will have to execute a transfer deed in favour of the Bank to make the shares a valid security for the loan. It also helps to get credit in the form of shares as well as money for 'carry-over' or *budli*. It is the most common method for share transfer in speculative dealings in this country. On every stock exchange, Blank Transfer is not only recognised as a valid delivery, but that alone is accepted for delivery at settlement. In short, Blank Transfer helps speculation in four ways:-

(1) It imparts a high degree of negotiability to the security along with safety for dealings and enables the share dealers and speculators to do any number of transactions without transfer and registration for any length of time;
(2) it lightens the burden of transfer by avoiding payment of stamp duty;
(3) it helps to procure loans for further speculation;
(4) it facilitates *budla*.

(vi) Margin Trading

47. In the foregoing sections of this chapter, various facilities for speculation have been dealt with, namely, long period settlement in forward trade, settlement by payment of differences, *budli*, blank transfer, etc. These are all available to members of stock exchange as well as to the public. We may now consider certain other facilities which lure outsiders to speculation. Accommodation for 'margin trading' is one such. It is a credit facility extended by brokers and banks to those who have no funds of their own for share dealings. It is important, as it is alleged to be a prime market often leading to crises and the failure of stock exchange members. Further, in regard to the facilities mentioned above exchanges exercise some supervision, directly or indirectly, but there is no such supervision or control in regard to margin dealings. It is entirely left to the discretion of the members, and exchanges in this country do not intervene to regulate this particular relationship between a member and his clients or between a member and a bank granting him credit.

48. Margin trading is widely prevalent in almost all the stock exchanges in the country. In fact, a very large proportion of the total business of the exchanges consists of margin transactions. Margin trading is not confined to or specially connected with forward dealings: on the other hand margin trading is more prevalent in the cash market. In New York Stock Exchange there is no forward market, but margin trading is the most common practice there and comprehensive legislation has been carried out for regulating it. Similarly, Calcutta Stock Exchange is to be classed as an exclusively cash market; yet margin trading is widely prevalent there.

49. Trading on margin implies trading on account, but it is different from trading on account for settlement of contracts - i.e., forward trade. We have seen that in forward trade, contracts for transactions are entered into with a view to setting off purchases by sales or *vice versa,* during a definite period and the balance only paid on the settlement day by any of the methods described under the settlement of future contracts. But, if the delivery is to be taken and if the customer has no funds, there too the method of margin transaction may be adopted for the purpose of settlement with the broker. But this accounting is different. In margin trade the transaction is completed with borrowed money or scrips as the case may be. It is a credit transaction, whereby credit is extended to a client by a broker when the former has no funds of his own to speculate in the stock market. In such a transaction the client pays only part of the price and the broker will pay the balance and take delivery of the securities which will be held by the broker himself as a pledge against the loan. The part payment the client makes to the broker is known as the 'margin' or 'equity'. It may be paid either in cash or securities or both. For the margin transaction the client is to open an account with his broker. In the account his margin deposit is debited, resulting in a net debit balance equal to the loan. This debit balance is secured only by the collateral - i.e., the securities taken delivery of and kept as the pledge, whose market price is then in excess of the loan by the amount of margin deposited with the broker. If the prices remain static or if they fluctuate only in favour of the client the margin deposited is sufficient to protect the loan advanced by the Broker. But if the prices move against the client, the value of the collateral will fall and the protection provided by the initial margin will dissipate. To protect the broker against such a contingency the client is usually to give an agreement to the former, undertaking to maintain an agreed margin. It is to be done by supplementing the initial margin deposit from time to time by additional margin equal to the amount of fall in price to provide with the same degree of protection as has been provided with at the outset. But if the prices move up as in a bull market in favour of the client, the value of the margin will automatically increase and on the same margin deposit the client may speculate further by additional purchases.

50. Thus in a bull market the margin deposit remaining the same, the volume of speculation usually will increase and the increasing purchases will raise the price further, drawing more and more credit into the market to meet both the increased volume of purchase and the increased price. The vicious circle often works up to a point, where the short sellers may be squeezed in the event of a corner or may result in an intensive 'bear raid' bringing down the price precipitously. In either case the evil is apparent. In the former case the bears may fail and in the latter the purchasing clients will have to find more margin and their brokers more credit to fulfil their contracts. In the latter case the inability to find more credit may lead to their failure and the market to a crisis exposing the credit they have already received from banks to risk and dissipation. Thus, margin trade increases speculation in both ways and if not strictly controlled it is always likely not only to create crisis in the stock market but may beget trouble even in the money market.

51. The margin may be viewed from two angles. It may be regarded as the ratio between the client's equity and the value of the collateral or as the ratio between the equity and the amount of the loan, i.e., in brokerage accounting, the debit balance. It may be figured in points or percentage or both. However, prices in stock market always

being dynamic the value of margin too varies. A flat margin therefore cannot afford safety to the credit involved in transactions. The requirements of equity should necessarily be flexible and regulated, not only to protect the credit already involved in the transaction, but also to prevent the client from over-trading, involving more and more credit in a vicious circle of operations. Usually the credit is not entirely supplied by the broker; he may have many clients doing margin trade and his resources may be inadequate to finance all. In practice he may advance sometimes part of the capital and the rest is obtained from banks with which the securities taken delivery of are hypothecated as collateral for the loan. Besides, clients are not the only margin operators in the market requiring credit. As there is no functional classification among the members of the Indian stock exchanges brokers themselves are agents as well as dealers. Brokers also usually do margin transactions when they trade on their own account with credit obtained from banks or other financiers. But there is one difference between the margin transaction of a client and that of a broker. The broker does not give an undertaking to maintain a percentage (or flexible) margin to a Bank that supplies him the credit. The Bank usually deducts a suitable flat margin from the market price of the securities under hypothecation before granting the credit. Thus, a very large volume of short term credit is required and involved in margin transactions.

Short-selling

52. Short sale, as defined by the Securities Exchange Commission, is "any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller". Its purpose generally is to take advantage of an anticipated decline in the market price of a security. The short seller hopes to 'cover' by the purchase at a lower price thus making a profit. But, if after the short sale the security rises in price, the short seller has to 'cover' by purchase at a price higher than the sale price and thus will have to incur a loss. Like margin dealings, short selling is a form of speculation, but while the margin dealer hopes to gain through a rise in prices, the short seller counts on gaining by a fall in prices.

53. Short selling like other forms of speculation fulfils a legitimate purpose. When there is too great a rise in prices, short selling tends to restrain it; conversely the covering of short sales tends to keep prices from going down too fast and too far, and thus 'cushions' the fall. On the these and other grounds, the "Twentieth Century Fund" analysis of security markets recommends that no general prohibition need be placed upon the practice of short selling. "One of the most essential functions of organised markets is to reflect the competent opinions of all competing interests. To admit only opinion looking to higher prices is to provide a one side market. To bring together an open expression of both long and short opinions is to provide a two sided market and if properly done better reflection of prevailing conditions will be shown in the price structure".

54. Short selling, however, is not without defects. Excessive short selling gives rise to corners. A 'corner' arises when more shares than are available for delivery on the day of settlement have been sold and the buyer holds the sellers to ransom, *i.e.*, as the shares come to be held by an individual or a syndicate the short seller will have to buy the shares at prices dictated to him by those who corner. Analysis of the Wall Street Crash of 1929 by American statisticians has shown that short sales did not actually provide the two advantages claimed for them, *i.e.*, restraint on rising prices and cushioning price fall. Moreover, there has always been an inherent opposition to people selling what they do not possess, and although the advantage of forward sales in commodity markets has long been recognised, similar advantages have not been conceded for short sales in the security market.

55. From early days, efforts have been made at controlling, even prohibiting, short sales. For instance, in England, Burnard's Act (1773) prohibited short sales altogether and a similar prohibition was attempted in Germany in 1896. But both these attempts were later abandoned, in

England in 1860 and in Germany in 1909. In the U.S.A. the wiser course of regulating short sales has been attempted and in this respect the practice of the New York Stock Exchange is notable. The object of regulation has been chiefly to prevent 'bear-raids'. In 1935 the exchanges in America adopted the following rule on the recommendation of the Securities Exchange Commission. "No member shall use any facility of the exchange to effect on the exchange a short sale of any security in the unit of trading at a price below the last 'regular way' the sale price of such security on the exchange".

56. It has been generally found necessary to suspend short-selling for limited periods to protect the interest of short sellers and of the public. In New York short sales were entirely suspended in September, 1931 when the U.K. went off the gold standard, but the suspension remained only for two days. The Bombay Stock Exchange has made provision in its regulations to make a temporary suspension of short selling in the public interest, but such suspension can be effective only for 24 hours, and for any longer period only with the previous consent of the Government. The Atlay Committee however took the stringent view that short sellers should be left to pay the penalty in the absence of any fraud and recommended the London Stock Exchange practice, namely, that all contracts entered into for the sale or purchase of shares must be fulfilled by the delivery of shares or by the payment of the purchase price. And, if he who has sold again on the day of settlement, the shares which he has sold, he must submit to the ordinary procedure of the exchange whereby the shares are bought in against him in open market, unless he can prove to the complete satisfaction of the Committee that he has been the victim of fraud. The Morrison Committee, however, recognised the need for protecting the sellers and thus recommended the view that the Board should be permitted to suspend the buying-in rule, so that the buyer may not utilise the machinery of the stock exchange to drive prices to an altogether an unwarranted height. Provision for this was then made in the rules of the Bombay Stock Exchange.

CHAPTER V.
THE SECURITY MARKET AS IT SHOULD BE.

We have in the previous chapters dealt with the constitution, management and technique of the stock market in India. It is now possible to enquire into the alleged defects of the stock market as it now functions, and to see how they affect the interests of the public and of the national economy as a whole. Only then can we be in a position to judge if the demand lately made for Government regulation is justified. It will then be for us to see what kind of regulation may be necessary to enable the stock market to fulfil its proper functions.

Raison d'etre of the Security Market.

2. At the outset, it is necessary to clarify what those purposes are which the stock market has to carry out. In other words, what is its *raison d'etre?* This has become necessary, especially because there are many persons who think that this institution has no legitimate purpose to fulfil. Not only a drastic reform, but even the total abolition of the stock exchanges has been advocated in recent years. Resolutions have been repeatedly put forward by influential members of the Indian Legislative Assembly demanding the abolition of all stock exchanges.

3. The stock market is an essential concomitant of the capitalistic system of economy, at any rate, of that form of capitalistic system at which most countries have now arrived. Corporate enterprise is essential for the proper functioning of this system; it brings together large masses of capital necessary for the economic development of a country. Although the first accumulation of capital in joint stock companies is done chiefly by underwriting firms, investment bankers, etc., it is chiefly the stock market that carries out the redistribution of those securities, which is also an essential function. The presence of stock exchanges where securities can be sold produces an interest in the securities on the part of the public. In other words, the stock market gives mobility to property represented by stocks and bonds. It is true that most of the trade on the stock exchanges is of a short-term character and highly

speculative, but such transactions can help in the flow of long-term capital into the most fruitful channels. A well-regulated security market can also serve as a barometer of general business conditions and could indicate, by price movements, the economic prospects of the different industries in the country. It also helps investments abroad and facilitates international payments without shipping gold.

4. Similarly, the stock market is necessary for the raising and management of the public debt, which is important especially in countries like India where economic development in many fields is in the hands of public authorities (Central Government, Provincial Governments, Municipalities, Port Trusts, etc.).

5. A stock market is therefore bound to arise wherever corporate capitalism is functioning. Whether there is an organised market or not, certificates representing Government loans and shares of ownership of corporate capital will be bought and sold. If this market is properly organised, it will serve its purpose well, and exert beneficent reactions on the national economy as well; if, on the other hand, it is neglected, mischievous manipulators will use it for their selfish ends, to the serious detriment of public interest. The abolition of stock exchanges will not therefore solve the problem; it will only make matters worse. Trade in securities will in any case go on, and unbridled speculation may arise causing serious risks to financial security.

6. Especially when a country is launching on a plan of industrial development, a healthy securities market must be considered as a necessary adjunct. Industrialisation involves large scale investment. Capital for such investment, if raised at home, must come from the savings of a large number of persons. If investment is made risky by too wide fluctuations in share prices, savings would go into safer investments like land and gold hoardings. This has long been one of the causes why investments in industry are scanty in India, although annual savings have not been too small. The jugglery of company promoters and the manipulations of share dealers have undermined to some extent the incentive for investment. But with well-organised stock exchanges working in a regulated manner, much more of the annual savings can be made to flow into industry and business.

FUNCTIONS OF A SECURITY MARKET

7. We will now see how the security market helps in encouraging investment. The following functions can be discharged by a security market, if it is properly conducted:-

(1) It gives securities sufficient marketability and price continuity necessary to serve the needs of investors.
(2) It can set prices for securities reflecting their investment worth as closely as possible; in other words, it can bring about a correct evaluation of securities.
(3) It provides safety for, and equity in dealings.
(4) It induces, directs and allocates the flow of savings, into the most productive channels.

Liquidity and Price Continuity

8. The fundamental object of the stock market is to impart sufficient marketability to securities so that under normal conditions they can readily be bought or sold. It should enable the investor to withdraw his capital from his investments just when he requires it, with least possible loss to its value in terms of its investment worth. In other words, it should ensure convertibility or liquidity to the invested capital without significant depreciation in real values. To this end a continuous market and price stability are essential. Huebner has, defined a continuous market as one, "where a security may be bought or sold during business hours at comparatively small variations from the last quoted price". For facilitating short-term investments, a ready and continuous market is necessary, and this can be achieved only through imparting negotiability to the certificates representing the invested capital. The market, therefore, should provide, (1) liquidity, 2) price continuity and (3) negotiability to capital locked up in investments.

9. It must be noted, however, that the stock market is able to provide such liquidity and price continuity only for the shares of joint stock enterprises which are accepted for trade on the stock exchanges. Owing to fairly strict listing regulations, the scrips of a large number of joint stock concerns are not admitted to dealings on the stock exchange and therefore their capital is not rendered liquid nor given price continuity, and as is well-known, a large number of businesses are financed on a proprietary, partnership or private limited company basis and even among the joint stock companies only a small number get the advantage just mentioned.

10. Nor can the stock market provide liquidity and price continuity in times of national or international crises like the two World Wars or in times of political or communal upheaval as has lately happened in this country; for in such times there arises a general preference for liquid funds as against securities, and the marketability of the latter remains only at the expense of price continuity. Thus the service rendered by the stock market is in a very limited field, but in that limited field it is real and worthwhile.

Evaluation

11. The correct evaluation of securities is a very important function expected of an organised and regulated stock market. The market, therefore, should provide the economic machinery by which values are set upon securities. "It should produce through its continuous process of evaluation, prices for securities as close as possible to investment values, based on present and future income-yielding prospects of the various enterprises, capitalised at the natural rate of interest".

12. Such price-fixing from time to time is essential to investors as well as creditors. The investor is in need to know the worth of his holdings at any given time so as to utilise his earnings in his best interests. The creditor wants to assess the security against which he advances money or credit to his clients. But evaluation can be done only if three factors are known, namely, (1) the net income from year to year, (2) the rate of capitalisation, and (3) the ultimate break-up value or assets in the event of a winding-up of the enterprise. All these are variables and are difficult to be known at any given time. Net income cannot be measured by absolute standards and depends, among other factors, much upon managerial discretion. Besides, it may vary from year to year due to changing fortunes of business and general economic conditions. Hence, a discounting of an uncertain future trend of business risk becomes essential. The rate at which new capital can be obtained may again be different. The natural rate of interest is a complicated factor. It is a rate "which will prevail if and when all the available liquid savings are employed" into productive application. The ultimate break-up value depends on the remaining assets and general economic conditions at the time of the winding-up.

13. Yet, the price of securities should always represent as closely as possible their intrinsic worth, or a capitalised value of discounted future earnings. This can be achieved, if at all possible, to some degree of accuracy only by intelligent anticipations of many; and here speculation and a continuous process of purchases and sales are essential. But over a wide field of investments, such evaluation and discounting of the future is not possible owing to the altogether limited scope of stock market as stated above in para 8.

Safety for and Equity in Dealings

14. An organised and well-managed security market is necessary to provide safety for dealings. One of the objects of the security market is "to maintain a high standard of commercial honour and integrity among its members and to promote and inculcate just and equitable principles of trade and business." With this end in view, it must work under a code of well-defined rules and regulations so as to minimise the danger inherent in speculative dealings and manipulations which are bound to arise when a large number of speculators scramble for profits. Membership of the stock market must therefore be strictly guarded; dealings must be regulated under definite rules and the contracts made among members and between them and customers must be enforced under the

unbending authority of the governing body. In other words, for ensuring safety in dealings, an organised and well-managed security market is essential.

Direction of Savings into the Most Productive Channels

15. Another important function which a security market could perform is to mobilise and harness capital and direct its flow into the most productive channels so as to serve in the best possible way the interests of investors and of the national economy as a whole. It serves to allocate only just enough funds for any line of industries and checks the flow of capital just when an industry begins to show a diminishing or uneconomic return.

16. Nevertheless, this function is more a result of the other three functions described in the previous paragraphs, and it is only indirectly performed by the stock market. No stock exchange directly collects any capital either for any industry or for Government. The original issue of capital is generally done either through issue houses or under-writing corporations, and it is directly subscribed to by the public whether as speculators or as investors. An exchange permits only trading in old issues when it is satisfied that the proposition is sound and the capital engaged will produce some profit.

17. But, the stock exchange provides a secondary market for the final distribution of such stocks. The issue houses, or under-writing firms or speculators initially absorb the issue only with a view to finally passing on to the hands of the investors. Such speculators undertake to shoulder the risk in the initial stage with the hope of realising a profit at a later stage. The investors subscribe only if they feel confident that they can liquidate their holdings without loss just when they require it. Thus, though the original financing usually takes place outside the organised exchanges, where the 'seasoning of securities' takes place, exchanges are essential for raising the necessary capital for productive purposes. Even an announcement that the company concerned has applied for listing on stock exchanges usually facilitates the supply of capital.

18. Sometimes a more direct method is also adopted in New York and London. In such a case the original issue is not directly offered to the public by the 'prospectus method.' The issue will be taken up entirely by syndicates or underwriting houses or Industrial Banks and subsequently it may be enlisted on an exchange and gradually passed into the hands of the investors or other speculators through trading on the exchange.

19. Whether the exchange plays a primary or secondary role, the ready and continuous market provided, the negotiability imparted to the securities and correct evaluation given to them from time to time, facility for promoting liquidation of holdings without significant loss, and the safety for dealings assured, makes the capital mobile and available for the purposes of investment. Even banks and people who keep money for contingent use will not hesitate to purchase the shares of companies. Thus, even through short-term investments, capital will be mobilised so as to serve long-term uses.

20. Moreover, by a process of continuous evaluation the organised market serves to determine the direction of flow of capital and allocate funds for different lines of industries. This is achieved through the help of the price movements on the exchanges. When a rise in the price of the securities of a particular industry is permanent, it indicates that more capital can be absorbed in that line. Similarly, when the price indicates a permanent decline, it shows that no more capital can be used in such a line with advantage and the flow of capital in that line can be arrested. Thus, it discounts future business conditions and allocates funds according to the return as between industries.

SPECULATION

Speculation has its use

21. For discharging most of these functions, speculation is necessary. What is 'Speculation'? It has to be defined along with the allied term, 'investment.' Investment implies purchase of securities for realizing the maximum income consistent with safety, marketability and other factors. By speculation is meant trading in securities with a design to make a profit out of the changes in their market price. Cynics may say that investment is a successful speculation and speculation is an unsuccessful investment.

22. There is no doubt that speculation in stocks if properly pursued can discharge an important economic function. It has been shown above that liquidity and price continuity are essential for capital to flow freely into industry and business. But these cannot be without a large and continuous volume of transactions A large number of buyers and sellers should be ready to trade at all times during business hours and this is only possible if there is speculation. Those interested in pure investment are necessarily few and their meagre transactions are not adequate to render the market liquid or continuous. Therefore, confining the market to investors' transactions is bound to defeat the object in view. If thus speculation is necessary for liquidity and price continuity, it is even more so for the correct evaluation of securities: Speculation helps in stabilising the price to provide price continuity which is essential for protecting the credit structure. Speculation also helps to mobilise capital and direct its flow into the most productive channels. It can also be of use in successfully discounting the future trend of business conditions. Therefore, if speculation is completely wiped out, the interest of the investors and the very object of the stock market may be frustrated.

Importance of speculation has been exaggerated.

23. But the importance of speculation has been grossly exaggerated by a host of American writers, many of whom wrote to further the interests of the stock exchanges. Their books and pamphlets have been given wide publicity by interested parties. They have been widely used in India too, especially in Bombay, for finding arguments against Government efforts at stock market regulation. The case made out for speculation on the ground that it helps to maintain liquidity and price continuity of the capital represented by stock will be readily conceded by most responsible people; but when it is assumed that a defence of speculation is also a defence of the forward market, a serious mistake is made, seeing that speculation can operate very actively in cash markets too, as has been demonstrated by the New York Stock Exchange.

Speculation in Commodities Vs. *Speculation in Stock*

24. In particular, when people use the arguments justifying speculation in commodities to justify also speculation in stock, it is necessary to enter a caveat. There is indeed a clear case for a futures market in commodities like cotton and wheat which are grown in fields subject to weather conditions, which are marketed in certain season, which are consumed regularly and which therefore must be rationed for the benefit of consumers in times of scarcity. In the case of commodities again, the necessity for fabrication, transportation and storage makes delayed delivery necessary and thus gives a legitimate opportunity for futures transactions. Can any such justification for forward dealings be rightly claimed in stocks and shares, which do not take any time to grow or to be processed or even to be transported? A real utility arises out of hedging on the commodity exchanges which permit the processor to transfer to the speculator the risk of price changes while the goods are in process, but is there any similar function performed by futures in stocks? On the other hand, is not the manipulation of prices of entire issues, say by short-selling, a much more serious danger in the case of stock than of commodities? The fact is, the justification for any speculation in stock stands on much more slender grounds than that in commodities. But, when people go further and

advocate a forward market also as essential in the national interest, they have neither theory nor practice on their side

Speculation can be misused.

25. In spite of such exaggerated claims, it must be admitted that speculation can perform a useful function but only if conducted by well-informed and disciplined businessmen, who are equipped for correctly interpreting business conditions, so that they may be able to accurately evaluate securities at their real worth and to anticipate future investment demand safely. If, on the other hand, speculation is left to unscrupulous manipulators and ignorant 'outsiders', violent and sudden fluctuations in prices will be caused and the result will be just the contrary of what has been stated above. Well-informed and shrewd traders skilled in forecasting prices correctly are a real aid to the security market in discharging its discounting function; and undue price fluctuations will thus be avoided. In fact, the profits made by such speculators are justified by the discounting service rendered and by the risk taken by them in buying and holding securities. But large sections of speculators even in New York and London are uninformed outsiders, with no real capacity for forecasting the future. They are generally susceptible to tips and rumours and often become the tools of professional pool operators. It is the sales and purchases of such traders that exaggerate the price movements begun by professionals. In the late twenties, such were the great majority of operators in the U.S.A. and hence the tremendous fluctuations in security prices which culminated in the stock market crash of 1929.

26. Thus, speculation which, if wisely employed, can greatly help in securing the four functions of the stock market mentioned above, has frequently run riot owing to the ignorance and self-regarding instincts in traders. In this way the objectives of the stock market have been defeated. Wide fluctuations in stock prices which result from unwise speculation lead to a break-down of liquidity and an erratic valuation of securities. A proper evaluation of securities must result in a comparative stability of prices as earnings from business do not show violent variations. Therefore, wide fluctuations in stock prices must be taken as an index of the failure of the purposes for which the stock market exists.

27. Liquidity is indeed valuable, but unless price continuity is maintained to invested capital at a valuation based on investment worth, and unless at the same time safety for and equity in dealings are also provided, liquidity cannot be of any use; thus the result may be diametrically opposed to the interests of the investing public.

28. Transactions in the speculative market always take place in quick succession; often several times even in the course of an hour. And in the absence of adequate regulation, a train of evils and malpractices will follow as a result of the scramble for profits. The objective of safety for and equity in dealings will disappear, and proper evaluation and price continuity will thus be frustrated. Under such circumstances, marketability would serve only to deprive the unwary investor of his life's earnings, and would only enrich the unscrupulous speculator who has large resources for manipulation in the market.

29. But the evil will not stop there. The erratic prices resulting from speculation will not only ruin the speculators (whether members or 'outsiders'), but may also endanger the credit structure of the country. Banks are inextricably bound up with the stock market and any crash there will affect banks which invest largely in securities and advance loans based on securities as collateral. The collapse of bond prices in the U.S.A. in 1931 resulted in the banking crisis of 1933 which led to the ruin of 15,000 banks, or nearly half the number of banks of that country. Not only banks, but insurance companies and endowed benevolent institutions like schools and universities, churches and hospitals, are also affected by violent fluctuations of prices, and in this way the whole nation is affected.

30. One of the chief functions of the stock market is to direct the flow of the nation's savings into the most productive channels. This is also utterly defeated by the violent price fluctuations caused by inordinate speculation. Wrong discounting of values necessarily leads to the misdirection of the flow of capital. By breeding a hope of making easy and quick profit in the form of quick capital appreciation in a fluctuating market, without the need for waiting any long time for return after investment in real worth, much of the investable capital is diverted from productive agencies. It thus results in the concentration of capital on existing enterprises, or old issues, bringing down the yield, and taking away the attraction for industrial investment.

SECURITY MARKET AS IT SHOULD BE

31. Therefore, speculation must be brought under control, so as to keep it within proper limits. This is what all advanced countries have done after experiencing the dire evils of uncontrolled speculation. Human nature is everywhere the same more or less. Hence the need for men willingly imposing certain controls on themselves. But India which has also experienced the worst of these evils for many years has not so far placed any effective cheek on speculation. Nay worse, a large section of people who have fattened on the illegitimate fruits of speculation have even come forward to argue that any curb on speculation will mean the end of economic progress!

32. How can speculation be kept within limits? This question may be answered by giving a picture of the security market as it should be. It is not merely an ideal system, but based on the actual working of the security market at present in many advanced countries.

33. Firstly, the entire security market should be organised and regulated, not only the stock exchanges but also the outside markets in whatever form. If people are to be permitted to assemble in groups to bid and enter into speculative contracts according to a common practice, they should have an organisation to maintain such practice. Every such organisation should have a legal entity to sue and to be sued in a court of law. This is highly essential as speculative biddings are always susceptible to many fraudulent practices. Such practices are to be prevented; and fulfilment of contracts are to be enforced if parties try to opt out when they incur losses. Also, defaulters are to be sued in a court of law when they refuse to surrender their assets to answer their liabilities. Besides, all the organisations or institutions forming the market should be similar from the point of view of management and practice, though the actual proprietary rights may be vested in any body such as a voluntary association as in most countries, or as a limited liability company as in some cities of India, or as a quasi-government institution as in France and Japan.

34. All the sections of the security market should work under a code of uniform, clearly defined and fully written rules. The rules, regulations and bye-laws must cover every phase of the stock market, every type of transaction. They should be particularly aimed at providing equity to the transacting parties, whether between members, or between members and clients, or, between parties through members as agents. They should give protection not only to the members, but also to their clients and the public as a whole, for whose benefit the market is supposed to exist. In the U.S.A., with this aim in view, the Securities Exchange Act of 1934 has provided rules to regulate 37 relationships between buyers, sellers, short-sellers, lenders, their brokers and the Stock Exchange and the stock clearing corporation.

35. The rules and practices on the exchanges should be published for the guidance of their members as well as the public. This requisite is particularly important, if contracts between members and their clients are subjected to the rules and practices of the exchange. The exchange should set standard practices in the market and should maintain a high standard of commercial honour, principles and integrity among its members. By rules, the public should have access to the management of the exchange to seek remedy against the wrongs done by its members. Under such circumstances, the exchange should settle disputes between members and their clients,

if the former's contracts with the latter are subjected to the rules and practices of the exchange. Besides, rules and practices should be calculated to regulate the volume of speculation with a view to serving only the needs of liquidity and price continuity.

36. The management should be firm and should put down all sorts of manipulations by members, or by others through them. The normal course of supply and demand should not be interfered with, in the sectional interest of traders, whether 'Bulls' or 'Bears'. But the management ought to intervene when extraordinary circumstances, such as a 'corner' or unjust 'bear-raid', threaten equity in dealings. Besides, culprits should be adequately punished and discipline should be maintained. The executive head of the exchange should not himself be a professional trader in the market, so that he may be in a position of vantage for administering the rules scrupulously and firmly.

37. There is a great responsibility attaching to the membership constituting the exchange, seeing that almost all the capital of the public companies is traded on the stock market, and in addition a large volume of bank credit is used in speculative dealings. Moreover, members apart from trading on their own account, are also advisers and broking agents of the public. The public is generally guided by the brokers' advice, given orally or through periodic circulars. Therefore, the regulation of the volume of speculation, however strict the rules may be, depends much on the cooperation, moral standards, integrity and experience of the brokers. The rules regarding membership are therefore most important and those must be strictly enforced.

38. For discharging such heavy responsibilities, the membership must be limited to men of high financial standing, and experience in the profession. A period of apprenticeship and training may be enjoined as a necessary qualification to membership. Any mode of selection for membership may be adopted - and methods vary in various countries; but what is wanted is that the training, experience, moral standards and financial status must be adequate to cope with the heavy responsibilities of membership. Broking, and dealing activities must be regulated, whether by separation as in the U.K., or by detailed restrictions as in the U.S.A.

39. Above all, members' relationship to customers should be defined and enforced by the exchange. Credit facilities to members, and by members to clients must be strictly regulated with a view to preventing over-trading. A schedule of minimum brokerage should be fixed and enforced. Settlement of contracts must be supervised by the exchange. Settlement by compounding with other members through private compromise in the event of difficulties, should be forbidden at all costs. Failures, misconduct and undesirable activities by members should be widely published for the knowledge of the public. Daily reports of the volume of transaction should be insisted on from members. Auditing and periodical examination of members' books must be undertaken by the Exchange authorities so that fraudulent transactions may be prevented. The financial stability of members to fulfil their contracts should be maintained, and this may be done by the principle of *solidarite* as in France, or by a guarantee fund as in Holland and Japan or by a strict auditing system as in the U.K. and U.S.A.

40. The value of the stock market as an agency for correct evaluation of securities and discounting of uncertain future trends of business depends largely on the prompt supply to the public of accurate data regarding securities and the condition of their issues, especially companies. Therefore, there should be an efficient information service for the use of the buyers and sellers as well as of the public. Not only should price quotations be published daily but all relevant facts regarding securities also should be periodically published. The withholding of relevant information regarding the state of companies has in the past enabled some persons, in collusion with some members of the exchanges, to make selfish use of inside information. Therefore, provision must be made for the prompt publication of all

information regarding companies whose scrips are traded on the stock exchange, so that facts regarding the condition of the company, its dividend, etc., may be common knowledge of the public and not be used anti-socially by a selfish few.

CHAPTER VI. THE INDIAN SECURITY MARKET AS IT IS

How far does the actual condition of the Indian security market fit in with the picture drawn in the previous chapter? There has been for some time a growing complaint that stock exchanges have not been working satisfactorily.

Wild Fluctuations in Stock Prices.

2. The principal charge is that owing to excessive speculation, wide and wild fluctuations in stock prices have taken place frequently, with the result that price continuity of securities has not been maintained, and that they have not been evaluated at their true investment worth.

Who is to Blame?

3. The reality of such fluctuations and the mischief they do are not doubted. The question is, who is to blame? The Stock exchange authorities generally disclaim responsibility for the violent price fluctuations. Such has been the attitude of exchange authorities in other countries too.

4. The authorities of Indian stock exchanges put the blame on outside brokers and speculators who deceive the gullible public by their manipulatory tactics. There is no doubt that outside operators, whether free-lance brokers and speculators, and influential syndicates of them, have also been instrumental in carrying out the manipulations which led to violent fluctuations in stock prices, but it is by using the exchanges that they carry out their nefarious operations, and as it is well-known that nearly all our stock exchange transactions are initiated and whipped by the members themselves, manipulations cannot have been possible without the co-operation of the stock exchange members. And it is a well-known fact that many members of our leading stock exchanges participate in the operations of the neighbouring curb markets, which have greatly helped in pushing on manipulations.

(A) STOCK EXCHANGES

Defects in the System of Settlement in Force

6. As has been made clear in Chapter IV, the principal defect of the Indian exchanges is in the system of settlement. Legally each contract is to be fulfilled by delivery of scrips and payment of price. If this is enforced and settlement of bargains is made within the time limit fixed, an orderly market will be maintained and speculation will serve a useful purpose. But it is easier to make a settlement of contracts by payment of differences in price, and this is what too frequently happens even on well-organised stock exchanges. It is this that serves as the main facility for over-speculation.

7. The main defect of the settlement in force is the facility for postponement of contract, by *budla*. The operation of *budla* has been explained in Chapter IV. It is in fact the worst form of credit facility that can be given to a speculator. The real defect of *budla* consists in the advance of credit without any adequate pledge or security. Thus *budla* transactions not only add to the volume of speculation; they also encourage speculators to over-trade, and thus endanger the entire credit structure.

Easy Credit Facilities

8. Besides *budla*, there, are other credit facilities available to speculators. Those are: (i) accommodation for margin trading extended by brokers as well as by many banks; (ii) advances by money-lenders and certain banks on low margin and sometimes without any margin (as in *budla*) ; (iii) facilities for short-selling; and (iv) the use of blank transfer. All these directly or indirectly lead to excessive speculation.

9. Blank transfer enables easy credit to be raised from banks and thus much money is made available to speculators. But the credit thus advanced is often without adequate margin, and the banks and *budliwalas* who thus advance credit are therefore exposed to serious risks. If the market in the meantime moves down, heavy capital depreciation will result and all except the short-sellers, will stand to lose.

10. It is the easy availability of credit facilities that make the Indian stock market fall a ready prey to over-trading.

Private Compromise

11. A principle which has to be strictly stuck to for orderly trade on a stock exchange is that a bargain once entered into in the market shall be implemented regardless of consequences. This may mean great inconvenience and hardship to individuals, but common good must take precedence. This is the principle relentlessly enforced in London and other markets. But in India, private compromise is very common, and in spite of rules to the contrary, it is going on even on the recognised stock exchanges, and it is learnt that even the exchange authorities use pressure on unwilling creditors to compromise with their debtors.

Put-through Business

12. The practice of 'put-through' business, prevalent among members of Indian stock exchanges, is found to foster inordinate speculation, often resulting in defaults and failures, and even crises some time. The ostensible object of this practice is this. A member who may have received a substantial order from a client who purchases or sells securities is deterred from executing such order in the name of his own firm by reason of his belief that the market will be put up or down against him and that his client will consequently be a loser. To obviate this difficulty, different members are employed to execute the business in the trading ring.

13. As the Morison Committee points out, such practice is legitimate when inspired by an honest desire to serve the best interests of the non-member, but it has led to serious abuse in more than one way. It is through put-through business that cornering is successfully effected in any stock market. When purchases are made through so many different brokers, the development of a corner may not be noticed by exchange authorities and the technical position of the market may not be visible to them before the clearance day. Further, when an influential broker resorts to put-through business for executing large orders, through many brokers, often the same parties, usually the smaller brokers, may purchase or sell, leading them into a technically difficult position, wherein they are not able to liquidate their commitments. Often this has been found to be the reason for the failure of many small brokers, leading the market to crisis involving large amounts of credit.

14. Although put-through business is resorted to ostensibly in the best interests of the client, it often causes loss for him by being charged double brokerage, often without his knowing it. The principal broker thus gets a payment, although doing hardly anything for the client.

15. Another serious evil of the system is that it gives opportunities for authorized clerks to trade on their own account with the help of other firms, without involving their own principals. This also is bound to lead to commitments by people with inadequate resources to answer their liabilities in the event of transactions ending in loss.

Speculation in Cash and Forward Markets

16. From the descriptive accounts of the market given in chapter IV, it must be clear that speculation can be done more easily in the forward market; it is in that market that speculation is more liable to get out of control. It is the long settlement period and the temptation for speculation on time bargains in the meantime that cause the trouble. Each contract should end on the day fixed, by delivery and payment, but in practice

this seldom happens, because it is for making profit out of time bargains by successive purchases and sales crossing each other during the interval between two successive settlements that speculators carry on forward dealings. Therefore, in effect, most transactions are only settled by payment of differences in prices. Moreover, many contracts are also closed for the current settlement by the process of *budlying*. This is specially the case in the forward markets of Bombay and Ahmedabad.

17. The result has been excessive speculation in those markets.

19. It is of course in times of crisis that the forward market causes the worst evils. The need for suspending it in times of war has been recognised; but it can be equally injurious in times of political uncertainty and national panic like those we have lately passed through. Especially in May 1947, the prices of scrips in the forward list of the Bombay Stock Exchange went down continuously under pressure of persistent bear raids. The bears were thus allowed to rob the investing public mercilessly and a serious financial crisis was threatened. The crisis has passed for the time being by the improvement in the political situation, but such situations have recurred and may recur, and the wicked bear raids should not be allowed to go on against the interests of the investing public.

Equity in Dealings

20. An important function of the stock market is to provide equity in and safety for dealings. As stock exchanges in India are only organised for the benefit of their members, no adequate protection is provided to the public (i.e., clients dealing with members), whether in the constitution or in the rules relating to the conduct of the trade. It is true that in the case of two recognised stock exchanges, the object clauses in the constitution and certain rules and bye-laws make some provision for some kind of protection to the public. But it is doubtful whether in practice these objectives have been properly carried out to any appreciable extent. In regard to the other exchanges, mostly of joint stock companies, protection to the public has not even been mentioned among the objects of the exchange. Members of exchanges are expected to do brokerage work for the public; but in practice, no exchange in India has been found to insist on their members executing agency contracts with clients. In fact, every contract with a client is only a dealer's contract and the client has no means of knowing what price his broker has obtained for his sales or paid for his purchases. Similarly, no brokerage is separately mentioned in any contract. Thus a client, be he investor or speculator, is denied the opportunity to know the real price at which his purchases or sales were made. Except in the case of a few reputed firms, this privilege of members has been found to be abused and this has caused serious annoyance to the public. Numerous cases of sharp practices by members have come to my notice in the course of the enquiry.

21. In regard to the delivery of scrips, although every exchange has got rules and bye-laws governing the conduct of trade between members, no exchange has any strict rules to regulate the relations between members and their clients. In the result, in a rising market delivery to clients is often found postponed and in an unfavourable market the members are found to insist on the acceptance of delivery by clients. Many cases of brokers defaulting to pay to clients the prices of shares sold, even running away with the clients' money, and also instances of clients' securities being pawned by the brokers have been brought to light in the course of this enquiry. Especially mofussil clients have incurred much loss this way, and this has brought stock exchanges into evil repute.

22. Sharp practices are prevented on the London Stock Exchange by the strict division of the members into brokers and jobbers. But as the functions of broking and jobbing are combined in Indian exchanges, a clash of interests between the two parties is bound to happen, when clients' orders are executed by members. This has been the principal complaint of many members of the public, whether investors or speculators. In fact,

it is believed by many influential persons that a separation of the two functions will rectify all the evils in the Indian stock market.

23. In the U.S.A., where such distinction between broking and jobbing is not strictly enforced, evils similar to those in India prevailed formerly, and consequently the Securities Exchange Act of 1934 has made provision for stamping out such shady practices. Although on the American exchanges there is no clear-cut division of functions between broking and jobbing as in London, provision for equity to the public has been made by members being strictly prohibited from and entering into dealers' contracts with their clients. Thus, in the practice of the New York Stock Exchange, contracts are strictly divided into agency contracts and dealers' contracts. If any broker wants to trade with his clients he is to take a written agreement from the client permitting him to do so and this has to be submitted to the exchange authorities for their timely information. Besides, by the provision for strict periodical auditing and examination of members' books both by the exchange authorities and by the officers of the Securities and Exchange Commission, such abuse of the privileges of a member against the clients' interests is prevented.

24. While a two-fold protection is thus provided to the public in the U. S., firstly, by the supervision of the S.E.C. and secondly, by the exchange authorities themselves, hardly any protection is provided in India from any source.

The net result of all the above is that equity is often denied to the public, whose benefit ultimately is the sole justification for the existence of the stock market.

Lack of Rules and Laxity in Enforcement

25. In the case of some stock exchanges, short-comings in the conduct of business may be due largely to defects in the rules and regulations of the exchange. In the case of well-established stock exchanges, however, there are elaborate rules drawn up, but they are often not enforced or their violation is connived at. All long-established exchanges have rules prohibiting private compromise, but as shown above this is honoured more in the breach than in the observance. In respect of many rules, enforcement on the Calcutta Stock Exchange is found to be very lax. To take up one instance : the rules of that exchange insist on members not pursuing other professions. Yet it has been found that in practice several members freely engage in other occupations also, thus making them liable to serious risks. Rules also prohibit members from trading on other exchanges, and these have also been frequently and glaringly violated. Even more serious is the nonenforcement of the rules regarding delivery. The Calcutta Stock Exchange permits only cash dealings and deliveries are supposed to take place on the third day of the transaction, but actually deliveries have been unduly delayed, taking umbrage under the vague wording of the rule "on or after the second day from the date of the contract." Deliveries have been in actual practice delayed, not for weeks but even for months, and especially after the clearing work by the Allahabad Bank ceased, the position has become much worse. Facilities for excessive speculation are thus provided and members are also enabled to profiteer at the cost of their clients in several ways, thus violating the equity between the members and the public.

Weakness of the Managing Boards

26. Such laxity in the enforcement of rules is generally due to the weakness of the exchange authorities. The managing boards of even the leading exchanges are weak and in some cases unwieldy, and are constitutionally averse to enforcing rules when it proves inconvenient to them as members. There are few members on the board who could take an independent line and are able to pull up the board when a wrong decision is taken, and the chairman himself, being drawn from among the members in most cases and depending upon periodical election by his fellow-members, is often unable to perform his duties with a firm hand. It is no wonder that even in the case of the Bombay Stock Exchange several responsible members according to very reliable authority refrain from seeking election to the governing board. If this is true of the Bombay

Stock Exchange, which has been working under rules recognised by a Government, what must be the position of the many inadequately organised exchanges that have lately sprung up?

The Services Rendered by the Stock Exchanges

27. In spite of all these defects of the organised stock market, it must be said that it has helped in maintaining continuous marketability although to a small number of securities, and if this has been often at the expense of price continuity and if correct evaluation of securities has not often been made, the blame for this cannot be laid entirely at the door of the stock exchanges. In many ways, this has to be answered by other sections of the stock market, as will be shown presently.

It is also fair to recognise that owing to lack of investment banks and underwriting houses in this country, it became necessary for the members of the stock exchanges to take up such functions also. Company flotations and the primary sale of securities would have been greatly handicapped, had it not been for the active co-operation given by the stock exchange members in this matter, although this work has not been done by them as members of stock exchanges. Thus, the stock exchanges, in spite of their defects, have proved beneficial in harnessing capital for productive purposes, and for imparting liquidity to a part of it (listed stock) and if more has not been done, part of the blame must be borne by Government which has so far done very little to guard the investment market from nefarious influences, some of which will be detailed in the rest of the chapter.

(B) STREET MARKETS AND SHARE BAZAARS

28. The curb markets in India still work in streets, with no legal entity nor any proper constitution. They also trade in the same securities as the stock exchanges, rather in the more active counters among them. In these street markets, hundreds of brokers and dealers participate in speculative group bidding according to some common practice. Their contracts are settled by payments of differences at closing; delivery of scrips is neither given nor taken. In other words, their business is gambling, pure and simple.

29. Such being the nature of the street markets, it is no wonder that their turn-over of business became large, especially in war-time when inflation ran wild and much black market money was floating about. Thus, hundreds of speculators have come to congregate in these dens, lured by the urge to make quick profits. At the Katni market of Calcutta, it is believed that more business is carried on than on any stock exchange in India. It works from morning till late in the evening, while the stock exchange works only for two hours, from 12 noon to 2 p.m. A vast concourse of people meets there and carries on business in great excitement, using quaint symbols with the help of fingers.

30. These street markets have hardly any legal status. They have no deed of association to bind them for maintaining the common practice whether for their own good or for the safety of the people who deal through them. It is true that most of them have their own private committees for the management of the affairs and settlement of disputes. Nevertheless they are neither legally authorised nor competent to exercise any discipline nor to maintain an equitable practice in the market.

31. None of the recognised qualifications for the membership of a stock exchange are required for being a member of share bazaars. Any one can enter as a broker *cum* dealer in the street market if a few others are willing to trade with him. Then, he becomes a recognised broker *cum* dealer and is able to obtain credit facilities from *budlivalas* and even from members of a stock exchange, as the latter too do business through such people. It is learnt that smaller banks too often give credit facilities to these curb dealers. In this way street markets and share bazaars have given rise to a large number of irresponsible professional speculators, with no rules to bind them and with no authority to curb them.

32. Serious results have come out of such developments. These street markets have proved most injurious to the public and to the more honest

among the brokers themselves and they have become a menace to the organised security market and to the credit structure as a whole.

33. Firstly, these street markets have been instrumental in lowering the commercial morality in the stock broking trade by conniving at, if not abetting, many fraudulent practices which unscrupulous dealers have been resorting to in their scramble for profits. It is the lack of definite rules and practices that enables brokers to deal with clients as it suits them. Many instances have been noted, of brokers opting out of contracts, not fulfilling stipulated engagements with clients at the appropriate time, but all the same, insisting on fulfilment by clients in times unfavourable to the latter. In such cases the position of the broker is protected in every way against legal remedy because of the vague generalized condition, that the contract is "subject to the practice and usage in the market". Further, according to usage, contracts to clients are entered into by brokers, only as dealers (not as agents), and that too without time limit for the performance of making or taking delivery. But in the event of a client's non-fulfilment or default, the broker is not only enabled to enforce the contract through the law courts, but has also alternatively a quick remedy to make good his loss by appropriating the margin or the advance of the client. Thus in this vicious system, the broker gets ample chances to defraud his client at every turn in the course of an operation, taking umbrage under the Contract Law, while the safety for and equity in dealings to the client is entirely left to the good sense of the broker. Many defaulting brokers thus escape without surrendering their assets to answer their liabilities, as remedy cannot be effectively sought in a court of law. Several instances of such fraudulent practices were noticed in the course of the enquiry, for instance, in the dealings of the shares of the Indian Aluminium Company.

34. Many innocent people have thus been lured into the meshes of these brokers through their enticing advertisements, circulars, market reports, touting and seemingly generous provision of facilities for credit and margin trading. In addition, large-scale group bidding has also been going on in these street markets without proper contracts between dealers and these have been found to cause (in addition to colossal loss of revenue to the Government, of which see later) frequent defaults and failures in the market with serious repercussions on the economy as a whole.

35. Secondly, the curb markets have contributed to rapid fluctuations in share prices leading to serious crises in the security market as a whole. This may be seen from what lately (since September, 1946) happened in respect of active counters, like Indian Irons, to the violent fluctuations of which recently reference has been made. (It must be noted that the Katni has for long concentrated on one or two shares like Indian Irons).

36. Thirdly, the operation of these street markets has greatly affected the organised security market in the country. This is inevitable, because these street markets deal mostly in securities listed on the stock exchanges and actively traded in them. Further, many, of the broker-members of the stock exchanges operate also in the street markets, especially as the street markets work in the close vicinity of the stock exchanges, and work from morning till late in the evening. In this way the two markets get intermeshed and the erratic price movements on these create disturbing repercussions on to the organised stock market also. The low brokerage on the curb has also seriously affected the business of the organised market. Thus, these street markets have become a serious obstacle to the safe working of stock exchanges, and no reform of the latter will be effective unless the former are closed down or thoroughly reorganised as to be complementary to the latter.

37. Fourthly, the jumbling of irresponsible professional speculators and stock exchange members in the integration of the curb markets has been found detrimental to safety of the credit structure as a whole, and this can be seen from what happened in Calcutta quite recently in regard to the numerous banks which had advanced liberal credits for share dealings in and outside the organised market.

(C) INDEPENDENT FIRMS & OUTSIDE BROKERS

38. Although the turn-over of business of independent firms and outside brokers (who form the 'over-the-counter market') may be less than that of the street markets and share bazaars, the activities of the former are found to be much more injurious to the orderly functioning of organised stock exchanges and are greatly more responsible for swindles in the share trade. In many cases, the manipulations on the organised exchanges are engineered by private dealers.

39. Although dealing in stock is a highly responsible occupation, there is nothing to prevent any one in India, whatever be his financial stability or integrity, from engaging in such dealings, and therefore numerous private share dealers have sprung up all over the country, especially during World War II. Some are private proprietary concerns or partnerships; but latterly the tendency has been to organise for limited liability companies, whether private or public. It may be seen from what follows that this preference to corporate form is due to the facilities provided by it for raising funds with the greatest ease.

40. The business of the independent firm is generally of a comprehensive character. They do not confine themselves to stock dealings; many of them also carry on speculation in bullion and commodities and some do even banking and managing agency work. They can act as broker or agent, or as dealer or as underwriter or issue house, and do all such functions simultaneously. Nor is there anything to prevent such combination of functions in this country, however strict the provisions against it may be in other countries.

41. Taking only the business of stock dealings, the firm is entitled to trade in any security listed on any stock exchange in the country. It can also trade in securities not listed on any exchange. Thus, the field of activities of these firms is almost unlimited compared to that of the stock exchanges, whose scope of business is severely limited by rules. The result of such unrestricted freedom is appalling. There are today private dealers and firms not only in large cities but even in the smaller towns. In the larger cities they function side by side with stock exchanges and street markets, and are a serious hindrance to the orderly working of the organised security market.

42. These independent firms, especially joint stock companies which have taken up this work, have gathered large funds for effectively pushing on their share speculation. They collect funds in several ways, chiefly by issue of shares. They often issue different kinds of shares having varying rights to profit. The ordinary shares, fully or largely paid-up, are unloaded on the unwary public, but along with this are also issued deferred shares which, while having only a small paid-up capital, are entitled to full dividends, and of course these shares are retained by the management and their friends. These companies raise funds from the public in other ways also, e.g., by offering high rates of interest for deposits, or even receiving deposits on a profit-division basis. In this latter case, the margin of profit offered is higher than the interest allowed by banks or even the investment yield from securities. Sometimes they combine fixed interest with a share in profit. They attract such deposit by alluring advertisements by which they make the public believe that high profits will come from the capital appreciation resulting from intelligent speculation. By offering such baits to the unwary but gullible public, they raise funds for their speculative ventures. It has been found that not only limited liability companies but also partnerships and proprietary firms are collecting deposits in this way by drawing into speculation a great deal of capital which ought to go into productive activity. They are evidently doing the greatest injury to the national economy. But such anti-social activities are not the concern of any public authority in the country.

43. Unlike the members of stock exchanges, these outside dealers are not precluded from sending out open circulars and they make full use of this freedom. They advertise widely in newspapers and issue their own financial bulletins, etc. In this way they collect orders for speculative share purchases. By offering credit facilities on attractive terms to those who speculate through them, and even by accommodating their clients

by taking their orders on account they have drawn into the vortex of stock market speculation large number of persons of small means and some of these have already burnt their fingers.

Connection with Stock Exchanges

44. We have seen that these private firms are absolutely independent of the stock exchanges, but it does not follow that their operations are unconnected with the work of the organised stock market directly or indirectly. But the connection between the two is subtle. Several of these private dealers are found to work as agents of stock exchange members. This is done extensively in upcountry places, but this also goes on even in cities where there are exchanges. Legally this action can be construed as mere clientship; but in reality it is a partnership in the brokerage business. The private dealer is often found doing the work of the tout, canvassing business for the members of the stock exchange on a half-commission or half-brokerage basis. The business thus brought is mostly of a speculative character. It is such dealers that rope in unwary persons of the middle class - teachers, lawyers, clerks, and others of small means - into the speculative business. They are attracted by the lure of vast profits but in most cases the result is the loss of their life's earnings.

45. But the connection of the private dealers with stock exchanges is much more than mere agency. In fact, they constitute a different division of the market trading in the same securities. They too are found to concentrate on active counters on the organised exchanges. This not only adds to the volume of speculation in the same counters; it also nullifies to a large extent the disciplinary effect of whatever collective regulations obtain on the exchanges.

Manipulations

46. These outside brokers are often also manipulators in the stock market. They are found frequently to create disturbances in the stock market by interference with supply and demand to suit their own ends. Corners of the exchanges are often created by them. They have certain special facilities for such manipulations. Firstly, they have large resources raised by several methods as shown above. Secondly, like investment trusts they can hypothecate the securities in their hands for raising further credit and use it again for more purchases. Thirdly, as independent firms, they can work up cornering by means of put-through business without the knowledge of others. Neither the members nor the management of the exchange will know that the same party is purchasing from the market. But if members of the exchange individually or as a group attempt a corner secretly, this is likely to leak out. Further, the exchange auhorities will have only some warning of this from the clearing house where there is one and therefore they can take timely action to prevent a crisis. But independent firms or dealers can work up a corner without the management of the exchange coming to know of it, although the operation is done through its members. Remedial action therefore is not possible in time and consequently attempts at cornering by private dealers can throw the entire organised market out of gear. It is even possible for them in such situations to insist on fulfilment of contracts and thus extort much money from members and speculators and even investors. Sometimes such activities may produce even a crisis in the market and thus jeopardize the solvency of the members. When members fail, investors will also suffer losses. Only one party remains unhurt - the private dealer - and he can extort money from his clients at every stage.

47. Even during their normal operations, these firms create wide fluctuations in stock prices. By suddenly putting thousands of scrips on the market or withdrawing large quantities from it, the dealer is able to rig up or bring down prices as it suits him, and with such operations at convenient levels through put-through action, they can extricate themselves from the current they create, but can draw others into it. In this way they have been repeatedly mulcting innocent people of their hard-earned money, and this has

caused serious embarrassment to institutions like insurance companies, trusts, banks, benevolent societies, etc.

Their Bear and Bull Tactics

48. We have seen that these firms carry on a multiple trading: stock, bullion, commodities, banking, etc. Such interlocking of stock dealings with commodity speculation has been upsetting the orderly functioning of the security market in many ways. When speculation is found more profitable in any other line, such as, bullion or cotton or jute or oil-seeds, by a rise in their prices, they suddenly liquidate their holdings in stock to take advantage of the upward trend in other markets. This sudden over-supply of scrips causes a precipitous fall in prices in the stock market. Even in the falling market thus created by themselves, they are often found to take advantage of bear-selling, thus making the fall in price all the steeper. Such action generally creates panic among the real investors and they too rush into market to liquidate their investments. Naturally this results in a loss to the genuine investor. Moreover, credit institutions like banks and insurance companies who often want to convert their short-term investments into cash in order to answer the demand from the depositors or creditors, often suffer heavy capital depreciation, on such occasions.

49. On the other hand, when there is a rise in stock prices, private dealers put on the reverse gear; they liquidate their holdings in bullion and commodities and rush into the stock market, this time as bulls. Here again, they try to corner and rig up the market with a view to profit by price fluctuations. Watching the upward trend of stock prices, speculative investors too are attracted. Even genuine investors also may be tempted to buying stock in such circumstances. After having the markets rigged up to unwarranted heights, they suddenly release the corner. Thus at every turn they are found to upset the orderly functioning of the market and at every such fluctuation they, being experts, loot the real investors, credit institutions and speculators of lesser experience.

50. Even if these manipulators fail in their nefarious activities, the actual loss will not be on them. It has already been mentioned that the bulk of the capital they use for their speculation is obtained from the public, by the issue of shares, by accepting deposits and raising credits from the banks. If the manipulators lose in the transactions, the loss is transferred on the public; but if they gain, a large portion of the profit is invariably appropriated by the management. Thus, in either case, the public is defrauded.

Arbitraging

51. These independent firms also carry on arbitraging between markets. They skilfully watch the trends of prices in different markets and benefit by them. In towns where stock exchanges and curbs exist side by side they directly participate in the business on the street markets and indirectly do business on the exchanges through members on half-commission basis. It is these unregulated facilities coupled with the lack of rules to maintain a minimum schedule of brokerage and to enforce delivery and payment on the street markets and over the-counter markets, which breed so much of undesirable arbitraging between the organised and unorganised market. Often such unregulated arbitraging is found to give rise to a train of malpractices in the security market. Usually it nullifies to a large extent the effect of collective regulations on the stock exchange. The practice of such unhealthy arbitraging is found to influence the price movements to the detriment of honest investors and credit institutions. Often the members of the public are also led into the vicious circle of such unhealthy speculation.

52. Not satisfied with their copious gains from stock market manipulations, these private firms and dealers have also operated in the field of company promotion and share pushing, and they have had some part in the stagging operations that have been going on in many Indian cities since 1942. In complicity with certain managing agencies and stock exchange members they have

been playing a part, not only to rig up the price of the new issues of shady ventures, but also to get such issues listed on stock exchanges.

(D) MANIPULATIONS BY OUTSIDE OPERATORS INCLUDING COMPANY PROMOTERS AND DIRECTORS

What is Manipulation?

53. By manipulation is meant "a planned effort by an individual or group of individuals to make the market price of a security behave in some manner in which it would not behave if left to adjust itself to uncontrolled or uninspired supply and demand". The object of manipulation is usually to force the price of a security upward so that holders of large blocks of shares may be enabled to dispose of their holdings advantageously to themselves. Manipulations may also be organised by forcing the market price down, either as a part of the campaign on the short side of the market or to facilitate covering of genuine small commitments already outstanding. Thus manipulation deliberately interferes with the free play of supply and demand. Generally groups of individuals or corporations combine temporarily into a pool for carrying out manipulations. Options are widely used by these pools. Such manipulations had been very common in the United States in the nineteen twenties and early thirties. Manipulations have been employed very widely in connection with company financing as also the secondary distribution of stocks. Some of the American manipulations, - the Radio Pool (1929), Fox Theatres Pool (1928-29), etc. - have become notorious. Manipulations in America are generally carried out on the floor of the exchanges, but some were operated outside the exchanges. Many of the operators were not members of the stock exchanges but they were able to use the machinery of the exchanges.

Manipulations in India

54. In India also manipulations have been a common feature for many years. They are worked up mostly by members of exchanges, and sometimes by outsiders. Syndicates are often formed for this purpose. In India too the operators have been working on the gullibility of the public by using various tactics for creating artificial market activity - such as 'wash sales' and 'matched orders' intended for creating a false or misleading appearance of market activity. False rumours, collusions, fake transactions and the like have been employed, as also publicity through the press and through news bulletins, market reports, etc. Those who have followed the course of the Indian Irons racket in 1937 will realise what ingenuity could be employed in carrying out manipulation and for working on the gullibility of the public.

55. Manipulations have been worked up also by the directors and other officers of companies with the help of stock exchange members using inside information; they rig up or down the market in the shares of their own companies, and make large profits. This has been done chiefly at the first sale of securities; it takes place also in their subsequent sales.

Sharp Practices in Company Promotion

56. Although securities come into the organised stock market only after issue and first sale, these latter are also as much a part of the security market in the wider sense. Further, as shown above, owing to the absence of investment bankers and issuing houses, members of stock exchanges perform some of those functions (although not by virtue of such membership). The issue and first sale of securities are therefore greatly intermeshed with the working of the organised stock market, and a great deal of manipulation has taken place in this field

57. Sharp practices by promoters of companies and their friends at the stage of issuing and fresh sale of the companies' securities have become very common in India, especially during the last few years when large numbers of companies were floated for utilising the big war-time incomes reaped by some people. Although several of the companies were floated with highly inflated capital structures, a tremendous demand for shares arose among the credulous public, owing to the flush of idle money in their hands. An appetite for company shares was also whipped

up by the glowing accounts appearing in prospectuses and in newspaper notices regarding the new issues. Thus, before allotment, even before issue sometimes, shares came to be sold privately at a high premium. This gave an opportunity to company promoters to carry on "stagging" operations of the most objectionable kind and thus reap large profits. Subsequently, the facts came to be known and prices suddenly slumped, but before this, manipulators had sold away their holdings and the gullible public was left to 'hold the baby'.

58. The ingenious technique employed by these clever company promoters to hoodwink the public takes many forms, and considerable information about these has reached me. They show clearly that in this country there cannot be any safety to the investor, so long as such daylight burglary is allowed to go on. The poor man is sent to jail for committing a petty theft, but those who make millions by deliberately deceiving the public are seldom hauled up.

59. The predatory practices of these mischievous company promoters ought to have been nipped in the bud by a vigilant Government. Indeed there has been a Capital Issues control by the Central Government since 1943, but that control pursued the matter only till the consent for issue was given - and even that control has been concerned chiefly with the anti-inflationary motive and has not proved very effective in detecting the tricks used by many promoters for deceiving the public. In any case, what happened after the consent was no concern of any authority. No doubt certain returns have to be submitted periodically to the Registrar of Companies of the Provincial Governments, but this has been altogether ineffective in stamping out the sharp practices by which company operators have been deceiving their unwary fellowmen. In the result, the financial dealings of companies - so important from the point of view of industrial development - are almost as unregulated as the dealings in their shares, and it is futile to attempt such regulation by a haphazard system of capital issue control or by a half-hearted provision for an annual return to an over-worked Provincial Registrar who has neither the equipment nor the time for such difficult work.

Unequal Voting Rights

60. Company promoters have also been employing various devices to keep voting power in their own hands. A device commonly used for this purpose is to issue "deferred," or "founders'" shares of low value with voting power equal to that of ordinary shares, thus vesting controlling power in a ring. The justification given out for such grossly disproportionate voting rights is that this was meant to prevent men who worked hard for starting a concern from being ousted by outside financiers who might buy up the shares. But the remedy is worse than the disease. Although the unfairness of this was patent, it was thought that Government was not justified in using a war-time emergency power like Capital Issue control for effecting drastic reform, whatever be its desirability. However, some limit was indirectly placed on the Directors' freedom in this matter, by laying down the rule that "issues shall not be allowed in which (disregarding debentures and cumulative preference shares, the holders of which have special rights which they can set off against any disadvantage in the matter of voting rights) it is possible for parties who have subscribed less than 25 per cent of the capital of an industrial concern (and 33.1/3 per cent capital of other concerns) to have more than 50 per cent of the votes". Government also objected in principle to issues including shares of a value of less than Rs 5/- each.

61. Company promoters have also been trying by various tortuous practices to undermine the power of the shareholders by interlinking of companies and by various other methods. It may not be necessary in this report to deal with all this, seeing that an enquiry into the defects of the Company Law is under way in the Commerce Department.

62. It must be pointed out here that at least one stock exchange in India has, by insisting on strict listing requirements, discouraged some of the practices mentioned above. The listing regulations of the by the Bombay Stock Exchange insist on voting rights being proportionate to the amount of capital subscribed, and an offer to the public of at least 50 per cent of the new issues and equitable terms of managing agency.

Unfair Use of Inside Information by Directors and other Officers of Companies

63. Directors, agents, auditors and other officers of companies have been found to use 'Inside' information for profitably speculating in the securities of their own companies. This has been possible because, these persons obtain information before every body else regarding changes in the economic condition of companies, and more particularly, regarding the size of the dividends to be declared or of the issue of bonus shares or the impending conclusion of a favourable contract. With such knowledge in their possession it becomes possible for them to speculate profitably in the company's shares.

64. In the U.S.A. effective provision has been made against this in the Securities Exchange Act of 1934, by the insistence under Section 16, that directors and officers of companies and stockholders who own more than 10 per cent of any registered issue of stocks have to file with the Securities Exchange Commission and the exchange concerned a statement of each such security, together with such changes of low of ownership as have occurred during each month. Moreover, any profit realised in this manner by such parties by using inside information is recoverable from them. In Canada also full provision is made for prompt and public disclosure of such transactions. In the U.K. enquiries recently made by the Cohen Committee disclosed serious flaws in the company law in this respect and this Committee has strongly recommended that all such transactions by directors and other officers of companies must be disclosed promptly and an amendment of the company law in this regard is already before the Parliament.

65. In India, such special legislation has not been carried out and no provision exists in the present company law to bring to book directors and managing agents of companies who make such unfair use of inside information. Stock Exchanges could insist on listed companies giving publicity to material events like declaration of dividends, but their admonition often falls on deaf ears. The President of the Bombay Stock Exchange, in his speech on 14th June, 1947, gives glaring instances of leading companies neglecting to give prompt publicity to declaration of dividends and issue of bonus shares. In the case of the latter, the President states that "in each and every case where bonus or 'right' shares have been issued, information has leaked out well in advance of the official announcement". In the result the reaping of unjust profits by 'inspired' operators has been very common. It is a pity that this has not caused the public indignation that it deserves. This is largely due to the lack of understanding of the fact that the profits thus made by company directors and their friends are extracted from the pockets of the investing public. Such 'inspired' operators are no better than the common thief, and must be put down in the public interest. This may not be possible by merely amending the company law; incessant co-operation of stock exchanges is necessary for carrying this out and such co-operation can only be effective if carried out under the auspices of some competent authority, as in the U.S.A., which has the personnel and the data necessary for scrutinizing the predatory activities of 'inspired' operators, from time to time. In spite of organised efforts made in the U.S.A., mischievous action by company directors has not been altogether stopped in that country. How much more helpless will be the condition of the investing public in India if no such precautionary measures are taken?

CHAPTER VII. ECONOMIC RESULTS OF THE INDIAN SECURITY MARKET (SUMMARY)

In judging whether the stock market in India has fulfilled its functions, we have to study first the trend of security price fluctuations. A study of the price data discloses the prevalence of 'wide and wild' fluctuations in stock prices. Fluctuations in India are found to be much wider than in other countries (Paras 2 and 3).

An analysis of the aggregate prices of ten leading securities shows that prices have behaved erratically (Paras 4-8).

The effect of price fluctuations is best exemplified in the period after World War II when a boom in stock prices was followed by a slump (Paras 9-11).

The violence of stock market fluctuations in India calls for special concern (Paras 13 and 14).

There is no proper safety for stock market dealings in India; nor equity between parties (Para 15).

It is also doubtful if the stock market has helped in fulfilling the function of directing the flow of savings into the most productive channels (Para 16).

Large funds have in recent years gone into joint stock enterprise, but this is not so impressive having regard to the vast increase in money incomes in war years. On the other hand, the sharp practices of company promoters and directors and excessive fluctuations in stock prices have discouraged investment in corporate enterprise (Paras 17 and 18).

Speculation in the stock market has been a potent factor in the inflationary situation in India in war-time and after (Paras 19 and 20).

Bank advances for stock dealings have greatly increased in recent years; the banking crisis at Calcutta in the middle of 1946 was due to too liberal advances on stocks (Paras 21-24).

Widespread tax evasion has been going on under contract stamps, transfer stamps and income-tax (Paras 25-29).

In the result, the stock market in India has failed to fulfil to any reasonable extent the functions which are expected of it. This is chiefly due to two causes, namely, lack of experience and training among the great majority of stock brokers and a general craze for speculation and gambling among certain classes of people in this country. Even those of them who have taken lately to industry have not shown so much interest in making production efficient as in profiting by clever company flotations and speculative share transactions (Paras 30-40).

CHAPTER VIII.
SHOULD THE SECURITY MARKET BE REGULATED? (SUMMARY)

The abolition of stock exchanges or even of all speculation is not advantageous as dealings are bound to go on unregulated and therefore more harmfully. The only alternative is wise regulation (paras 1-4).

The opposition to regulation on the ground that it is an invasion of private rights is unjustified, having regard to the important repercussions of the stock market on the banking system, credit structure, trade and commerce and general economic security of the country. The stock market is a barometer of general business conditions and is a powerful influence both as a depressant and as a stimulant of business activity. To leave in private hands, which means in the hands of speculators themselves, an institution so closely intermeshed with the gears that drive the wheels of industry and commerce, is a serious omission of public duty (Paras 5-9).

Another line of criticism is that Government is not properly equipped for exercising intelligent control. The lie direct to this has been given by the outstanding success of the Securities and Exchange Commission in U.S.A. (Paras 10-13).

A third argument is that stock market control will hit industry, especially in the undeveloped state of India's economy. Yet Japan established strict control over the stock market as early as 1893 when the economic development of that country had only started. A regulated stock market would be a great help to carry out a healthy economic development (Paras 14 and 15).

Stock exchange authorities favour control, provided, of course, the control is on outside brokers and street markets and manipulators only (Paras 16-19).

They forget that stock exchanges also have blemishes. Clearly, some Central authority is necessary for preventing unlicensed persons or bodies from maintaining stock exchanges and for ensuring a reasonable uniformity between existing stock dealers in regard to rules of business (Para 20).

In the present circumstances, Government regulation must go further and tone down the excessive price fluctuations, especially in times of panic and political uncertainties as lately witnessed (Paras 21-26).

The ultimate aim of regulation must be to make regulation unnecessary by strengthening the internal discipline within stock exchanges (Para 27).

Government regulation in Bombay since 1926 has been ineffective owing to serious defects in the law and the lack of a competent authority to administer it effectively (Paras 28 and 29).

War-time control of forward dealings under D.I.R. 94C has been even more ineffective owing to various causes (Paras 30-32).

CHAPTER IX.
METHODS OF CONTROL IN OTHER COUNTRIES (SUMMARY)

In other countries also stock markets had been in the past full of blemishes, but firm action taken by Government has greatly rectified them (Paras 1 and 2).

In London the regulation is largely confined to outside dealers whose sharp practices had in recent years evoked public criticism. There has not been any need for stringent regulation over the London Stock Exchange, but no other country is in this respect able to follow the British example (Paras 3-7).

In Paris, the main stock exchange (Parquet) is almost like a department of Government, members being appointed by the President of the Republic and the managing board working under the supervision of the Ministry of Finance; the supervision of Government extends also over the curb market and the free market (Paras 8-12).

In Germany stock exchanges are subject to very detailed Government regulations. On the Berlin Stock Exchange a State Commissioner appointed by Government is responsible for administering all laws and regulations (Paras 13-15).

In Tokyo Government regulation of stock market is even more complete. Government approval is necessary for the appointment of all stock exchange officers, and Government has power even to inspect the books of the exchanges and of the brokers. A guarantee fund has also to be deposited with the Government by every exchange (Paras 16 and 17).

In the U.S.A. federal legislation started only in 1934 after a wide-spread public agitation for the same. Since then a comprehensive regulation has been carried on by a high-powered body, the Securities and Exchange Commission. This Commission administers not only stock exchange law but also company law and the laws relating to public utility-holding companies, trust indentures, investment companies, investment advisers, etc. There was considerable opposition to Government supervision when it began, but subsequently, harmonious relations have prevailed (Paras 18-23).

Conversion of the stock market into a semi-Government department as in France is not recommended for India, but comprehensive supervision is essential. We may draw many lessons, especially from the U.S.A. (Paras 24-26).

The position of the stock market in India today has much in common with that of the American stock market before 1934 (Paras 27-36).

CHAPTER X.
NATURE OF REGULATION (SUMMARY)

Regulation in India must cover the entire market, stock exchanges, curbs and private dealers. Manipulations must be controlled by various methods. Dealings in the shares of a company by its own directors and agents must be regulated, as also the share pushing activities of promoters at the flotation stage. The crux of regulation is the setting up of a competent authority to administer the law. Mere legislation and leaving it to be administered by Provincial Government is bound to be futile in rectifying matters (Paras 2-4).

It is here that the example of the U.S.A. is most helpful for us. Effective action has been taken in America to put down manipulations, to discourage the unfair use of inside information by company directors, to control the over-the-counter markets and to reorganise exchanges, and this entire work has been done by the Securities and Exchange Commission (Paras 5-18).

The problem in India is analogous. Provincial action cannot be effective as a large part of the trade is in inter-market counters, as manipulations and pool activities operate on an all-India scale. Further, the uniformity in rules of business is essential and not to have this would only drive business from regulated to unregulated markets. To leave the administration of such a matter to the Provincial Governments will therefore defeat the objective in view. They will be helpless in carrying out the urgently needed reform (Paras 19-21).

Nor has any existing department of the Central Government the convenience or equipment to carry out this work. Only an independent and quasi-judicial authority with fullest powers of supervision could discharge this work effectively. A National Investment Commission is therefore necessary (Para 22).

The planning of investment on the lines proposed by the Finance Member (Sir A. Rowlands) is neither feasible nor urgent; even in the U.K. a similar proposal had to be shelved; what is urgent in India is to make investment safe, in the interests of social justice as well as of attracting more of the year's savings into corporate enterprise, rather than be hoarded as formerly. Therefore, to attempt a balanced investment in the altogether confused and insecure state of the investment market in India is like putting the cart before the horse (Paras 23-26)

The first step must be basic legislation in regard to stock market regulation. The stock market has not been expressly mentioned in the Central, Provincial and Concurrent list of the Government of India Act, 1935. Assuming that it comes under the provincial head, trade and commerce in the province, permission from the Provincial Governments has been obtained by the Central Government to legislate under Section 103 of the Act. But, if this will not empower the Centre to administer the law, the very object of legislation will be defeated, and therefore, the right step will be to seek a declaration by the Governor General under Section 104 of the Act thereby placing stock dealings in the Concurrent list (Paras 27-33).

The legislation urgently needed is to empower the Government of India to (i) regulate the stock market by licensing stock exchanges and other dealers in stocks, and to make rules and bye-laws, (ii) to register securities seeking to be enlisted on the stock exchanges and insist on certain periodical returns regarding them, (iii) to impose restrictions on *budla*, blank transfer and other objectionable practices, (iv) to administer laws relating to the securities trade, by setting up suitable agencies for the purpose, (v) to fix margins for stock dealings from time to time, (vi) to call for books of member-firms, and to examine the financial position of, and call for explanation from brokers, and (vii) to levy a sales tax on sales of stock (Para 34).

For assisting the Commission or other authority set up, it may he advisable to have a standing Council of Stock Exchanges, composed of representatives from leading stock exchanges (Para 36).

It is hoped that control of stock market dealings will be included among the powers of the Union in the Constitution to be soon drawn up (para 37).

CHAPTER XI. LINES OF REGULATION-PROPOSALS

If it is decided to set up a National Investment Commission, as suggested in the previous chapter, it will be best to leave to that body the drawing up of rules and regulations regarding the conditions of registration of stock exchanges and outside dealers, and the conduct of business to be insisted on. These matters will have to be decided in consultation with the stock exchanges. It is therefore proposed to deal in this chapter with only a few salient points.

No Rigid Control Recommended

2. The need for bringing stock exchanges and outside brokers under regulation has been stressed in the previous chapters. But the object of the regulation, let it be noted, will not be served by bringing the stock exchanges under a rigid control which may deprive them of the initiative necessary for conducting exchanges successfully. In order to enable stock exchanges to discharge the functions expected of them, we have to see that, they are properly organised with suitable rules of business; we have also to free them from the vexatious competition of curb traders and free-lance brokers, which has lately been one of the chief causes of confusion in the stock market.

Re-organisation A Pre-requisite

3. It must be our aim, *firstly,* to reorganise the stock exchanges and revise their rules, in order to bring them up to reasonable standards and to strengthen their governing boards for enabling them to enforce their rules effectively, especially in times of emergency; *secondly,* to apply more or less the same rules in regard to the outside markets, and *thirdly,* to see that each section of the market is allotted a definite sphere of trade, so that unhealthy competition may not take place between the two.

4. For carrying out these objectives, the most essential thing to do is to give a monopoly in each city to one stock exchange for the trade in their listed securities. In those cities where any legitimate need is felt for a second stock exchange with a different list of securities they can also be given permission to trade, on the lines of curb exchanges in the U.S.A., provided they also work under approved rules and will not butt into the legitimate sphere of the principal stock exchange. There can also be room for independent firms to do over-the-counter business, because large numbers of companies will not have their stock listed on the stock exchange or even on the curb exchange. In the U.S.A., it is estimated that a vastly greater number of securities (although not larger in dollar value) are traded over the counter than on the exchanges, and in the case of bonds, the great bulk of trading is over the counter. But they must also come under strict regulations and these need not be stricter than those now governing over-the-counter firms in the U.K. - a country noted for its non-intervention policy.

5. This will need a drastic modification of the present position. The present freedom - rather licence - must cease, in the interests of all.

6. The above steps may be possible in the principal cities which have their exchanges already. But what about the smaller cities and towns where there are no stock exchanges to cater for the needs of the public? In India distances are extremely large and there are numerous towns which cannot afford to have their own stock exchanges. Should demand arise for stock and share dealings in such towns, this has to be met either by local brokers being allowed to deal in all shares irrespective of whether they are listed in the nearby stock exchange or not; or, in the alternative, the member firms in the large cities must be allowed to open branches in such towns.

Registration of all Exchanges and Outside Brokers and Dealers

13. No stock exchange, curb market, outside brokers or dealers should be permitted without a licence. Trading in stocks and shares without such registration must be made illegal.

14. All stock exchanges, curb markets and independent brokers must take out licences authorising them to trade in stocks and shares. Licences must be given under prescribed rules which insist on certain standard practices being observed. Only with the previous consent of the Commission should stock exchanges suspend the buying-in rule or suspend short-selling or close the market for more than 24 hours. Proper contract forms should be prescribed and enforced. Fulfilment of contracts by payment and delivery should be enforced whether on organised exchanges or in the outside markets. The rules of licensing, however, may have to vary as between different sections of the stock market. A reasonable fee must also be charged at the original registration and every renewal of licence.

15. Members of a registered stock exchange need not take out separate licences from the Government. It is true that in France and Japan, members as well as the stock exchanges have to take out licences. But this is not necessary in the conditions of India.

17. As expressly stated in their objects, stock exchanges are organised "to furnish exchange rooms and other facilities for the convenient transaction of business by their members as brokers". It is therefore more like a private club. Hence the other object enumerated: "to maintain a high standard of commercial honour and integrity among the members and to promote and inculcate just and equitable principles of trade and business". In other words, a stock exchange does not directly deal with the public, nor transact any business in its own name. Therefore, incorporation is not essential. The body that runs the stock exchange may be either incorporated or not; it may be a joint stock company, or it may be a voluntary association. Uniformity is not essential in this respect.

Rules and Regulations

18. Uniformity, however, is essential in the methods of business on the stock exchanges and other constituents of the stock market (curb exchanges, independent firms, etc.). In other words, whatever may be the nature of their organisation, stock exchanges must work under a code of uniform, clearly defined and written rules and regulations approved by Government. Government must have also the ultimate power to add, to alter or rescind any of the rules. It may be best to provide the stock exchanges with a set of model rules. In the event of an exchange failing to observe any of the rules, Government should have the power to enforce such rules, even by superseding as in the case of municipalities. The rules should provide access to the public for remedies against their members, on an undertaking by the public that the verdict of the exchange will be accepted without demur. Equity should be provided to the transacting parties, whether between members and clients or between parties through members as agents. The relation between broker-members and their clients should also be defined in the regulations, so as to provide safety to investors for whose benefit the market is provided and even to general public who have a large stake in the concern.

Should Members Provide Security?

18A. Certain fundamental rules must be insisted on in the Act itself as a condition to licences being granted to Stock Exchanges. One of them is regarding securities to be taken from members. Provision for members of stock exchanges giving sureties or security and contributing to a guarantee fund exist in the legislation of many countries.

Outside Representation on the Governing Board

19. Should the governing board have on it representatives from outside the stock exchange?

Opinions have often been expressed that it is advantageous to have on the governing board representatives of important commercial bodies and banks. It is however, doubtful if such outside representation will be effective for counter-acting the self-interest of the inside members, as members from out-side may not always be available to attend meetings, especially emergency meetings; the need for which may frequently arise in the course of the stock exchange business. The suspension of cornered scrips or timely action to prevent a corner or a hammering when it is in sight cannot wait till members from outside assemble for a quorum. The usefulness of outside representation will largely depend also on the nature of experience possessed by the outside representatives. If suitable persons can be found on the spot, outside representation may be useful. It may be advisable, for instance, to have on the governing boards of stock exchanges one representative of the shareholders' association, if any and of the Provincial Government, Finance Department. This will at least serve as a restraining influence.

President

20. Perhaps more necessary than outside representation on the governing board is that the President should be one who can have enough independence for enforcing rules against the pressure of powerful vested interests within the stock exchange. How this is to be managed is to be carefully considered. In any case, presidentship, at least in the larger stock exchanges must be a full-time appointment for a term of years and the holder should not function as member during his period of office. It is also for consideration whether the appointment and removal of the President should have the sanction of Government.

Powers of the Governing Board

21. One of the crucial issues connected with the working of stock exchanges is regarding the powers to be vested in the governing board to interfere in the normal operation of the market. A fundamental principle of stock exchange administration is that except in certain clearly definable circumstances there should be no interference with the natural course of the market. As the Morison Committee put it: "Every bargain must be regarded as a contract to deliver or to take delivery of a stated amount of stock at a stated price and within a stated time", and any failure to implement fully such contract on the terms of that contract, by bona fide money payment, must automatically and without exception be followed by a public declaration of default.

24. The Committee, however, agreed that it was necessary to give the Board power to suspend buying-in of securities when circumstances appear to them to make such suspension desirable in the general interest. When the market is subject to bear raids, it cannot be said that the natural forces of the market cease to operate. But when an "effective corner" has been established, the natural forces do so cease to operate, and settlement of bargains can only be effected at prices which will not be dictated by individuals or group of individuals who may have successfully brought about a corner. The Committee, however, pointed out that on any stock exchange which realises its responsibilities, resort to suspension of the buying-in rule is only had in very exceptional circumstances. So far as Mr. Morison's recollection went, this power had been utilised in London only once in thirty years and that was to deal with a situation created by a temporary corner.

25. The Committee also thought that in the interests of the general public, in periods of emergency the Board should have power to suspend short-selling in any scrip or scrips with the least possible delay. But such power should be restricted to occasions when the general body of investors throughout the country have to be protected from the anti-social activities of unscrupulous individuals who might attempt to utilise a grave national or international situation to their own advantage.

26. It was the view of the Committee that in order to ensure against any improper use of the power of suspension of buying-in and short-selling, that power should be exercised only with the previous consent of Government. But the Board should have the power to close the market for twenty-four hours without the consent of the Government; but if closing is necessary for a longer period the consent of Government must be obtained.

27. The above recommendations were in the main accepted by the Governing Board of the Bombay Stock Exchange. On the whole, they have worked satisfactorily, and may well be adopted by other stock exchanges.

Forward Dealings and Budla

28. It has been shown in Chapter V how facilities for forward dealings have been a potent cause of excessive speculation. It is not claimed that speculation would cease by the adoption of the cash basis. Nor is it our aim to stop all speculation; what we are interested in is to adopt a system which is comparatively less liable to be used for excessive speculation. The term settlement by the very nature - the long period allowed, facility for differencing and carry-over (*budla*) - lends itself to excessive speculation, and lures people to it, as explained in Chapter IV. The speculator may buy for the long account and sell short during the same period, with the hope of making a profit out of time bargains. The long period provided will lead to excessive speculation by members, and when prices move contrary to expectations, it may lead either to objectionable practices, such as, settlement by payment of differences or may necessitate *budla* involving credit without appropriate security for its safety. The undesirable results of term settlements have been reaped in London also (see Chapter IV, para 7), in spite of the peculiar genius of the British to make the best of even bad systems. America, therefore, abandoned the term settlement system long ago, and Amsterdam after careful consideration decided not to adopt it.

30. It is true that the two Bombay Committees did not recommend the abolition of forward dealings. They indeed recognised its evils, but apparently took it as a necessary evil to be put up with, owing chiefly to the undeveloped character of the Indian stock market. This can no longer be considered a valid ground for continuing a system, which lends itself to undue speculation in a country where the temptation to gamble is very strong among a large group of persons. Further, New York has shown how under proper regulation the best results can be obtained from an exclusively cash market.

31. In these circumstances, it would be in the best interests of India in future to establish an exclusively cash market as was done at New York and elsewhere. This may be a drastic change if introduced abruptly; it may also lead to other reactions. In the meantime, therefore, forward dealings may be limited to a few special scrips appropriately selected for the purpose. Even these should be allowed only under strict controls, and under the special supervision of the Commission. Under no circumstances should scrips of credit institutions like banks be permitted for forward trading. In periods of panic and uncertainty - not only war, but political and communal troubles like those that occurred after September 1946 (which let us hope will not recur) - the forward market must be suspended after due consideration by the Commission or other authority appointed to administer the law.

Ready Delivery Contracts

33. One of them is the period of the contract. It is therefore essential that uniform rules regarding the performance of ready delivery contracts should be made and enforced, not only on all stock exchanges but also in all sections of the stock market.

34. The wide divergence in rules between the various exchanges is also a matter for urgent rectification by the promulgation of uniform rules.

Listing Regulations

35. The necessity for tightening up the listing regulation of our stock exchanges has already been urged. Official quotation on a stock exchange does not guarantee the value of any security; but at least it ensures to the public full knowledge regarding the affairs of the company. Leading stock exchanges like those of London and New York have exerted powerful influence on company promoters and directors by insisting on certain minimum standards being maintained by them in the interest of the investor. In India, something like this has been done by the Bombay Stock Exchange. But most of the stock exchanges have not taken a firm line in this matter and therefore some doubtful companies have obtained official quotation on some of them. It is therefore necessary to insist on uniform listing regulations being maintained in all stock exchanges, leaving unseasoned securities to prove their mettle on curb exchanges, if any, or in the over-the-counter markets.

It was with a view to helping the stock exchanges in this respect that under the Securities Exchange Act of the U.S.A., all securities listed or seeking to be listed on the national security exchanges have to be registered in the office of the S.E.C. Not only has complete information regarding the working of the company to be filed initially, but returns have to be made from time to time regarding all material changes in company affairs. A similar step is essential in India and provision should be made for this in the forthcoming legislation.

Compulsory Margins

36. It has been shown in Chapter IV that margin trading is practised in India. The larger firms insists on margins being deposited by their customers, but such insistence is not widespread owing to the keen competition among the eager brokers. It has been held that the introduction of compulsory margins would be desirable as a means of preventing the excessive use of credit and of controlling speculation and over-trading.

37. On the New York Stock Exchange, margin regulation have been in existence for a long time.

38. While it may be true that compulsory margins have helped in reducing unhealthy speculation on American stock exchanges, they have not been effective in eliminating speculation.

40. In India, the question of margins has been under consideration in Bombay. Mr. A. D. Shroff, in his evidence before the Morison Committee, urged Government to take power to permit forward trading only under prescribed margin requirements. It was not enough to fix an initial margin; there was also need to maintain the margin at the required level as the transactions increase. He went further, and urged the need for every broker submitting daily a list of transactions at the overnight closing time, in order that the stock exchange authorities may see that the required margin is maintained.

41. The Committee was convinced that margins are necessary, but many of the proposed schemes were found too complicated for a market unused to such a system. The Committee suggested (i) a percentage margin on the initial bargain price, (ii) an additional percentage margin on the make-up price at the first settlement if the contract is carried over, and (iii) for the additional percentages as supplementary margins at each of the following settlements.

42. The margin on the initial bargain price may be fixed at 40 per cent, and the maintenance margin at 35 per cent of the current market price. Margin may be either in cash or in approved securities.

43. Should margins be provided by non-members only or by members also? Having regard to the large volume of transactions by members, it may be advisable to insist on members for providing margins. It is true that members

of some stock exchanges have to keep a compulsory deposit with the exchanges. But such deposits are at present not very large (Rs 20,000 in Bombay, Rs 5,000 in Madras). Further such a practice does not obtain in many stock exchanges. If the deposit is made compulsory for members and if the amount fixed up is sufficiently large, members' margins may perhaps be reduced if not altogether dispensed with.

44. It is not enough to prescribe margins for those who deal on the stock exchange. Safety demands that strict margins should be prescribed in respect of banks' advances on stocks and shares. As this is primarily a concern of the Reserve Bank, it would be for that authority to lay down rules in regard to such margins.

Brokers and Jobbers

45. A vexed question, mooted for long, is whether the functions of broker and jobber should be separated. In India both functions are performed by the same persons. In fact, some brokers are not only jobbers, but also underwriters.

46. It would be a great convenience if jobbers and brokers can be separated. But there are great difficulties for such separation in India. There must be a much larger number of listed securities; the number of members must also be larger and there must be a sufficient number of members with large resources who are able to take up the exclusive function of jobbing. None of these conditions at present seem to obtain in India. It is on the larger stock exchanges in India - those of Bombay and Calcutta - that any attempt could be made in this direction, but attempts so far made have proved futile.

Control of Jobbing by Brokers

47. What is more required in the conditions of India is to strictly regulate the broking and dealing activities of the members, in the interest of the public. As things are now, there is necessarily a conflict of interests between a member's broking business and his own jobbing. In other words, it is extremely difficult for a member to trade for himself without prejudice to the best interests of his customers. This point has been urged by several prominent persons who supplied information in the course of this enquiry. One remedy proposed is to prohibit members from trading with their clients as principals. They should not be permitted to purchase from clients' securities or sell their own holdings to their clients. In the contract, the member should state from whom he has purchased or to whom he has sold securities. Brokerage should be separately stated in the contract, whether the contract be for the cash market or the forward market. Besides, members doing '*tharawani*' work as in Bombay and Ahmedabad, and the 'shunters' of Calcutta, should be brought under strict control by adequate measures, as their activities are positively undesirable. One of these, as suggested by the Morison Committee, is the fixation of a large unit of trading as jobbers.

47A. In connection with the proposals in the above para, Section 14 of the S. Africa Stock Exchange Control Act is worth noting. "Any stock broker who has been instructed by any person to buy any stocks or shares on his behalf shall not, in connection with the purchase of those stocks or shares, enter into any arrangement where by a lien of buying those stocks or shares from any other person, he sells his own stocks or shares to such first mentioned person, unless he has obtained his consent thereto and disclosed to him in a note of purchase and sale that the stocks or shares are his own". Similar provision has also been made in regard to sales of securities through brokers. Having regard to the serious misgivings in the public mind regarding sharp prices by brokers, it may be advisable to make a somewhat similar provision in our legislation.

Minimum Brokerage

48. As the custom of cutting rates of brokerage has in the past caused various evils, a schedule of minimum brokerage should also be fixed and

enforced by the exchange, so that variations in stock prices between broker and broker may be avoided.

Need for Special Training for Membership

49. It has been shown in the course of this report that the lack of training for membership has been a serious hindrance to the maintenance of proper standards by member-firms and their functioning investment advisers to the public. One way of remedying this will be to insist on a minimum educational qualification and five years of apprenticeship in a member-firm as essential qualifications for membership. Provision must also be made for a special course of training being given to those intending to take up a stock market career.

50. A few memberships of the London Stock Exchange are reserved for authorised clerks who come up to certain standards of proficiency, and opportunities are also given to them for obtaining training. It is essential that such opportunities should be given to auhorised clerks on the Indian stock exchanges also, and it will be desirable to make provision for the really competent among them being elected to membership. It may also be advisable to select every year a certain number of the clerks for the training mentioned above, so that by the time they become eligible for membership, they may become well equipped for discharging their responsibilities properly.

Holidays

51. Apart from the habit of keeping stock exchanges closed when it suits the convenience of the governing board, there is an inclination to have too many holidays on stock exchanges in India. Rules may be so modified that the market will only be closed for purpose of holidays, on all Sundays, all bank holidays declared by the Government under Negotiable Instruments Act (which are themselves too many) and special religious holidays considered essential in the particular area.

Clearing Houses

52. One serious obstacle to the establishment of clearing house is its heavy cost. Nor can Government be expected to incur expenditure for this purpose. If, in our two largest cities, the bulk of the business comes into one stock exchange, the maintenance of a clearing caring house should become economical. In centres where clearing houses are not available, settlement may be done in the stock exchange halls during fixed hours under the supervision of its authorities.

Blank Transfer

54. The causes for the popularity of blank transfers have been dealt with in Chapter IV. This question has given rise to an acrimonious controversy. In countries where every company has an office at the headquarters where the predominant stock exchange is located, transfers can be easily effected. This is the case in the U.K. But in India, head offices of many companies are located in distant cities and towns, and communication between them take a long time and involves much cost. In these circumstances, if the blank transfer is made bad delivery, as suggested by the Morison Committee, it would greatly impede the work of stock exchanges and undermine liquidity, which is essential for investment and capital formation. After all, blank transfer has not been abolished in any country; it has been held valid delivery even by the Privy Council. We should devise some method by which the facilities for over-speculation and tax-evasion can be greatly reduced, without undermining the liquidity of securities.

55. Various steps can be taken for this purpose. The first step must be to see that dividends of companies are distributed to registered shareholders only. The position is quite different now. Secondly, we must limit the currency of the blank transfer, say to two months, and for this purpose Government must insist on the use of transfer forms embossed with stamp fee and date of issue. The buyer then will have to take steps to register the transfer with the company within two months.

Uniform rules must be adopted by all stock exchanges in this matter, and they will have to be strictly enforced.

56. One of the factors that have encouraged blank transfers in the past is the high stamp duty charged by the Government, and the large transfer fees by some companies. It is for Government to see if both these charges are reduced. Thereby it may also be possible to reduce evasion and to raise larger revenues from these items.

Over-the-Counter Market

57. So far, we have dealt with the organised stock exchanges. Much as we may desire that trade in stocks and shares should be concentrated in organised stock exchanges, there may still be private firms and dealers. They have special facilities in dealing with certain classes of scrips, especially new issues, and such issues which for some technical reason or other may not be accepted for trade on the stock exchanges. Especially in towns not served by stock exchanges, dealers are bound to spring up to meet the needs of local people. All these have to be compulsorily licensed as otherwise business is bound to flow from regulated to unregulated areas. The regulation of these private markets is essential, seeing that serious abuses are rampant and frauds widely practised in this section of the stock market.

58. Stringent rules have been drawn up by the Board of Trade in U.K. for the licensing of private dealers. We in India may with advantage draw on these rules. The following are the conditions of licensing in the U.K.:-

(i) The giving of true information as prescribed and substantiated by a statutory declaration;
(ii) The provision of reference as prescribed;
(iii) The provision of sureties as prescribed;
(iv) Undertaking to comply with prescribed conditions as to the conduct of rules; and
(v) That the applicant is not an undischarged bankrupt or has not been convicted of any offence involving fraud or dishonesty.

59. If, as in the U.S.A., when any association of private dealers is to be formed, it should be registered and licensed as a stock exchange.

Reform of Company Law

61. With a view to discouraging the malpractices, regarding share dealings, of promoters and directors of companies, provision should be made for the following in the amended Act:-

(i) In the case of new flotations, information regarding distribution of holdings at the time of allotment should be reported to the National Investment Commission or other authority established for stock market regulation.
(ii) Immediately after the issue and original sale of shares a separate statement containing detailed information regarding allotment to directors, their relations and friends, and underwriters, if any, for the purpose of holding beyond the period agreed to for underwriting should also be sent to the above authority. For such reporting a definite period should be stipulated in the Act.
(iii) Any change within a period of six months in the holdings of shares of a company by any of its directors or officers or even its auditors, directly or indirectly, should be forthwith reported to the said authority by the secretary of the company.
(iv) Stagging by the directors or other officers of the company, directly or indirectly in the names of others, whether relations or otherwise, should be prohibited and even penalised by the forfeiture of such office.
(v) Any purchase or sale of securities of a company by any of its own directors or officers or even its auditors, directly or indirectly, at any time within six months prior to the declaration of dividend, whether the security is registered or held in blank, should be reported to the said authority by the company as well as by the person concerned with the transaction.

(vi) Declaration of dividends should be communicated to the said authority and the various stock exchanges, telegraphically or otherwise in minimum time, so that it may be published simultaneously in the different trade centres.

(vii) Companies should be statutorily required to submit quarterly balance sheets.

62. With a view to discouraging blank transfer and allied evils, the following measures are desirable:

(i) Transfer fees chargeable by companies should be statutorily fixed and should be on the same *ad valorem* basis, *i.e.*, it should not vary among the companies.

(ii) A period for completing the process of transfer and registration of shares by the company should be statutorily fixed. Deviations or evasions should be penalised by a right to claim damages or loss. The period for transfer should be so fixed as to make the limitations of life of blank transfer practicable.

(iii) Similarly a period for splitting or subdivision of scrips should be defined and fixed.

(iv) Companies should issue certificates in marketable lots as practised on recognised stock exchanges.

(v) Scrips in respect of new issues of companies should be issued within a specified time after the date of subscription of capital. (Long delays have happened in some cases on the ground that printing was delayed).

Supply of Statistics

66. It is essential that Government should have power to collect statistics from stock exchanges and dealers. One of the conditions of licensing must be the sending of certain periodical returns to Government, and provision must also be made for the supply of any additional statistics that may be called for.

67. It should be a condition of registration of stock exchanges that they should supply statistics regarding their volume of business weekly to Government. For this, purpose every member must file with his stock exchange an account of his daily purchase and sale within an hour of the closing of market. Members who give wrong information or neglect this duty must be severely penalised by stock exchange authorities

A Sales Tax on Security Transactions

68. For undertaking a proper regulation of the stock market on any lines, funds will be required. It is but fair that such funds should be raised from the securities trade and not from the pocket of the general tax-payer. No doubt a part of these will come from the licence fees levied from stock exchanges and outside dealers, but this cannot be adequate. Further, so widespread and important a business as stock market has a duty to contribute to the general revenues apart from whatever contribution it may be making to the income-tax and the new capital gains tax.

70. I, therefore, recommend that a sales tax on share transactions should be levied every time a scrip is sold. The proper procedure will be for every member of the stock exchange to submit a list of his sales every evening to the committee of the stock exchange with a full amount of tax as fixed by Government, The tax may be levied at either of the 1/2 per cent of the market value of the shares sold or 2 per cent on the par value of the shares whichever is higher.

71. This tax may not be regarded as a serious burden and will be passed on to buyers just as sales tax is now passed on. An advantage of this tax is that it will also be a curb upon speculation but a premium on investment. Those who speculate on shares will have to pay duty several times, over and over again, but the investor will have only a light burden. At the same time the burden on the speculator is not heavy enough to discourage him altogether. Therefore, it may serve as an elastic source of revenue. Of course, the tax will have to be levied, not only from members of the stock exchanges but also from private dealers. Strict provisions will have to be made for this in the regulation of the over-the-counter market.

REPORT OF THE STUDY GROUP ON FINANCING OF THE PRIVATE CORPORATE SECTOR IN THE SIXTH FIVE YEAR PLAN
(Chairman: C. Rangarajan, India, Planning Commission, 1982 (mimeo))

[The Summary of only Chapter IV of the report is presented below.]

CHAPTER IV.
CAPITAL MARKET

24. The amount of capital raised from new issues, on an average, has been of the order of Rs 58 crores per annum during the decade ended 31.3.1980. There has, however, been a sharp increase in the quantum of capital raised from new issues in 1981-82 due, inter alia, to liberalization of investment policies and procedure by the Government.

25. The favourable public response to issues of such shares is, however, mostly confined to well established companies. Issues by new concerns continue to be unattractive even if the projects are considered to be viable.

26. In the case of debentures, the over-subscription has been confined mostly to convertible debentures, and almost all non-convertible debentures were under-subscribed and some of them heavily so.

27. Apart from new issues, the companies have been raising capital by means of right issues and through company deposits. The amount raised through right issues has recently become quite substantial. Company deposits hold a crucial position as a significant source of finance for meeting the working capital requirements.

28. Mobilisation of resources by the private corporate sector has not been commensurate with the growth in the household savings. Measures would need to be taken in order to draw a larger proportion of the household savings by way of company securities. To this end, the Study Group has made a set of recommendations intended

a) to improving the attractiveness of the instruments to the savers and

b) to strengthening the infrastructure of the capital market.

29. Shares of companies promoted by new entrepreneurs have not found favour mainly due to lack of return in the initial years. In order to mitigate this problem, the Study Group feels that such companies should be enabled to go in for public issues only at a stage near the completion of the project. Till that time, the financial institutions could provide the required funds by way of project loans. This facility may be extended mainly to medium sized and large projects promoted by non-MRTP and non-FERA companies. The details and modalities of the implementation of the scheme may be worked out by the financial institutions.

30. It has been represented to the Study Group that in addition to the above there should be a scheme under which investors in new equity can be assured a reasonable return by way of interest on the amount invested, pending earning of sufficient profits by the company to declare dividends. There is considerable merit in the principle underlying the suggestion but there are some problems in the implementation of this suggestion. The Study Group would recommend that the proposal may be examined in detail and a practical alternative scheme be evolved.

31. The proportion of capital raised by way of preference shares has steadily come down over the years. In part, this phenomenon appears to be the result of more attractive instruments of securities now available to the investing public. With a view to correcting this, the Study Group recommend that the ceiling rate on dividend on preference shares may be raised to 15%.

32. Stock Exchanges play a crucial role in the mobilisation of savings for investment in industrial securities and in strengthening the capital market. The spread of stock exchanges is rather limited and their functioning has left much to be desired. The Study Group recommends that the functioning of the stock exchanges needs to be studied in depth by a High-powered Committee very urgently with a view to ensuring that the working of the stock exchanges is not disrupted by recurrent crisis, that they are able to efficiently

handle a much larger volume of instruments and that their management is broad based so as to be representative of all the interests whose activities are influenced by the functioning of these exchanges.

33. The existing procedure for raising capital by companies from the market is both time consuming and expensive. There would seem to be a need to consider the streamlining of the existing procedures and requirements with a view to making the issue of capital simpler and less expensive.

34. The restrictions on the duration of transfer deeds are reported to be impeding the fresh flow of transactions of stock exchanges. The Study Group feels that there is a need to extend the period of the validity of the currency of the transfer deeds.

35. A factor which seems to inhibit the development of an active secondary market in debentures is the high rate of stamp duty on transfer of debentures imposed by some State Governments. The Study Group recommends that the rate of stamp duty be uniformly fixed by all State Governments at 50 paise for Rs. 100/-. The Group further suggests that the stamp duty should be related to the consideration amount and not to the face value of debentures.

36. Return of the excess application money in time is necessary to ensure flow of funds into the corporate sector. The Study Group recommends that Section 73 of the Companies Act be amended providing for payment of interest on the excess application money at a penal rate of interest for the period of delay beyond 10 weeks from the date of closure of the subscription list till the date of despatch of refund orders. Pending an amendment of the Companies Act, the Group feels that the Ministry of Finance may consider the feasibility of issuing a suitable guideline to the stock exchanges.

37. The Study Group had received a number of other suggestions which it has not found possible to accept. These pertain to liberalisation in regard to grant of loans against shares, raising of debt-equity ratio, raising the rate of interest on debentures and increasing the ceiling on the amount of deposits that can be accepted by non-banking and non-financial companies. The Study Group feels that in all these cases, the status quo should continue.

REPORT OF THE HIGH-POWERED COMMITTEE ON STOCK EXCHANGE REFORMS (Chairman: G.S. Patel, India, Ministry of Finance, 1986.)

[The Summary of the main recommendation of the committee are presented below. The separate summary of amendments to the related laws and rules, presented in the report, are not reproduced since they are referred to in the different chapters.]

I Organisation and Management of Stock Exchanges

Form of Organisation of the Stock Exchanges

The Committee recommends that it would be appropriate to have a uniform model for the organisation of the Stock Exchanges in the country on the lines of the companies limited by guarantee without share under the provisions of the Companies Act, 1956.

Once a uniform model of organisation is adopted, all the Stock Exchanges should be required to have common Memorandum and Articles of Association. In this connection, it is suggested that the Memorandum and Articles of Association of Madras and Pune Stock Exchanges which are organisations limited by guarantee may be taken as a model with suitable modifications as may be required.

The Committee is of the opinion that besides regulating the working of the Stock Exchanges, it is also important to regulate the activities of all others associated with the Stock Exchanges. The Committee, therefore, recommends that either a separate legislation be enacted or comprehensive amendments to the Securities Contracts (Regulation) Act may be made providing for the incorporation and regulation of the Stock Exchanges and for regulating the activities of those concerned, directly or indirectly with the securities industry.

Pending amendments to the Securities Contracts (Regulation) Act or the enactment of a separate legislation, the Committee recommends that hereafter the Government should grant recognition only to such Stock Exchanges constituted as companies limited by guarantee and licensed under Section 25 of the Companies Act, 1956. Also, in respect of existing Stock Exchanges which are unincorporated associations of persons, they should switch over to the new form of corporate organisation by following the procedures laid down in the Companies Act, 1956. As regards the Stock Exchanges which are companies limited by shares, they should follow the procedure for reorganisation as laid down in Sections 391/394 of the Companies Act, 1956, by obtaining the approval of their members at a general meeting and also of the High Court for the reduction of capital under Sections 100 to 104 and thereafter seek the approval of the Central Government under Section 25 of the said Act. Where the existing Stock Exchanges are companies limited by guarantee but with share capital incorporated under the Companies Act, 1956, they should take suitable steps to get themselves licensed under Section 25 of the said Act.

With a view to expediting the reorganisation of the existing Stock Exchanges the Committee recommends that the Securities Contracts (Regulation) Act should be amended expeditiously so as to empower the Government to bring about the recommended changes in the organisational structure of the Stock Exchanges which are presently association of persons or company limited by shares, rather than wait for these Stock Exchanges to complete the formalities for reorganisation on their own volition.

Management of the Stock Exchanges

The Committee recommends that immediate steps should be taken by the Government to broadbase the existing Governing Bodies of the Stock Exchanges to make them fully representative of various interests.

The Governing Body of each of the Stock Exchanges should consist of elected and non-elected members on a 50:50 basis not exceeding 18 in number, excluding the Chairman and the Managing Director. Additionally, the financial institutions should have a right to appoint their nominees not exceeding 2 in number on the Governing Body of any Stock Exchange which avails of financial assistance from them.

The Committee further recommends the following conditions for the elected Directors:

(a) The elected Directors should be from amongst the existing members of the Stock Exchanges.
(b) 1/3rd elected Directors should retire every year by rotation.
(c) The elected Directors may have a maximum of 2 consecutive terms of 3 years and after a minimum break of one term, they may be eligible for re-election of further 2 terms of 3 years each. Thus no member can hold the Office of Director for a period exceeding 12 years in the aggregate.

The nominated members of the Governing Bodies should be nominated by the Government from the Government departments, development banks/institutions, investment institutions, the Reserve Bank of India, economists having necessary expertise in stock and capital markets, industrialists and professionals from recognised bodies such as Institute of Chartered Accountants of India, Institute of Costs & Works Accountants of India, Institute of Company Secretaries of India, Institute of Management, etc. The terms and conditions of services of such nominated members should be decided by the Government.

The nominated members should be adequately compensated by the Stock Exchanges. The position of the President of the Stock Exchanges may be dispensed with. Instead there should be a Chairman of the Governing Body to be appointed by the Government of India.

As regards the appointment of Chairman of the Governing Body, the Committee recommends that a panel of 3 names of independent persons may be recommended by the Governing Body of the Stock Exchange concerned. In case, however, the Government does not approve of any of the names on the panel suggested by the Governing Body for the Chairmanship, the Government may appoint any person of their choice in consultation with the Governing Body. Such a Chairman of the Governing Body should be an independent person not having any direct or indirect interests in the trading activities of the Stock Exchanges.

The tenure of the Office of the Chairman should be for a period of 5 years and he should be eligible for reappointment for only one additional term of 5 years.

The Committee recommends that there should also be a post of Vice-Chairman which may be filled up by way of election by the Governing Body from among the elected Directors.

Each of the Stock Exchanges should have a Managing Director who should possess the requisite expertise in the field and who should not have any direct or indirect dealings in industrial securities. The terms and conditions of service of such a Managing Director should be determined by the Government. The Managing Director should have a term of 5 years which may be further extended from time to time at the discretion of the Government but not beyond the age of 65.

The Stock Exchanges should also have specialised ,departments dealing with different aspects of their business activity.

In addition to the defaults committee, arbitration committee, etc., the Stock Exchanges must have at least 2 other committees one for planning and development of securities business and the other for the purposes of audit. It is recommended that the Governing Body of the Stock Exchanges should co-opt eminent persons on such committees. The Committee also recommends that the defaults committee and arbitration committee should each be headed by an eminent independent Chairman.

The Governing Body of the Stock Exchanges should be vested with adequate power and authority to institute civil and criminal proceedings against the members and non-members for any breach or violation of any of the provisions of the Securities Contracts (Regulation) Act, Rules, directives, etc. The Securities Contract (Regulation) Act, the Rules framed there-under, etc., may be suitably amended.

Overall Administration, Supervision and Control of The Stock Exchanges in the Country

The Committee does not favour setting up of a Commission on the lines of Securities and Exchange Commission as in USA. The Committee recommends that an apex body called the Council for Securities Industry be established instead (The functions of the proposed Council have been enumerated in the Chapter). The composition of the Governing Body of the Council for Securities Industry should be as under:

Number of members:	Mode of selection:
4	Chairmen of the Stock Exchanges, at least one of whom should be a Chairman of a small Stock Exchange.
4	Independent members from Government officials, experts from the field of corporate finance, commerce, accountancy, management and law (not more than two from Government officials).
2	One member each from investment and development finance institutions which would be contributing towards the initial capital of the Council for Securities Industry.
10	Total Members

Additionally, the Governing Body of the Council should be headed by a whole-time Chairman-cum-Managing Director.

The appointment, tenure of the Office, terms and conditions of service of the members of the Governing Body of the Council including its Chairman-cum-Managing Director may be determined by the Government.

The Council for Securities Industry should be a statutory body with adequate powers, embodied in the statute to enable it to function effectively.

The Council, to begin with, should have Regional Offices where the principal Stock Exchanges are situated. Later, if need be, Branch Offices could be established at other centres where the Stock Exchanges are situated.

The initial funding for the establishment of the proposed Council should be done by the financial institutions, particularly the investment institutions by way of subscription to its initial capital. Subsequent expenses of the Council can be met from the levy on the turnover of the Stock Exchanges, surcharge on the listing fees, etc.

The strength of the Stock Exchange Division of the Ministry of Finance should be considerably increased and upgraded.

II Membership of the Stock Exchanges

Educational and Professional Qualifications

(i) The Committee recommends that for the present the minimum basic educational standard should be pegged at XIIth standard or equivalent. After 5 years or so, the Question of raising the minimum educational standard to graduation could be examined.

(ii) The Committee further recommends establishment of a separate Institute designated as National Institute of Investment and Financial Analysts in the country. This Institute should be established on an All-India level on the lines of Institute of Chartered Accountants or Company Secretaries, etc., by the financial institutions, Universities or the Institutes of Management. The Institute can also offer a special diploma course of a year's duration for those seeking membership of the Stock Exchanges as also for the existing members, authorised assistant clerks and for the persons working in the Stock Exchanges, investment and financial institutions.

(iii) The Committee has separately recommended the establishment of a Council for Securities Industry. The Committee is of the opinion that this Council, in collaboration with Institutes of Management or Institutes of Chartered Accountants/Company Secretaries of India or the Universities, should organise diploma course of a year's duration through the Stock Exchanges for those desiring the membership of Stock Exchanges.

Candidates seeking membership of the Stock Exchanges must as a pre-requisite qualify for the diploma offered either by the National Institute of Investment and Financial Analysts or by the Council for Securities Industry. The Committee also recommends that there should be no exceptions as regards the completion of this diploma course, for persons succeeding to the established business of a diseased or retiring member of the Stock Exchange.

(iv) With a view to professionalising the existing members, all Stock Exchanges must conduct, from time to time, part-time refresher course of 6 to 8 weeks' duration.

(v) The Council for Securities Industry should also organise induction courses periodically for sub-brokers licensed securities agents and licensed dealers for canvassing business for industrial securities.

(vi) Members of the Stock Exchanges and others associated with the working of the Stock Exchanges should have reasonable background in economics, corporate finance, taxation, etc. Further, these persons must be reasonably conversant with the provisions of various Statutes, Securities Contracts (Regulation) Act, 1956, Securities Contracts (Regulation) Rules, 1957, Companies Act, 1956, Capital Issues (Control)

Act, 1947, Income Tax Act, 1961, Monopolies Restrictive & Trade Practices Act, 1969, policies of financial institutions, etc.

Experience and Practical Training in the Business

(i) In case of candidates desiring membership of the Stock Exchanges and who have passed at least XIIth standard, the minimum experience should be as under:

(a) three months in case of MBAs, Chartered Accountants, Cost Accountants, Company Secretaries or post-graduates in commerce or economics;

(b) Six months in case of others.

(ii) Other candidates who are presently working as authorised assistants/clerks or apprentices of a member who do not have the required minimum educational qualifications but have qualified for the diploma/ certificate course organised by the National Institute of Investment and Financial Analysts or the Council for Securities Industry, must undergo practical training for two years with a stock-broking firm.

(iii) Each Stock Exchange must have a panel of approved members who are in a position to impart adequate knowledge and training to the aspirants for membership.

Financial Solvency and Viability

(i) Security Deposit:

The Committee recommends fixation of security deposits (for doing business only in non-specified shares) per member for different Stock Exchanges as under:

Bombay Stock Exchange	1,00,000
Calcutta Stock Exchange	75,000
Delhi Stock Exchange	75,000
Madras Stock Exchange	50,000
Ahmedabad Stock Exchange	50,000
Other Stock Exchanges	25,000

Security deposits should be further stepped up by 50 percent if the member wants to do business in 'specified shares'. It is also recommended that such security deposits should preferably be taken in cash, and only in exceptional cases they should be taken in approved liquid securities with a margin of 25 percent. However, in no event, the membership card or the share/s of the Stock Exchanges should be considered to be an approved security. Only such members who have paid the security deposit in full should be permitted to conduct any business in industrial securities. However, in case of new members, the facility of payment of the security deposit in two installments may be given in deserving cases with such restrictions as the Governing Body may impose.

The Stock Exchange authorities may, in their discretion, collect from any member additional security deposit.

(ii) System of Net Capital Requirements or Liquidity Margins:

The Committee feels that there should be a linkage between the volume of business and owned funds of a member in his business. It, therefore, recommends that in addition to security deposit as aforesaid, a system of 'net capital requirements' or 'liquidity margins' should be evolved by the Stock Exchange and limits fixed for each member in relation thereto, for doing separate types of business such as cash business, forward business, underwriting business, etc. Details of this scheme may be worked out separately by the Council for Securities Industry.

(iii) Annual Subscription:

Annual subscription for membership should be minimum of Rs 2,500 per annum for smaller and new Stock Exchanges. In major Stock Exchanges the same should be at least Rs 5,000 per annum.

Publicity by Members

The Committee is of the opinion that the members of the Stock Exchanges may be allowed to issue advertisements in any media, provided the advertisements are within the guidelines framed for the purpose. Besides, copies of all advertisements should be preserved by the members for three years as the same should be available for inspection whenever required by the Stock Exchange authorities.

Other Issues

Provision for admission to membership:

(i) In view of the changes suggested in the educational and professional qualifications, experience and training, present rule regarding election to the membership, being approved by the two-thirds of the votes cast in the meeting of the Governing Body, would be redundant.

(ii) Candidate for membership should be asked to give references of two reputed persons, one of whom may be a member of the Governing Body or any other member having at least 7 years standing or a member under whom he has received his training.

(iii) Membership may be approved by a simple majority of the members of the Governing Body. In the event of the candidature being rejected by the Governing Body, the candidate shall have the right to appeal to the proposed Council for Securities Industry whose decision shall be final and binding.

(iv) The Committee is of the view that it would not be advisable to make financial institutions and commercial banks eligible for the membership of the Stock Exchanges.

Right of nomination/transfer of shares:

(i) The committee recommends that the membership should be always open to any person who is qualified, having adequate experience and has also qualified for a professional diploma indicated earlier in the Report.

(ii) At present, the entry into stock broking business is very easy for members, close relatives, etc. There cannot be any objection to such persons being admitted as members. However, with a view to professionalising the membership of the Stock Exchange, it is recommended that the norms of eligibility for membership in regard to educational qualification, experience and practical training, etc., as recommended above, should also apply to those acquiring membership on a hereditary basis or through nomination.

(iii) With a view to allowing the heirs of a deceased member or the resigning member the benefit of the goodwill of the business, it is recommended that 50 percent of the prevalent admission fee should be paid to the nominee/heir of the deceased member or resigning member as compensation. This facility should also be extended to the existing members as well. The Securities Contracts (Regulation) Act Rules may be suitably amended for the purpose.

Inactive members:

(i) The Committee recommends that the provisions of the Securities Contracts (Regulation) Act Rules may be amended to enable the Governing Body of the Stock Exchanges to terminate memberships which are dormant for a period of one year or more.

(ii) The Committee further recommends that the Ministry of Finance or the proposed Council for Securities Industry should lay down norms defining the minimum amount of business (including subscription to new issues, buying and selling of scrips, underwriting, etc.) to be done by each member to remain in business. These norms should, however, vary from one Exchange to another and may be reviewed from time to time.

(iii) In the event of termination of inactive membership where the membership card is held by the heir/nominee of a deceased member or in the case of a member who has retired from active operations, in all such cases the card holder or the successor must be paid 50 percent of the admission fee prevalent at the time of termination.

Corporate membership:

The Committee is of the view that the companies may be allowed membership of the Stock Exchanges on the lines suggested by the Government, provided:

(a) The company is formed in compliance with Section 322 of the Companies Act, 1956.

(b) All the Directors assume unlimited liability, and

(c) A majority of the Directors are members of the Stock Exchanges and also shareholders of the corporate member.

Multiple membership:

(i) With a view to encouraging all the Stock Exchanges in the country and facilitating arbitrate transactions, interflow of information, etc., it is suggested that to begin with multiple membership may be permitted in major Stock Exchanges. A member of a minor Stock Exchange may, however, be permitted to be a member of a major Stock Exchange as well.

(ii) Members of Stock Exchanges should be encouraged to open branch offices at different places excluding centres where minor Stock Exchanges are situated.

Increase in membership:

The constitution of Stock Exchanges should be suitably amended so that the present inbuilt hurdles which prevent continuous increase in the membership of Stock Exchanges are removed. For the purpose, the Committee recommends that the existing Stock Exchanges should be reconstituted as companies limited by guarantee and that the Stock Exchanges to be established in future should also be similarly constituted. The Securities Contracts (Regulation) Act may be amended to give powers to the Government to direct the Stock Exchanges to increase their membership.

Specialist members:

(i) The Committee recommends that a class of specialists members be created who would specialise in buying and selling of some securities, particularly the inactive ones, allotted to them on the Stock Exchanges.

(ii) These specialists should be allowed to keep inventory of securities in which they specialize. To augment their financial strength for the said purpose, Reserve Bank of India may be requested to permit Commercial banks to grant liberal advances to such members on the strength of certificates issued by the Stock Exchange authorities. Also the financial institutions may be requested to give lines of credit to this class of specialists and evolve a suitable scheme of encouragement as is done in the case of new entrepreneurs.

Authorised assistants/clerks:

(i) The members must be made fully responsible for any business transacted by the authorised assistants/clerks irrespective of any private understanding or arrangements amongst them.

(ii) All existing and future authorised assistants/clerks should be asked to place a security deposit as under:

Centre	Amount (Rs)
Bombay	10,000
Delhi	7,500
Calcutta	7,500
Ahmedabad	7,500
Madras	5,000
Other Stock Exchanges	2,500

In case the authorised assistants/clerks also deal with public and procure orders for the members, besides trading on the floor, they may be required to pay additional security deposit to the extent of 100 per cent of the aforesaid amounts.

(iii) Authorised assistants/clerks who are badge-holders should pay annual subscription to the Stock Exchanges as under:

Centre	Amount (Rs)
Bombay	500
Delhi	250
Calcutta	250
Ahmedabad	250
Madras	250
Other Stock Exchanges	100

(iv) Members of the Stock Exchanges should be required to take suitable insurance covers in respect of the acts and omissions of their authorised assistants/clerks.

(v) After 1987, all authorised assistants must qualify for a diploma/certificate course to be conducted by the Council for Securities Industry.

Sub-brokers:

The dealing with the sub-brokers should be effectively regulated and controlled and they should be brought under the discipline of the Stock Exchanges. Further, the member brokers should be made fully responsible and accountable for the dealings and the acts and omissions of the sub-brokers attached to them.

Licensed dealers:

(i) Dealers in securities should be licensed from one of the recognised Stock Exchanges in or nearby their place.

(ii) The licensed dealers should be of sound financial means and should pay a security deposit of Rs 25,000.

(iii) The licensed dealers must be required to undergo an induction programme of a fortnight or a month's duration within 6 months of their being licensed to act as a dealer. In addition, they should undergo such training programmes or pass such examinations conducted by the Stock Exchanges or the proposed Council for Securities Industry within a period of three years of their becoming dealers as may be prescribed. Exemptions may, however, be given in case of highly qualified licensed dealers.

Licensed securities agents:

In the opinion of the Committee it will be useful to have an additional class of licensed securities agents situated at places where there are no Stock Exchanges. The functions of these agents should only be to canvass new issues of industrial securities and to assist the investors in documentation relating to transfer of securities, filling up of application forms, consolidation of holding, etc. In this context, the Committee recommends that the agents of the Unit Trust of India, Life Insurance Corporation of India and General Insurance Corporation of India and its subsidiaries may be licensed for the purpose.

Gratuity fund:

The Committee is of the opinion that the gratuity fund for the members may be established and every member whether existing or new or active or not, should be asked to contribute a certain minimum amount towards the fund. In the event of the demise of a member, a fixed sum may be paid to his family, over and above the amount represented by voluntary contributions per member fixed by the Body administering the fund, depending upon the period of membership of the deceased member.

Audit of the accounts of the members:

The Stock Exchange authority should undertake, whenever deemed necessary, audit and inspection of the books of accounts and documents of any member and '*sauda*' books of authorised assistants. For the above purpose, a special task force may be created by each of the Stock Exchanges and the reports thereof should be placed before their respective Governing Bodies at regular intervals. It is also suggested that the Stock Exchanges should establish a panel of outside auditors for the purpose.

Disputes amongst members of Stock Exchanges:

In the event of disputes or claims/counter-claims between members of different Stock Exchanges the same will be referred to the proposed Council for Securities Industry and its decision should be final and binding on the parties.

Other recommendations:

(i) It may be provided in the Securities Contracts (Regulation) Act that the pending orders of the clients on the books of a broker will be executed first before any order on account of the broker himself or on account of his partner or employee is executed unless the intention behind such an order is to earn commission only.

(ii) The contract note issued by a member must separately give the price at which the security is purchased/sold, time at which the purchase was put through and the brokerage charged. It must also be indicated therein, whether the broker is dealing with the client as a dealer or as a broker.

III Listing of Industrial Securities on Stock Exchanges

A company seeking enlistment on a Stock Exchange, at present, has to apply for the purpose to the regional Stock Exchange as well as to the other Stock Exchanges where it wants enlistment along with the prescribed documents. The procedure is not only time consuming but also involves considerable unnecessary expenditure for the companies. The companies seeking enlistment on more than one Stock Exchange may, therefore, approach only the regional Stock Exchange for approval of the listing application. For purpose of enlistment on other Stock Exchanges, the companies need to submit only a simplified listing application. Upon approval of the regional Stock Exchange, the companies would be automatically listed in the other Stock Exchanges where the applications have been made for enlistment.

The main listing application form, the simplified application form, the listing agreement and the practices adopted by the Stock Exchanges for grant of listing should be uniform for all the Stock Exchanges. In order to ensure, inter alia, proper scrutiny of the listing applications, all Stock Exchanges should have a qualified secretary as the secretary of the Exchange. The Stock Exchanges should not take more than 3 working days for admission of securities to dealings on the Exchange once the listing application is complete in all respects.

A guidance cell should be set up in every Stock Exchange and a uniform check-list containing standard set of norms required by the Stock Exchanges in respect of formalities to be completed by the companies regarding listing be prepared.

The powers conferred on the Government under Section 21 of the Securities Contracts (Regulation) Act should be invoked to compel the unlisted companies to get their securities listed in the following cases:

(i) where the companies propose to raise term loans (excluding foreign currency loans), debentures from the financial institutions (all India and State level) or raise resources by way of issue of shares/debentures of Rs 3 crores or more in the aggregate, outstanding any time, and

(ii) the companies have a net worth of more than Rs 1 crore or have made profits (before tax) in at least three years out of the last five years. In case the companies had made losses in the last two years, such companies might either be exempted from the compulsory listing or they may be given more time for listing of their securities.

The Companies Act or the Securities Contracts (Regulation) Act may be amended suitably to ensure compliance of these provisions. The existing bonus guidelines may be reviewed at least with regard to companies requiring to list their securities as per the aforesaid net worth criterion having a small capital base but, with large reserves, so as to permit them to issue bonus shares in the ratio exceeding 1:1.

Whenever such companies seek institutional finance, the institutions should disburse funds only after obtaining the necessary Board resolutions of the companies to list their securities within one year of disbursement of loans from the financial institutions.

The minimum paid up capital of a company for eligibility for listing should be raised from the existing level of Rs 20 lakh to Rs 50 lakh. The Minimum paid up capital of non-banking financial companies coming under the purview of the RBI should be fixed at Rs 1 crore for listing purposes.

A listed company should be delisted after giving six months' notice if the number of public shareholders falls below five for every Rs 1 lakh of capital offered to the public or if the public shareholding falls below 50 per cent of the public offer. These requirements will not be applicable if the infractions are due to the holdings of the public financial institutions.

Any violations of the provisions of the listing agreement should be made an offence punishable by the Stock Exchanges by levy of fine by them directly under their bye-laws or by instituting suitable proceedings in a Court of Law. In the later case, prior approval of the Government must be obtained by the Stock Exchange. Suitable provisions should be incorporated in the Securities

Contract (Regulation) Act in this regard. Annual listing fees payable by companies should be uniform as given below for all the Stock Exchanges:

Size of Companies	Rupees
Companies with paid-up share and/or Debenture capital, upto Rs 1 crore	3,000
Above Rs 1 crore and upto Rs 5 crores	6,000
Above Rs 5 crores and upto Rs 10 crores	10,000
Above Rs 10 crores and upto Rs 20 crores	20,000
Above Rs 20 crores and upto Rs 50 crores	30,000
Above Rs 50 crores	50,000
Initial listing fees	5,000

The scale of listing fees for Stock Exchanges other than the first two Stock Exchanges, including the regional Stock Exchange, should be 50 per cent of both initial and annual listing fees mentioned above.

The companies having a capital of Rs 5 crores and above should be required to be listed on at least two Stock Exchanges, including the regional Stock Exchange. Further, all existing listed companies should statutorily be required to be listed compulsorily on the Stock-Exchange of the State/area where the registered office or the main works/fixed assets of the company are situated.

All companies which raise capital through prospectus should statutorily be required to get their securities listed compulsorily provided their paid-up capital meets with the minimum requirements prescribed in this regard.

The existing provisions in Clauses 19 and 20 of the listing agreement have to be amended suitably to make them foolproof to ensure that companies furnish timely and complete information regarding consideration and recommendation of bonus shares or right shares or declaration of dividend, to the Stock Exchanges so that there is no scope for misuse of such price sensitive information by anyone.

Suitable provisions should be incorporated in the listing guidelines/consent issued by the Controller of capital issues to the effect that the promoters/management group of the companies should not sell/transfer/hypothecate their shares at least for a period of 3 years from the date of enlistment on the Stock Exchanges and that the companies concerned will make suitable endorsement to this effect on the share certificates issued to the promoters/management group of the companies.

All listed companies should be required to furnish unaudited financial results on a half-yearly/quarterly basis within two months of the expiry of the period, for the information of the public.

Suitable guidelines for private placement of securities should be evolved for the protection of investors. Apart from certain information being furnished to the Government in the matter, the shares subscribed by the original promoters should not be transferable for a period of the first three years. This fact should be prominently superscribed on the share certificates.

The feasibility of development of an unlisted securities market (U.S.M.) on the lines of such a market in the U.K. may be explored to enable medium and small sized companies which do not get their shares listed for one reason or the other to come into the listing fold.

Companies having provisions in the Articles of Association which are not in tune with sound corporate practice, such as some specified directors having powers of veto tantamounting to overruling the majority decisions of the Board, should not be listed unless the Articles of Association of these companies are suitably amended to ensure that the majority decision of the Boards of Directors shall always prevail in all matters relating to the affairs of the companies.

The Committee feels that there should be free transferability of shares as a matter of principle in case of all listed companies. However, some problems may arise in companies. However, some problems may arise in curtailing the right of the Board of Directors of companies to refuse transfer of shares. Nevertheless, the Board of Directors of a listed company should not refuse to register the transfer of shares to the nominal value of Rs 10,000 subject to the condition that the total holdings of the transferee either individually or jointly shall not exceed the nominal value of Rs 25,000. The Committee is, however, glad to note that the Securities Contracts (Regulation) Act has since been amended providing for free transferability of listed securities subject to inadequate safeguards against undesirable take over-bids or destabilisation of managements. The amendment also provides that in case a company wishes to refuse transfer of securities on the ground that any requirement under law has not been complied with, it has to notify the transferor and transferee of the same within two months from the date of lodgement of the instrument of transfer. In other cases, the company will have to make a reference to the Company Law Board and act according to the directions of the Board.

The Stock Exchanges should bring out an updated brochure on matters relating to listing. The Stock Exchanges should make an annual review of the compliance of the provisions of the listing agreement, publicise the names of the companies which have not complied with these requirements and submit a report to the Government in this regard.

With a view to minimising the cost of servicing the shareholders' it is suggested that the minimum lot of transfer and sub-division corresponding to the market unit of trading should be stipulated.

Companies must be required to pay interest on the amount to be refunded at the rate of 15 per cent per annum from the expiry of ten weeks from the date of closure of the subscription list till the actual date of posting of the refund order.

Section 73 of the Companies Act, 1956 may be amended empowering the regional Stock Exchanges to extend the period for admitting the securities of the company for dealing beyond ten weeks from the date of closure of the subscription list in suitable cases on merits.

The listing agreement may also be amended to provide for notification to the Stock Exchanges any acquisition or disposition by the company or by its subsidiary of shares of another company resulting in such company becoming or ceasing to be a subsidiary company, delivering to the Stock Exchanges copies of the Chairman's address or other announcements, etc.

Rule 19(2) (a) (iv) of the Securities Contracts (Regulation) Rules relating to forfeiture of unclaimed dividends may be amended so as to bring it in consonance with the provisions of Section 205A of the Companies Act, 1956. Rule 19(2)(b) of the Securities Contracts (Regulation) Rules may be amended to provide obtaining approval of the Government under the said rule only by the regional Stock Exchange, which should automatically apply to the other Stock Exchanges where the securities of the company are proposed to be enlisted.

Whenever bonus or right shares are issued by a company it should as far as possible be done in such proportions that the issue of fractional certificates is reduced to the minimum. Even the residual fractional certificates required to be issued to the shareholders need not be issued. Instead they may be paid the proportionate amount in cash.

IV Measures to Reduce the Cost of Public Issues of Capital

The financial resources which are expected to be mobilised, through the channel of the new issue market would reach a level of at least Rs 5000 crores per annum in the next few years. Recognising the vital need for minimizing the cost of raising these resources the Committee has made the main recommendations as under:

[I]. MANDATORY COSTS:

1. *Underwriting and Brokerage*

The Committee is of the view that there is a need to rationalise the charges payable towards underwriting commission and brokerage and making the same consistent with the need to ensure that resource mobilisation through the medium of the Stock Exchanges is not adversely affected.

A. Underwriting:

(i) Whenever a company makes a public issue of securities at a premium of 25 per cent or more, no underwriting arrangements should be permitted;

(ii) In respect of public issue of securities by existing companies which have earned net profits in any 3 out of last 5 years or where the premium is less than 25 per cent of the face value, the underwriting arrangements should be optional to the companies concerned;

(iii) In such and other cases the Controller of Capital Issues/All India financial institutions should use his/their discretion to decide about the extent of underwriting to be permitted to a company in view of the size of the issue, nature of the industry, background of the promoters, anticipated response of the investing public, etc.

(iv) There may be cases where the projects are vetted by the financial institutions and they are agreeable to provide financial assistance by way of term loans and/or underwriting of the issues. Even in such cases, there may be unfilled gaps of underwriting of the issues. If the financial institutions agree to provide standby arrangements to take-up unsubscribed portion of an issue in the event of its under-subscription there may not be any need for underwriting arrangements. The financial institutions, if necessary should put in their applications on the last day of the closure of the issue, in case the minimum public subscription has not been received by then. This would ensure compliance with the minimum subscription requirement under Section 69 of the Companies Act, 1956.

(v) Underwriting commission on equity shares should be reduced from the existing rate of 3 per cent to 2.5 per cent. Further, there should not be any distinction between the amounts devolving on the underwriters and amounts subscribed by the public;

(vi) Underwriting commission payable to an individual underwriter for preference shares, convertible and non-convertible debentures should be at the following rates:

	On amounts Devolving on the Underwriter	On Amounts Subscribed by the Public
(a) For amounts upto Rs 5 lakh	2.5%	1.5%
(b) For amounts in excess of Rs 5 lakh	2%	1%

(vii) It may be clarified by way of circular/notification by the Controller of Capital Issues that the rates of underwriting commission fixed by him are the ceiling rates, within which any company is free to negotiate the same with the underwriters;

(viii) Underwriting commission should not be payable on the amounts taken up by the promoters' group, employees, directors, their friends and business associates; or by the depositors and the debenture holders of the companies in case of preferential allotment;

(ix) In the case of equity issues upto Rs 1 crore, the financial institutions could consider taking up the entire issues on a consortium basis, so that the smaller new companies may not have to go to the market for those issues, if they so desire. The institutions may also, at their discretion, consider taking-up equity issues above Rs 1 crore. Later, when the companies reach the stage of profitability, these issues may be off-loaded by the institutions to the public in a manner which does not destabilise the existing management. For this purpose, the financial institutions be exempted from complying with the public issue formalities, and when they offload the shares of such companies to the public, the benefit of Section 80 CC of the Income Tax Act, 1961 as available to the public at present in respect of equity issues of the new companies, should continue to be extended to the investing public for such issues. This recommendation is made taking into consideration the fact that the initial taking up of the entire issue by the institutions is a mere postponement of the issue to the public and does not tantamount to a public offer by itself.

According to the Committee, a better course, however, may be to establish a separate institution by the consortium of financial institutions, banks, State Industrial Development Corporations, etc., to take up the new issues of capital made by the Non-Monopolies Restrictive Trade Practices and Non-Foreign Exchange (Regulation) Act Companies.

B. Brokerage:

(i) Brokerage rates applicable to all types of public issues of industrial securities should be fixed at 1.5 per cent irrespective of whether the issue is underwritten or not;

(ii) It should be clarified by the Controller of Capital Issues by way of circular/notification that the mailing cost and other out-of-pocket expenses should be borne by the brokers and no separate reimbursement of the same should be made by the companies. A clause to this effect must be included in the agreement to be entered into between the broker and the company;

(iii) The listed companies be allowed to pay brokerage on private placement of capital, by whatever name it is called, @ 0.5 per cent only. It should be clarified by a circular that the cost of public issue includes the cost of private placement of issues, if they are out of public issues sanctioned by the Controller of Capital Issues;

(iv) Brokerage in case of public issue of capital or in case of private placement out of such public issue should not be payable in respect of promoters amounts taken up by the directors, their friends, business associates, the employees, depositors and debenture-holders of the companies in case of preferential allotment and the rights issues taken up or renounced by the existing shareholders or the debenture-holders. Unless they are offered to the public, no brokerage should, however, be paid on the amounts taken up by or placed with the financial institutions/banks out of the right issues offered to the public;

(v) Brokerage should not be paid when the applications are made by the financial institutions/banks against their underwriters' commitments or on the amounts devolving on them as underwriters consequent to under-subscription of the issues. This also applies in case of the right issues offered to the public and underwritten by the institutions/banks;

(vi) The licensed securities agents which may be appointed to canvass the public issues of capital may also be paid a brokerage of 1.50 per cent.

2. *Fees of the Managers to the Issue*

The companies should be free to appointment one or more agencies as managers to the issue, but the aggregate amount payable as fees to such persons should not exceed the following limits:

(a) For issue upto Rs 5 crore: 0.5 percent;

(b) For excess over Rs 5 crore: 0.25 per cent.

Further, managers to the issue should not be paid any fees in respect of the following:

(a) Amounts agreed to be taken by the financial institutions and the amounts devolving on the financial institutions as investors/underwriters.

(b) Amounts taken up by promoters, employees, directors, their friends and business associates, depositors, debenture-holders in case of preferential allotment.

(c) On amounts subscribed on rights basis.

(d) In the case of rights issues offered to the public, on the amounts underwritten (taken up by or placed with the financial institutions and banks).

3. *Official Brokers*

Provision regarding compulsory appointment of official brokers to the issue from each of the Stock Exchanges should be deleted from the listing agreements between the Stock Exchanges and the companies.

4. *Statutory Press Announcement*

Statutory press announcements released in the newspapers should not exceed half a page.

5. *Listing Fees*

The Committee does not see much scope in reducing the expenses related to the listing fees.

[II]. VARIABLE COSTS:

1. *Printing and distribution cost in respect of Prospectuses & application forms*

(i) Given the limited practical utility of the prospectus in its present form from the point of view of the investor and the cost involved in its printing and distribution, it is recommended that Section 56 of the Companies Act, 1956 requiring every application to be accompanied by a prospectus may be amended and the companies may be allowed to issue an application form giving the main highlights of the issue as duly approved by the Controller of Capital Issues/ financial institutions/Stock Exchanges. However, a copy of prospectus, as required to be issued at present, may be made available to any investor on demand from the offices of the company concerned, Stock Exchanges, underwriters, managers to the issue, bankers to the issue, etc.

(ii) The formal, size and the contents of the prospectus itself should be simplified by incorporating only the vitally required details which are not otherwise available in the Memorandum and Articles of Association, application form of a company, etc. A suitable statement be included in the prospectus and the application form to the effect that the company has complied with the statutory requirements.

(iii) The free supply of application forms and prospectuses should be restricted as under:

(a) The members of the Stock Exchanges should be given 100 application forms and prospectuses each for issue upto Rs 1 crore and 200 application forms and prospectuses each for issues about Rs 1 crore;

(b) Underwriters should be given, if demanded, 1000 application forms and prospectuses for every Rs 1 lakh of capital underwritten;

(c) The managers to the issue and each of the Stock Exchanges should be given 500 application forms and prospectuses.

(iv) For additional supply of application forms and prospectuses, over and above the free quota as enumerated above, the same should be supplied on payment of actual cost not exceeding 25 ps. per application form and Re 1 per prospectus and the company should keep a proper record thereof;

(v) All agencies concerned with the marketing of the public issue must place firm orders for the supply of application forms and prospectuses with the company sufficiently in advance of the opening of public issue;

(vi) The free quota of application forms and prospectuses to be supplied by the companies should be reduced as under after the amendment of Section 56 of the Companies Act, 1956:

Sr. No. (1)	Category Public Issue (2)	Quantity Size of the forms (3)	Application (4)	Prospectuses (5)
(i)	Members of the issue	Any size	100	10
(ii)	Stock Exchanges			
	(a) Upto Rs 1 crore		200	20
	(b) Above Rs 1 crore			
(ii)	Underwriters		1000**	50**
(iii)	Managers of the issue	Any size	500	50
(iv)	Stock Exchanges		500	50

** For every Rs 1 lakh of capital underwritten, if demanded.

2. *Advertisement and Publicity*

(i) The provisions of the listing requirements need to be re-examined with a view to imposing restrictions in respect of the number of advertisements given in the newspapers for the benefit of the investors, the type of newspapers in which the advertisements should be released, the size of the advertisement, etc.

(ii) There is a need for discipline in respect of expenditure incurred on account of the brokers and investors' conferences in posh hotels at metropolitan cities. It would be more useful and productive if such conferences are organised in semi-urban and rural areas to evoke wider investors interest and response.

(iii) Expenses being incurred by the companies to mobilise non-resident savings being rather high, such expenses need to be controlled by the companies concerned.

3. *Expenses of Registrar to the Issue*

Proper planning, better co-ordination, close monitoring and follow-up between the company and the agencies involved with the collecting bankers would help reduce delays which in turn would reduce incidental costs of raising capital.

(a) Centres for acceptance:

(i) In respect of public issues of securities not exceeding Rs 5 crore, the centres for acceptance should be all the recognised Stock Exchanges and the prescribed centres in the State where the regional Stock Exchange is situated and the centres in the State where the nearest major Stock Exchange is situated.

(ii) In respect of public issue of securities exceeding Rs 5 crores, the centres for acceptance of applications should be all the recognised Stock Exchange centres and all the centres prescribed by the Government.

(b) Minimum Subscription\Allotment:

The applications for securities be invited from the public for a minimum amount of Rs 1000 (100 shares of Rs 10 each or 10 shares/debentures of Rs 100 each) with a minimum allotment of 100 shares of Rs 10 or 10 shares/debentures of Rs 100 each.

(c) Adjustment of excess application money/number of calls:

The companies may be permitted to adjust excess application money at the time of allotment and if no such excess application money is available, call money notices for the balance amount be allowed to be issued at the time of allotment. Further, the companies should also be permitted to invite application money at 50 per cent or 100 per cent of the issue price at their discretion.

(d) Minimum offer period:

For minimising workload and expenses involved in heavy over subscription, the subscription list should preferably be allowed to be closed at the end of the first day of the opening of the issues in case the same is oversubscribed by that day. However, to begin with, the minimum period to keep the subscription list open be reduced from the present level of 3 days to 2 days.

(e) Despatch of instruments/documents:

The companies should despatch instruments documents by means of 'Recorded Delivery' instead of 'Registered Post'. However, with the implementation of the suggestion above, there may perhaps be an increase in the instances of instruments/documents being lost in transit. The companies should, therefore, re-examine their procedures for the issue of duplicate shares/debentures certificates and/or any other instruments/documents to simplify them to avoid inconvenience to the investors.

(f) Intimation of basis of allotment:

The basis of allotment of the issue need not be intimated to the applicants and it should suffice if the companies publish the same in a widely circulated newspaper.

(g) Centralised servicing centre/issue house:

The Committee is of the opinion that the Government should examine, as early as possible, the setting up of a centralised servicing centre/issue House by the financial institutions and investment institutions in collaboration with the commercial banks and/or Stock Exchanges. Such an Issue House/[servicing centre] should have branches at important centres in the country and should act as registrar to the issues, share transfer agents and trustees for the securities.

4. *Measures to minimise delays in processing of applications and realisation of application moneys*

(i) The Committee recommends that the application moneys should be collected only through the prepaid instruments like demand drafts, postal orders or a new type of an instrument called 'security cheques' or even cash. With this system the company would be able to draw out a list of successful allottees without encashing the application moneys received from the applicants. The application moneys received in respect of successful allottees alone should be encashed. The unsuccessful applicants should be returned the financial instruments tendered by them as their application money. However, in case of partial allotment or in the case where application money has been given by way of cash, the present procedure of refund order should be continued. To implement the above proposal suitable amendments to Sections 69 and 73 of the Companies Act, 1956 may be made, if necessary.

(ii) In addition to the introduction of the system of payment of application moneys through prepaid instruments, the Committee also recommends modification in the present format of the application form. With the proposed modification in the application form, the companies would be in a position to expedite processing of the applications received without waiting for the collection of the application moneys received in respect of all applications tendered at various branches of the receiving bankers. The new procedures would facilitate quick processing, easy reconciliation of applications and moneys received, early allotment of securities and expeditious despatch of refunds to the unsuccessful applicants.

[III]. FIXATION OF OVERALL CEILING ON THE COST OF PUBLIC ISSUES:

The Committee realises that there are a number of variable and imponderable factors which come in the way of evolving a clear cut formula for fixing ideal standard norms for the overall expenses to be incurred by the companies in respect of their public issues. All the same in the larger public interest the Committee recommends the following overall ceilings on the amount of expenditure incurred by the companies in respect of their public issues of capital:

Particulars/size of the issue	Limits of the cost
(a) Equity & Convertible Debentures:	
Upto Rs 5 crore	Mandatory costs +5%
In excess of Rs 5 crore	Mandatory costs +2%
(b) Non-Convertible Debentures:	
Upto Rs 5 crore	Mandatory costs +2%
In excess of Rs 5 crore	Mandatory costs +1%

Expenditures incurred beyond the above limits should not be allowed for deduction for the purpose of taxation. This would require suitable amendment to the relevant provisions of the Income Tax Act, 1961.

The auditors of the companies concerned should be required to qualify the reports suitably if the cost of public issues of the concerned companies exceeds the overall limits as mentioned above.

The above limits could be reviewed and revised suitably from time to time in the light of prevailing conditions.

It has to be emphasised that every agency connected with the public issue has an equal responsibility in the matter and should extend maximum co-operation to the companies concerned to minimise the cost of public issues. Of course, the companies should be conscious of the need to minimise the cost of public issues. In the ultimate analysis there is no substitute, or for that matter there cannot be any, for self restraint, self discipline, consciousness on the part of all concerned with the public issues about the need to minimise such costs.

V Recommendations Relating to Trading in Securities and Measures to Ensure Smooth Functioning of the Stock Exchanges

Trading for Settlement Business

Trading for settlement business is necessary for the purpose of ensuring liquidity and price continuity of securities on the Stock Exchanges. However, to ensure stability in the Stock Exchanges, it is necessary that such trading should be allowed in a regulated manner. In this context, the Committee is of the opinion that the ban on trading for the settlement in general should continue and the trading for settlement business in certain specified shares which is presently permitted should be properly regulated and controlled.

Disclosures by the Investors

(i) Every investor must disclose, at the time of placing order for purchase or sale of shares, whether he wants to take or give deliveries of shares or is interested only in trading for settlement business.

(ii) The stockbrokers will be required to issue two types of contracts - one, for cash, and the other, for settlement transactions, the contracts issued being in distinct and different colours for easy identification. This system will assist the genuine investor and would facilitate the Stock Exchange authorities to know the volume of transactions on a cash or a carry over basis, which in turn would enable them to take timely measures to deal with emerging situations.

Specified Shares

(i) The criteria for inclusion of scrips in the list of specified shares should be made more rigid and uniform for all Stock Exchanges.

(ii) The list of specified shares should be under constant review and periodically revised by excluding the dormant scrips and by including some of the active scrips from the non-specified group.

(iii) There is no justification for preventing any scrip from being included in the specified group on more than one Stock Exchange. In fact, the Committee is of the opinion that the proposed Council for Securities Industry should finalise a common list of specified shares and should frame suitable guidelines and procedures which would be applicable to all the Stock Exchanges for trading in such specified shares with a view to ensuring that transactions in specified shares are effected in a regulated and controlled manner. Such a step would actively encourage inter-market arbitrate business, paving the way to a national securities market.

Financial Resources of the Investor

(i) Any one who wants to buy or sell shares of listed companies on the Stock Exchanges must have sufficient financial resources to back up his business commitments. Every investor, must therefore, pay front-end margins before buying or selling equity shares in the markets. Front-end margins should be applicable both in respect of transactions on a cash basis and a settlement trading basis.

(ii) In case of cash transactions, every individual investor must pay 25 per cent of the contract value at the time of placing order for purchase as front-end margin. In the case of sale of securities, on a cash basis, deliveries should be effected by the individual investors within 7 to 10 days of placing the order for sale. In the case of non-fulfilment of the stipulations, suitable penalties should be imposed on the investor concerned.

(iii) If an investor wants to buy or sell specified shares for trading for settlement business he should pay front-end margin money of minimum 20 per cent at the time of placing the order for purchase or sale of shares. This can be stepped up further if the situation so warrants.

(iv) The front-end margin money collected should be deposited with the Stock Exchanges by the stockbrokers immediately.

(v) An investor must be properly introduced to the stockbroker. If an investor sells or purchases equity shares of more than Rs 10,000 face value for settlement trading, he should have a satisfactory reference from a scheduled bank.

No Dealings with Defaulting Clients

A stockbroker should not deal with any outside party which has failed to honour its business commitments with any other stockbroker of any Stock Exchange. For this purpose, the names of defaulting clients should be reported by the member to the Stock Exchange authorities immediately.

Minimum Liquidity Margin

(i) To ensure smooth and healthy functioning of the Stock Exchanges and to prevent excessive speculation, the Committee recommends that the volume of business and trading of every member stockbroker should be linked to his financial resources. It is further recommended for the purpose that a system of minimum liquidity margins should be introduced whereby each stockbroker would be required to maintain sufficient financial stake in the business and his volume of activity in different fields, such as business in securities, underwriting, etc., would be related to his financial resources. The proposed Council for the Securities Industry shall frame a suitable scheme on the lines of the broad outline of the scheme given in the annexure to the Report.

Disclosure of Information by the Stockholders/Stock Exchange Authorities

(i) Every stockbroker must report to the Stock Exchange, on a daily basis, scrip-wise list of names of parties who have purchased or sold shares of the market value of more than Rs 1 lakh in cash or settlement basis.

(ii) All Stock Exchanges should publish, on a weekly basis, in leading newspapers, information regarding volume of business in specified shares and non-specified securities for the information of the general investing public.

Distinction between Contracts for Trading for Settlement Business and Contracts for Genuine Investments

There should be a distinction between contracts for trading for settlement business and contracts for genuine investments. This calls for amendments to the present Bye-laws and Regulations for making specific provisions for delivery and payment of shares. At no time, any investor should be made to suffer in receiving deliveries of shares against payment or sale proceeds of shares delivered by him.

Carry-over of Transactions

(i) The Committee recommends that the carry-over of transactions should be allowed for not more than 4 settlement periods of 14 days duration each with the aggregate time span of 60 days. If the delivery of shares is not completed within the stipulated time and at the contracted price, the member broker should be deemed to have defaulted and the shares should be acquired by auction and delivered to the investor. In such cases, the difference in price should be recovered from the defaulting member. Strict penalties should be provided in the Bye-laws and Regulations against carry-over of transactions of cash scrips.

(ii) Every member must settle his accounts and square up his positions once in 60 days and a certified statement to this effect must be filed by the member with the Stock Exchange authorities.

Trading Dours

The Committee is of the opinion that the trading hours of all the Stock Exchanges should be increased to 5 hours a day, in a phased manner, and there should be separate sessions for cash business and for settlement business.

Outside Finance

(i) The stockbrokers should not be allowed to arrange for finance from outside by offering shares under purchase with blank transfers as security for speculative trading on their own account.

(ii) At the end of each settlement period, every stockbroker should submit to the Stock Exchange authorities, details regarding the quantum of monies he has borrowed from outside and the rate of interest at which the money has been raised by him.

(iii) Non-banking finances used for '*badla*' and speculative purposes by non-member operators should be brought within the purview of Usurious Loans Act or Money Lender's Act or should be regulated by the Reserve Bank of India as is done in case of fixed deposits, operations of chit funds, etc.

(iv) It may be prescribed that necessary returns detailing the names of the parties concerned, quantum of moneys involved, rate of interest at which money is borrowed, securities offered, etc., are filed with the Stock Exchanges and the Reserve Bank of India, in case of large deliveries exceeding Rs 5 lakh in market value, given or taken through the clearing house or through the stockbrokers direct.

Option Trading and Kerb Trading

(i) The ban on option trading should be continued and persons indulging in this activity should not be allowed to enter the Stock Exchange premises during the trading hours.

(ii) Option trading is a cognizable offence punishable with an imprisonment of 2 years and expulsion from the membership of the Stock Exchange. This should specifically be brought to the notice of the stockbrokers.

(iii) A vigilance squad should be established in each of the Stock Exchanges to detect the members who indulge in Option and Kerb trading.

(iv) Stock Exchanges should ensure that transactions done in Kerb do not get recorded on the next day or later, officially.

(v) Orders placed by an investor after the close of official trading hours should be accumulated by the stock broker and executed during the trading session on the next working day.

Closing Quotations

No closing quotation of any scrip should be recorded officially if it is put in the last fifteen minutes unless it is for more than 250 shares of Rs 10/- each or 25 shares of Rs 100/- each.

Spread in Two-Way Quotations

The spread in the two-way quotations of equity shares should be reasonable and be regulated by the proposed Council for Securities Industry.

Undesirable Activities

Any activity on the part of the members of the Stock Exchanges which is undesirable and which would adversely affect the general health of the stock markets and the orderly functioning thereof, such as manipulation, false trading, market rigging, insider trading, Kerb trading, etc., should be treated as civil and criminal offences punishable with heavy fines and imprisonment upto 5 years. For this purpose, the Securities Contracts (Regulation) Act may be amended suitably.

Disclosure of Information by Companies

To prevent speculation on the basis of rumours regarding the current functioning of the companies, it should be provided in the listing agreement that all companies must publish at least their unaudited working results on a half-yearly basis, and on a quarterly basis if their paid up capital is Rs 10 crores or more. Also, any price sensitive information should always be included in the agenda of the Board Meetings of the companies which is required to be circulated to the Stock Exchanges well in advance.

Insider Trading

Insider trading must be made a punishable offence with severe penalties or fines or even imprisonment. Suitable provisions may be incorporated in the Securities Contracts (Regulation) Act on the lines of a draft annexed to this Report.

Trading in Securities Before Listing

(i) The time span between the offer of shares to the public and grant of listing should be reduced. The Committee is of the view that it would be better if provisional listing is granted to facilitate official trading. It should be examined whether trading in securities can be permitted from the date of issue of the prospectus. The Bye-Laws should be amended to permit such trading with suitable regulations.

(ii) The regulations framed for the purpose will be applicable to all the persons in charge of management and their merchant bankers managers to the issue.

System of Margins

(i) Besides introducing a system of front-end margins as suggested earlier, the Committee recommends that a carry-over margin should be levied uniformly at the rate of 10 per cent. However, if the price of a scrip increases by more than 5 per cent during a settlement period and by more than 10 per cent as compared to the previous marking-up price of the settlement preceding the current one, the carry-over margin should then be 20 per cent. These margins can be stepped up further when circumstances so warrant.

(ii) Carry-over margin money should be collected only in cash.

Operation of the System of Margins for Reasonable Periods

All the margins collected from the members should be retained by the Stock Exchanges till the time the actual outstanding transactions for which the margins have been paid get settled or alternatively the technical position of the market becomes stable, with the discretion vested with the Managing Director of the Stock Exchanges. Once the margins are imposed, they should be in operation for a reasonable duration so that their impact is not allowed to be whittled down by fresh bouts of speculative activity. Even withdrawal of margins, when decided upon, should be permitted in a phased manner.

Disclosure of Information in Transactions by the Stockbrokers

With suitable amendments in the Bye-Laws and Regulations of the Stock Exchanges, it should be made obligatory on the part of the stockbrokers to make full disclosure of the information regarding the transactions effected by them as and when and to the extent required by the Stock Exchange authorities.

Powers of the Stock Exchanges and Other Facilities Available to Them

(i) Stock Exchanges should also be vested with adequate authority to ask for reports on the activities of any authorised clerks or '*Taravaniwallas*' and to take disciplinary action against them, if required.

(ii) Stock Exchanges should be empowered by suitable amendments to the Bye-Laws and Regulations to direct the members to maintain such books of account as may be required by them. Additionally, the Stock Exchanges should also be empowered to introduce compulsory audit or to conduct on the spot surprise audit and inspection of the books of account maintained by the stock brokers.

(iii) Stock Exchanges should have well organised secretariats and research and statistical divisions to collect and interpret necessary data, to judge trends in trading, to monitor activities of the brokers, etc.

Organisation and Management of the Stock Exchanges

The organisation and management of the Stock Exchanges should be revamped as recommended so that the Boards of the Stock Exchanges become professionalised and more effective in curbing excessive speculative activity in the stock markets.

Pursuit of Common Policies, Practices and Procedures

For the purpose of effecting better control on speculative transactions, the Stock Exchanges should follow common policies and there should be uniformity in the practices and procedures covering all aspects of trading amongst the different Stock Exchanges, such as common dates of settlement of transactions, closure of transfer books, marking of securities ex or cum right/bonus/dividend basis, fixation of uniform rates of margins, trading hours, etc. Additionally, all Stock Exchanges must adopt uniform measures for regulation and control of trading for settlement business and micro-processors and computers should be used by the Stock Exchanges to handle the growing volume of business. Other infrastructure facilities available to them should be improved.

Augmentation of Supply of Equity Shares

(i) Closely held unlisted companies should be encouraged to get their shares listed, as recommended.

(ii) 50 per cent of the total funds raised by the public limited companies from the capital market should be in the form of fresh equity. This, however, should be achieved not by preventing debenture issues but by encouraging well managed companies to raise funds by issue of equity shares.

(iii) Development Institutions, Life Insurance Corporation of India and General Insurance Corporation of India and its subsidiaries should also be active sellers of equity shares in the Stock Exchanges.

(iv) Institutions should establish a suitable machinery for consultation and co-ordination of the activities for the sales and purchases of shares.

(v) Norms of debt-equity ratio in case of project financing should be reviewed by the development institutions so as to facilitate larger issue of equity capital rather than rely on debt finance by the entrepreneurs.

(vi) Entrepreneurs who corner the shares of the companies after listing to disturb the proper distribution of shareholding to the public, should be made to offer part of their shares to the public; to comply with the requirements of the listing agreements.

Capital Gains Tax

Minimum period of holding in respect of industrial securities, to get exemption from the Capital Gains Tax, should be reduced from 3 years to 1 year provided the net proceeds of the industrial securities are reinvested within a period of one year in any other industrial security of the listed companies.

Revision in Bonus Guidelines

The Committee recommends that companies may be allowed to issue bonus shares as and when their reserve position permits them to do so. The present guidelines in respect of bonus issue which, amongst other matters, specifies that there should be at least 3 years' gap between 2 issues of bonus shares and in a period of 5 years a company cannot issue bonus shares on more than 2 occasions, should be suitable amended.

Turnover Levy

Turnover levy should be levied @ 0.05 percent on the volume of transactions effected by the brokers on a gross basis.

Improvement in the Self Discipline of the Stock-Brokers and Their Awareness of Their Social Responsibilities

Improvement in the self discipline and ethical behaviour of the stock brokers and awareness on their part of their social responsibilities brought about through upgrading of their technical skills and knowledge and the desired changes in their mental outlook and approach through proper education, training and experience and formulation of code of conduct will not only help the Stock Exchange authorities to moderate speculative excesses in the markets but also in resolving many other problems faced by them. The Committee has recommended necessary measures in this regard.

VI Simplification and Minimising Delays Relating to Stock Transactions

Publication of Pamphlets and Hand-outs

The Committee is of the opinion that in order that an investor is made aware of the mechanics of trading on the Stock Exchange so as to enable him to choose the best type of order he can place, Stock Exchanges should publish pamphlets and hand-outs explaining all these matters in an easily understandable manner. Such publication would help in protecting fully the interests of investors.

Improvements in the Practice

(i) As instantaneous availability of information relating to fluctuations in prices and volume of securities traded is of vital importance for efficient trading and close monitoring of the transaction on the Stock Exchanges, the Committee recommends that the present method of recording the transactions and prices by the stockbrokers only in the Sauda Book and thereafter the prices being broadcast or written on the black-board should be replaced by an electronic system whereby there is an instantaneous record of transactions and prices for the use of the offices of the stockbrokers and the Stock Exchange authorities. On the basis of the keyed-in information different types of data can be built up, manual work-load and documentation reduced, procedures simplified and considerable improvement achieved in the efficiency and functioning of the Stock Exchanges. The Committee also recommends that there should simultaneously be an instant display of prices in the trading hall and at all the other places, both in the Stock Exchange and elsewhere.

(ii) The Committee also recommends that the Stock Exchanges should use their good offices to exhort their members to make increasing use of the computer or micro-processor facilities either on an owned basis or on pooling arrangements or time-hire basis for a speedier disposal of work in their offices.

(iii) The Committee is of the view that the Bye-laws of the Stock Exchanges should be suitably amended to provide for the compulsory issue of contracts to the clients. These contracts should not only give the price of the contract and brokerage and other charges separately but must also indicate the time of the execution of the contract so that the client is able to verify the veracity of the prices.

(iv) The Committee is of the opinion that the members in their returns to the Stock Exchanges should give the code numbers of their clients as regulation in respect of matters like collection of margins, etc., is related to the gross open position of a member. Besides, this will also help in working out the accounts of members vis-a-vis their customers.

Settlement of Transactions

At the request of the Committee, the Unit Trust of India commissioned Tata Consultancy Services (TCS) to make a study on the feasibility of automation of the operations on Stock Exchanges in India. The TCS has suggested that the present system needs to be replaced by the timely capture of the data relating to each transaction by electronic devices. TCS has suggested the following approaches in this regard:

(i) Instantaneous daily data collection by Stock Exchange personnel for immediate data entry into computer system through the terminals installed in the Trading ring. For this purpose, onus of reporting may have to be fixed on one of the parties to the transaction, preferably the seller. He should be required to keep with him a pad of sauda slips in triplicate wherein he would fill the details of the transactions like the code number of the buyer broker, the code number of the security, the quantity, the rate and the time of transaction as soon as the transaction is entered into. The selling member can deposit one copy of the Sauda slip into a receptacle in the trading hall from where the information will be directly keyed to the personnel. He can give one copy of the Stock Exchange Sauda slip to the buyer for his record and retain the other copy.

(ii) Use of screen projection of VDU contents for the continuous display of security prices and volume information in the trading ring.

(iii) Use of Star Network of Communication lines for the purpose of communication among the Stock Exchanges. To start with, this communication system would be used for exchange of information on price fluctuations, company news and announcement. In the long run, the Network would also be used for recording inter-exchange deals with brokers.

The Committee endorses the suggestions of the Tata Consultancy Services. The second phase of the study by the Tata Consultancy Service would deal with the technical details, cost aspects and other related matters. The Committee is of the opinion that after receipt of the second part of the Report from the Tata Consultancy Services, the details of the whole Scheme should be worked out by the proposed Council for Securities Industry in consultation with any reputed computer agency selected for the purpose and implemented as soon as possible.

VII Measures to Improve Overall Service to Investors

Part A: Measures to Improve Services to the Investors

Members of the Stock Exchanges should have adequate financial resources and infrastructural and research facilities to offer appropriate services to the investors. With this end in view, it is recommended that as far as possible, stockbrokers of small means should be persuaded to merge with others so that they can form viable and efficient units which could render more meaningful service to the investors. Excessive speculative activity should be curbed and stockbrokers should be made to concentrate more of their attention on genuine investment business rather than on speculative business.

Disclosure on the part of stockbrokers and prohibition of certain transactions:

(i) The stockbroker should be prohibited from matching the transactions of his clients in his office. All orders of sale/purchase should be executed only on the floor of the Exchange.

(ii) The contract notes issued by the stockbrokers should indicate the prices at which the securities are bought or sold, amount of commission charged, whether the stockbroker has acted as an agent or principal, the time of execution of the bargain, and whether the securities bought or sold are cum or ex-dividend, bonus or rights.

(iii) The Stock Exchanges should strengthen their cadre of floor governors who should constantly monitor and ensure that the transactions taking place on the floor of the Exchange are promptly and properly reported and recorded and no manipulation takes place therein.

(iv) Closing quotations of prices should not be allowed to be recorded unless transactions are for a sufficient number of securities. (This point has been dealt in detail in Chapter 7).

(v) The Stock Exchange authorities should conduct surprise audit and checks to ensure due compliance of the above and also of the Bye-laws and Regulations by the stockbrokers.

Kerb trading:

Kerb trading should not be allowed to take place and it should be ensured that transactions done in kerb are not regularised.

Prompt deliveries/payments:

(i) Severe penalties, including suspension of membership, should be levied in the event of a member not effecting timely deliveries or payments to his clients,

(ii) Stock Exchanges should publish in widely circulated newspapers, details regarding settlement programmes giving dates for delivery of shares and pay-ins and pay-out, list of securities which are cum or ex-dividends, rights or bonus, etc.

(iii) The moneys and securities of a client should not be mixed up with that of his stockbroker. For the purpose, the stockbroker concerned should maintain separate bank accounts and safe custody accounts for depositing his client's moneys and securities.

Squaring up of transactions:

If an investor wants delivery of shares in respect of which he has placed an order, squaring up of such transactions should not be allowed. In the event the stockbroker is unable to effect deliveries at the contracted price, the shares should be acquired through auction within a specified period and delivered to the investor. The difference in the contracted price and the auction price should be recovered from the defaulting stockbroker. The Bye-laws of the Stock Exchanges regarding closing out of contracts need to be suitably amended for the purpose.

Responsibility for the actions of sub-brokers:

The stockbroker with whom a sub-broker is associated should be wholly and directly responsible for any acts of commission or omission on part of the sub-broker, notwithstanding any agreement or arrangement entered into between the stockbroker and the sub-broker.

Bad deliveries:

Strict disciplinary action including suspension should be taken against members of the Stock Exchanges who have effected 'bad' deliveries and who do not co-operate in the removal of the objections and other infirmities in the documents delivered by them.

Bank finance for some transaction of stockbrokers:

(i) The commercial banks should provide loans against non-convertible debentures pledged with them by the stockbrokers. Also credit facilities should be granted against securities of cash price. However security margins in respect of finance made available against cash scrips should be much higher as compared to the margins applicable in respect of non-convertible debentures.

(ii) The banks should provide loans to the specialists (this point has been examined in detail in Chapter 4).

(iii) Loans should be granted to stockbrokers for purchase of office equipment, furnishing of the premises, etc., at reasonable rates of interest.

(iv) Adequate working capital facilities should be provided by the banks to the members of the Stock Exchanges to augment their business finance to facilitate payment requirements of their clients.

(v) At the time of sanction of issues of capital for bonus or right shares or convertible bonds/debentures to the existing shareholders, it may be ensured by the Controller of Capital Issues that the quantum of fresh capital allowed to be raised does not, as far as possible, result in odd lots.

(vi) The basis of allotment of shares in respect of public issues should, as far as possible, be done in a manner which results in issue of marketable lots.

(vii) The class of market makers known as 'specialists' which is recommended to be created for dealing in infrequently traded and non-active shares should also deal in odd lots of shares on a fixed commission basis. 'Specialists' should be extended the facility of bank finance for their operations, as stated earlier.

(viii) If three certificates of odd lots of shares together make a marketable lot and if requisite number of transfer deeds are tendered, the delivery of documents should be accepted even though the shares represented by them may stand in the names of upto three different persons. The Stock Exchanges may examine this suggestion and amend the concerned Regulation, if necessary.

(ix) In case the odd lots of shares which aggregate to a marketable lot or more, are tendered for transfers, the companies themselves should effect consolidation and issue certificate in marketable lots to the extent possible.

(x) The companies should take the initiative and request the shareholders to tender their odd lot holdings for encashment. These odd lot holdings should then be consolidated into marketable lots in the name/s of the assigned nominee/s appointed for the purpose by the Boards of the companies and sold in the Stock Exchanges. The sale proceeds thereof should thereafter be distributed to the original odd lot shareholders on a pro-rata basis.

(xi) The quotations in respect of odd lots should also be separately reported in the newspapers.

Formalities and procedures of transfer:

(i) The validity of the transfer deed should be two months from the date of stamping or one month after the re-opening of the Register of Members of companies, whichever is later. Section 108 of the Companies Act, 1956 may be suitably amended.

(ii) The Committee does not favour deletion of Section 108 of the Companies Act, 1956.

(iii) The period of notice to be issued by a company for closure of Register of Members should be increased from 7 days to 30 days. Such a notice should also be given to the Regional Stock Exchange. Section 154 of the Companies Act 1956 may be suitably amended.

(iv) The seller of shares should effect delivery of shares 21 days before the closure of Register of Members as against before 14 days, as at present. Rule of the Stock Exchange in this regard may be suitably amended.

(v) The transfer deed and the application form for new issues should provide a column giving detail of the existing portfolio number, if any, of the shareholders/applicants. The investors should also have the benefit of getting their dividend/interest warrants or refund orders directly credited to their bank accounts. For the purpose, suitable space for giving particulars of the bank accounts of the shareholders applicants should be provided in the transfer deed and in the share application form.

(vi) Companies should accept the signature of the transferor if his signature is duly attested on the transfer deed by any of the following:

(a) Bank officials of the rank of Branch Managers and above;

(b) Gazetted Officers;

(c) Honorary Presidency Magistrate;

(d) Notary Public; and

(e) Managing Director of the Stock Exchange (recommended in the revised organisation structure of the Stock Exchanges in the Committee's Report on the subject).

Signatures in all Indian languages and also thumb impressions, if they are attested by any of the aforesaid designated officials, should be accepted for the purpose of transfer of securities. The relevant provisions of the Companies Act 1956 may be suitably amended, if necessary for the above purposes.

(vii) With a view to insulating the companies against any financial liability resulting from fraudulent attestation of the signatures of the transferors, the companies should obtain an insurance cover for the purpose.

(viii) In the event of the company not accepting a transfer of securities on account of infirmities in the documents executed or for any other reason, the company's decision in the matter should be immediately communicated to the transferee and to his stockbroker. Additionally, dividends, bonus, rights issue of shares/debentures or right entitled letters should not be despatched in respect of such shares, debentures to the seller of the securities (i.e. in whose name the securities stand registered). Such dividends, bonus shares, rights shares/debentures or right entitlement letters should be withheld by the company, in trust, for the purchaser till such time the matter is resolved between the transferor and the transferee. The Committee also recommends that the voting rights in respect of such disputed shares should also be frozen. The companies should be required to record all such disputed cases in a separate register. Suitable legislative changes may be made in the concerned Act.

(ix) In case duly executed transfer deeds together with share/debenture certificates are 'posted' to the company before the date of closure of the Register of Members but are received by the company after the date of closure, in such cases, the companies should accept the documents. In other words, if the documents lodged for transfer are not received by the company concerned before the closure of books due to postal delays, the delay in such cases should be condoned. Section 108 (1A) (b) of the Companies Act, 1956 should be amended to substitute the word 'delivered' by the word 'posted'.

(x) In principle, there should be free transferability of shares. However, for the present, when the aggregate holding of a shareholder does not exceed beyond a specified amount, free transferability should be ensured.

(xi) If in case the signature of a transferor on the transfer deed differs from his specimen signature recorded with the company, the power to say so should vest only with the Secretary of the company.

(xii) Guidelines regarding procedures to be followed in case of death of a shareholder, loss of share/debenture certificates, etc., should be uniform and be simplified. Such guidelines should be framed by the proposed Council for Securities Industry.

(xiii) The stamp duty on transfer of securities should be made uniform throughout the country and be levied at 25 per cent for every Rs 100 or part thereof, of the market value or consideration amount both in respect of shares and debentures.

(xiv) Stock Exchanges should be permitted to use franking machines for the purposes of payment of share transfer stamp duty. Additionally, share transfer stamps should be made available at all post offices.

Facilities provided by the stock exchanges and their general functioning:

(i) With a view to improving the services to the investors the Stock exchange authorities must ensure that there is strict observance of the Rules, Bye laws and Regulations on the part of their members and if there is any violation, prompt and strict disciplinary action should be taken.

(ii) It should be ensured that speculative activity and other harmful activities relating to securities business are kept under strict observance and control so that crises do not emerge in the stock markets.

(iii) Membership of the Stock Exchanges should be increased commensurate with the securities business.

(iv) The Arbitration Committees must look to the interests of the investors. These Committees should be headed by outside persons with a view to ensuring impartiality and they should meet more often to avoid delays.

(v) All Stock Exchanges should follow uniform practices and procedures relating to marking of quotations, cum and ex-rights or bonus, cum and ex. dividends (on the dates of closure of transfer books), settlement periods, trading hours, clearing systems, electronic display on the notice boards of prices prevailing on other Stock Exchanges, imposition of margins, etc. Also all Stock Exchanges should be connected to electronic network facilitating simultaneous display of prices at all Stock Exchanges.

(vi) Greater reliance should be placed on the mechanical aids such as computers, microprocessors, etc., by the Stock Exchanges.

(vii) The grievance cells proposed to be established at each of the Stock Exchanges should be managed by the senior executives of the Stock Exchanges.

(viii) One of the measures to prevent excessive speculation would be to require each broker to make full disclosure of the volume of transactions and the prices to the Stock Exchanges. Consolidated information of the same should be complied by the Stock Exchanges and released for the general information of the public. In case of large purchases/sales the Stock Exchange should call for the disclosure of the name of the parties on whose account the large transactions have taken place.

(ix) Companies should be made to disclose the names of the persons/group of persons who directly or indirectly have acquired 5 per cent of the paid-up capital of the company. This disclosure should be immediately made to the Stock Exchanges and also advertised in at least two newspapers of the region where the registered office of the company is situated. Besides, disclosure of the name of the purchasers the prices at which the shares have been acquired, from time to time should also be disclosed.

Services to be offered by companies:

(i) Staff of the share departments of the companies should be made aware of their responsibility to the shareholders and their working should be toned up and made more efficient. Management of companies should take keen interest in such matters.

(ii) The Chambers of Commerce, Merchant Chambers and other such associations should evolve a code of conduct for the companies to follow in matters relating to proper service to the share debenture holders.

(iii) Institute of Company Secretaries of India should issue suitable guidelines for the Secretaries of the companies to tone up the efficiency of the Secretarial and Share departments of the companies and also to help the managements to simplify and streamline the procedures and practices connected with the work of the share departments.

(iv) The Stock Exchanges should monitor due compliance by the companies of the listing requirements relating to service to share debenture holders.

(v) Companies should publish their unaudited working results on a half yearly basis and on a quarterly basis, if their paid up capital is Rs 10 crores or more and also publish frequently news items about other important developments having a bearing on their working for the information of the shareholders and the investing public.

(vi) The companies, should make dividends/refund orders/interest pay orders payable at par at all the branches of their banks.

Part B: Measures to Encourage Investors in Semi-Urban and Rural Areas to Invest in Industrial Securities

Instruments to be offered:

(i) The investors in the semi-urban and rural areas should be educated about the benefits of investment in industrial securities.

(ii) It would be appropriate that, for the present, the investors from such areas are not exposed to equity issues of new companies. They should rather be encouraged to invest in safe instruments like units of Unit Trust of India or cumulative convertible preference shares.

(iii) Development Institutions may consider issue of participation certificates of the minimum face value of Rs 10,000 each offering reasonable yield and buy-back arrangements to the investors in such areas.

(iv) Measures should also be taken to encourage public sector companies to issue debentures with buy-back arrangements to the investors in these areas.

Reservation of issues for rural and semi-urban investors:

To begin with 20-25 per cent of the public issues in respect of convertible and non-convertible debentures and equity shares of well managed dividend paying companies should be reserved for subscription by the investors in the semi-urban and rural areas with a population of 1,00,000 and less. Condition to this effect should be incorporated in the consent for the issue of capital given by the Controller of Capital Issues.

Publicity for creating awareness:

(i) Publicity in different forms in regional languages should be undertaken by the proposed Council for Securities Industry or by other agencies with a view to creating awareness and highlighting the benefits of investment in industrial securities.

(ii) Within a regulated framework, the stockbrokers, investment consultants, merchant bankers, etc., may be allowed to advertise to promote investment in industrial securities.

(iii) The Government may consider publicising over radio and TV, the benefits of investment in industrial securities and also the quotations of prominent scrips of the Stock Exchanges, periodically.

(iv) Publicity Campaigns undertaken by stockbrokers and others connected with the securities industry, over radio and TV may be allowed at concessional rates, subject to the contents of the advertisements being within the guidelines laid down for the purpose.

(v) Concessions should be granted on postal tariff in regard to the distribution of various types of investment literature, to the investors. Such a step would further the cause of investment in industrial securities.

(vi) Seminars, lectures, press conferences should be organised in semi-urban and rural areas at different intervals by the Stock Exchanges. Establishment of Investors' clubs and Investors' Bureaus should also be encouraged by the Stock Exchanges.

Stock Exchange Centres:

(i) Stock Exchanges should be established, in a phased manner, in all the non-metropolitan centres having a population of 5 lakh or more. In the alternative, to begin with, the existing Stock Exchanges may be allowed to open their branch representative offices in such centres. However, such offices of Stock Exchanges should have adequate facilities of simultaneous display of stock prices and other vital investment information. In the early stages, the Government may consider subsidising the cost of the electronic link-up so required and subsequently the same could be financed by stockbrokers and other operators working in the branch/representative offices of the Stock Exchanges.

Network of sub-brokers and agents:

(i) Stockbrokers should be encouraged to enlarge their network of sub-brokers, particularly residing in semi-urban and rural areas.

(ii) Sub-brokers who are located in semi-urban and rural areas should be allowed to undertake other gainful activities to augment their income.

(iii) Stockbrokers should be encouraged to open their branch offices in centres where there are no Stock Exchanges.

(iv) Services of the agents canvassing business for Life Insurance Corporation of India, Unit Trust of India, national savings certificates, etc., should be utilised for spreading the message of industrial securities and should be given the same rate of brokerage as payable to the members of the Stock Exchanges. The services of security dealers which may be licensed should also be enlisted for the purpose.

Use of services of post offices and Commercial Banks:

(i) Services of post offices should be utilised for the distribution of literature in industrial securities, application forms, etc.

(ii) The services of commercial banks operating in the rural and semi-urban areas should be utilised for canvassing of investment in industrial securities in these areas.

(iii) The bank branches situated in semi-urban and rural areas should encourage their account holders and other investors to hold corporate securities either jointly in the name of the bank or in the name of the bank only as their power of attorney holder or custodian. This will facilitate the rural and semi-urban investors in overcoming irksome hurdles and avoid compliance with formalities on their part.

(iv) The bank branches should also encourage the investors to open accounts with them and obtain mandates from them so that they can render services to them like applying for new issues, collection of dividends and interests, etc. The banks may levy a nominal charge for rendering such services. The staff of the banks will have to be trained, if necessary, in the knowledge about acquisition and dealings in securities.

(v) If the commercial banks are not willing to undertake this work, the help of the Cooperative and Rural Banks with adequate branch network should be solicited.

(vi) The Committee does not favour, for the present, establishment of a separate Institute or utilisation of the services of the proposed service Institute Issue House for the purpose.

Investment advice and services:

(i) Intensive research and in depth study should be undertaken in regard to the securities business preferably by the proposed Council for Security Industry and the information compiled there from should be freely circulated to the Stock Exchange and at subsidised price among the stockbrokers, sub brokers, agents, etc., who in turn would distribute the same to their clients.

(ii) The stockbrokers and others connected with the securities business should develop necessary expertise and have adequate knowledge on various inter-related matters so as to offer proper investment counsel to their clients.

Protection to Investors:

As Already Recommended

(i) Investors' Protection Fund should be created with a view to compensating the investors in the event of loss incurred on account of defaults committed by their stockbrokers.

(ii) Each member of the Stock Exchange should obtain insurance covers with a view to protecting the investors against the loss of documents in transit or by fire and in the event of fraudulent acts committed by the staff members or others associated with him.

REPORT OF THE HIGH-POWERED STUDY GROUP ON ESTABLISHMENT OF NEW STOCK EXCHANGES (Chairman: N. J. Pherwani, India, Ministry of Finance, June 1991)

[Section I of this report is taken from Chapters II of the Study Group's report and Section II is taken from Chapter III of the Study Group's report and Section III is reproduce from Chapter 8 of L.C. Gupta's Book, Stock Exchange Trading in India: Agenda for reform, 1992. *L. C. Gupta was a member of the committee.]*

I. Review of Existing Stock Exchanges*

Areas of concern

The Committee initially reviewed the performance of existing Exchanges, with a focus on those that were established between 1980 and 1990. Major areas of concern were identified, which the Committee believes have directly affected the interest of the investor, and have rendered transactions in the capital market to be a costly, risky and dilatory affair.

The Committee has identified five major areas of concern:

(1) Lack of liquidity: The explosive growth of the Indian capital market over the last decade..... has largely been confined to the stock exchanges at Bombay, Delhi, Calcutta, Madras and Ahmedabad. In most of the other markets, there has been a relative lack of liquidity, in terms of depth and breadth.... There is evidence to suggest that as a direct consequence of this lack of liquidity, investors in regions serviced by the smaller exchanges have not been able to fully exploit the recent boom conditions in the capital market.

This lack of liquidity is reflected by an inadequate supply of stocks/tradeable scrips on the one hand, and inadequate demand on the other:

(a) Smaller stock exchanges have faced considerable difficulties in inducing companies to list on their exchange. Consequently, these exchanges have been unable to also provide adequate infrastructure and services to their members and investors.

(b) On the demand side, the absence of large institutional players in the smaller markets has affected the liquidity at these exchanges.

(c) A further problem contributing to the lack of liquidity in smaller markets, has been the absence of market-making, especially for the medium and small sized companies listed on the exchange.

As a consequence, a large percentage of listed securities are either traded infrequently, or not at all, with volumes concentrated on a relatively few number of scrips.

(2) Lack of infrastructure facilities: All stock exchanges are faced with- the problem of inadequate infrastructure facilities, like adequate office space, effective computerisation, telecommunication systems, etc.. Consequently, exchanges have not been able to provide members with the facilities needed for efficient trading, back-up office for members, library and other administrative requirements.

The level of computerisation across stock exchanges has been inadequate, resulting in lower operational flexibility of stock exchanges and brokers to handle sudden surges in volumes. The absence of computer linkages between stock exchanges and its members has also hampered effective inter-market operations, monitoring of trading and post-trading operations, as well as the free flow of information on an intra- and inter-exchange basis.

This has in turn restricted growth across exchanges, and the ability of exchanges to handle increasing trading volumes.

(3) An inefficient and outdated trading system: The poor infrastructural facilities at exchanges has also resulted in exchanges following inefficient and outdated trading systems. A major drawback has been the absence of on-line transaction recording systems. This has led to a lack of transparency in trading operation. In addition, it has led to delays in settlement, which in turn has affected investor confidence, and acted as an impediment to the spread of the equity cult.

(4) An outdated settlement system: A major shortcoming of the existing settlement system is the need for the physical transfer of stocks. This has resulted in enormous paperwork, bad and

improper delivery of stock, and delays in registration and transfer of scrips. Objections raised during registration of transfers results in further delays in settlement.

The settlement system in existence today is also grossly inadequate to meet the growing volumes of business, and has led to settlement delays and aggravated the loss in market liquidity.

(5) Lack of a single market: Due to the inability of the various stock exchanges to function cohesively, the growth in business in any one exchange or region has not been transmitted to other exchanges. The limited intermarket operations have only increased the costs and risks of investors in the smaller markets. This problem has been aggravated by the lack of cohesion between exchanges in terms of legal structure and regulatory framework, trading practices, settlement procedures, jobbing spreads, etc.

Inadequacy of investor service

It is clear that exchanges, particularly the smaller ones, have been unable to service their investor base adequately, and have been able to make a limited contribution to the spread of the equity cult in their region.

The inadequate infrastructure and ineffective trading practices/ settlements has also resulted in a lack of NRI confidence in the Indian capital markets. Major Indian corporates today need to diversify their sources of capital, and seek the direct participation of foreign investors. The areas of concern detailed herein would effectively deter such direct foreign currency investments. The upgradation of existing stock exchanges thus has to be viewed as an integral component of the increasing globalisation of the Indian economy.

Improving investor access to capital markets

In view of the foregoing, the Committee felt the need to widen the perspective of the Study in order to arrive at a more balanced and strategic view of its terms of reference. The explosive growth of the capital market and the extension of the investor base to regions outside those served by the existing stock exchanges, argue the case for first improving the access of investors to the capital market.

However, it is a moot point as to whether such access can be best provided by establishing new exchanges, or through some alternative mechanism. In evaluating this issue, the Committee has per force kept in mind that the ultimate objective is to ensure that investors should directly benefit from the emergence of any new system, and that this benefit in turn should be transparent to the investor.

The Indian capital market has witnessed an explosive growth in the last decade. The number of stock exchanges, the number of listed companies, ... market capitalisation, ... and trading volumes, ... have all grown substantially. In line with this growth, the investor base in the country has also grown in size and geographical spread, ...

In spite of the increase in the number of stock exchanges, there are still a large number of regions, where interest in the primary and secondary markets is evident, but where access to exchanges is difficult for a variety of reasons. Poor liquidity in regional exchanges, absence of broker and/or security house networks, and inefficient telecommunication facilities have largely contributed to this problem. Consequently, the further spread of the equity cult is hampered by these factors, with a clear barrier arising between the primary and the secondary markets.

The scope for increasing the investor base is considerable. Although market capitalization has increased significantly from Rs 25,000 crores in 1980 to as much as Rs. 90,000 crores in 1990, it still accounts for only 20% of GNP. It must be noted that in USA and Japan, the corresponding figures are 56% and 127% respectively. Moreover, the number of shareholders as a percentage to total population remains insignificant at 2.5% as against 20% in USA.

The scope in this regard is evident from the relatively low incidence of financial assets amongst households.... extremely efficient communication links and the high degree of automation available in these countries.

II. The National Stock Market System*

Establishing new stock exchanges

The Committee determined that existing exchanges have not met the objective of liquidity to any reasonable extent, and have provided a less than adequate level of service for the small investor. The Committee determined that despite the substantial growth in the capital market, exchanges, especially the smaller ones, have found it difficult to meet the objective of liquidity to a reasonable extent..... In conjunction with other factors, this has resulted in poor levels of service for small and regional investors. In view of the foregoing, the establishment of new stock exchanges must be predicated on setting into place a set of conditions that would ensure that exchanges operate efficiently, are liquid and are financially viable. This would perhaps be the only approach to improving service to investors.

After considerable discussions, the Committee arrived at the conclusion that the setting up of additional stock exchanges would in itself not serve the purpose of spreading the equity cult, or enhancing liquidity in the secondary market.

In line with international trends, the Committee is of the view that a systemic improvement can only be achieved by establishing closer links between exchanges.

The Committee is of the opinion that the issue of establishing new exchanges, and the criteria thereof, can be meaningfully examined only in the context of streamlining the operations of the existing exchanges, and their ultimate networking to establish a National Stock Market system.

International trends are clearly towards a lesser number of exchanges, and in fact, several developed economies have closed down a number of exchanges.... This is essentially due to the

Need for a National Stock Market System

The Committee is of the view that in the ultimate analysis, the problems enumerated herein can only be addressed with the emergence of an integrated Stock Market System, with each stock exchange in the system streamlined and possessing the necessary telecommunications and related infrastructure. Indeed, the Committee submits that there is an extremely strong case for the creation of an integrated National Stock Market System.

Under this system, all exchanges in the country would be inter-linked to facilitate the easy flow of transactions between them. The national integrated system would comprise several distinctive but inter-related elements. The major pre-requisites for the effective functioning of such a system include:

(1) greater degree of automation within stock exchanges;

(2) 'net-working' between stock exchanges;

(3) establishment of National Clearing and Settlement Facilities and a Central Depository Trust under the aegis of a single nodal Corporation;

(4) the establishment of a Securities Facilities Support Corporation to oversee the net-working of all stock exchanges.

Given the experience derived by more developed economies, the establishment of such a system can be accomplished in India in a relatively rapid time frame, not exceeding 3 years. In the meantime, to cater to the increased investor base, the Committee recommends, subject to the criteria presented in Chapter V of the (Study Group) Report, the setting up of a few more exchanges in the 'high potential' investment regions. *The Committee recommended new stock exchanges at only four places, viz, Nagpur, Gwalior, Chandigarh and Shimla. This is apart from the recommendation for setting up the NSE at the New Bombay to provide computerised securities trading with all-India coverage.

Once the integrated national system is in place, it would not be necessary to set up any additional exchanges. Indeed under the proposed system it would be possible for investors in remote locations to access major markets easily.

The proposed national system would achieve an over-all improvement in the working of stock exchanges, which would directly lead to better service and protection to investors This would, in turn, facilitate the further growth of the capital market.

It is with this perspective that the Committee recommends that the establishment of new stock exchanges be regarded as part of an overall scheme of developing the country's capital markets. A large number of stock exchanges, working in isolation, would only fragment the market, and create investor dissatisfaction, leading to considerable inefficiency in the system. Steps thus need to be taken to achieve an integrated system.

The Concept of National Stock Market System

In the ultimate analysis, a liquid market is the only means of providing every investor the opportunity to trade securities freely. It is only a large and liquid stock exchange market that would be viable in terms of cost, efficiency and sophistication of infrastructure needed to provide the quality of service required by the investor. Thus, a large number of independent small exchanges would not, by itself, provide the necessary impetus to capital market growth.

The Committee is thus of the view that such a market can only be provided within the framework of a nationally integrated Stock Market System. Under this system, all exchanges would be inter-linked, facilitating an easy flow of transactions and resources. It would also be the most cost effective and efficient solution to the present problems be-setting the smaller exchanges.

* Members of the Group were: M.J. Pherwani (Chairman), K.U. Mada, D.K. Bhatia and L.C. Gupta. The report was submitted to the Government of India in June 1991. The following recommendations of the Study Group have been reproduced from Chapter 8 of L.C. Gupta, Stock Exchange Trading in India: Agenda for Reform, Society for Capital Market Research and Development, 1992.

* This part is taken from Chapter 2 of the Study Group's Report, pp. 5-9.

* This part is taken from Chapter 3 of the Study Group's Report, pp. 10-12.

III. Promotion of the National Stock Exchange

The Bombay Stock Exchange (BSE) is the largest Stock exchange in the country, with over 2,600 listed scrips and an ever increasing volume of trading. The BSE today accounts for 70% of all transactions, and has provided the underpinning for the exponential growth of the capital markets. It has played the role of a leader in setting the pace of the market, and in recent times, has provided unprecedented liquidity in all major counters. This is, indeed, laudable, given that the Exchange is housed in a congested location, and lacks adequate space for members and a modern trading ring.

The larger companies listed on the Exchange have been serviced well, with 80% of trading concentrated in the 'A' category where carrying forward of transactions is allowed. Daily transactions are carried out in about 250-300 companies. However, due to the physical constraints referred to earlier, other scrips are either traded very infrequently or not traded at all. The Exchange has also been unable to develop a debt market, due to shortage of space, and the apparent unwillingness of members to act as market makers.

The Committee has observed that the debt market, especially for long-dated fixed income securities, in fact accounts for the major proportion of the volume of trading in more developed economies. It is this availability of a secondary market in debt that has provided the major impetus to capital formation, especially in the USA and the UK.

In view of the foregoing, the Committee strongly recommends that a new Stock Exchange be promoted immediately at New Bombay as a 'Model Exchange' and to act as a 'National Stock Exchange' (NSE). The NSE would provide access to investors from all across the country on an equal footing, and work as an integral component of the National Stock Market System.

Principal features

The NSE could limit itself to listing only medium-sized companies..... [and] focus on creating a market for debt instruments..... Wholly neglected by the BSE as well as other existing exchanges.....

The Exchange could be promoted by financial institutions and mutual funds, and financed on a self-sustaining basis through levy of membership fees.....

At least 50% of the Managing Board of the Exchange should comprise of professionals who are not members.......

The Exchange should be completely automated in terms of both trading and settlement procedures. The implementation of the automated trading and settlement procedure should be planned on a priority basis.

In addition to the admission of professionals, corporate members and institutions, representation should be permitted from across the country, and not limited to the city of Bombay. This would allow for direct access to the market to potential investors and professionals from other investment centres of the country. Members of existing exchanges would be limited to 25% of the total number of individual members of the NSE. The balance 75% would be new professional members.

The Committee urges the introduction of the concept of compulsory market makers/jobbers in the NSE - a role that would eminently suit institutional members. This role is in fact essential to ensure liquidity to all scrips listed on the Exchange.

REPORT OF THE COMMITTEE ON REVIEW OF DISCLOSURE REQUIREMENTS IN OFFER DOCUMENTS (Chairman: Y.H. Malegam, Mumbai, Securities and Exchange Board of India, June 1995)

[The summary of the recommendation of the committee, as given in Annexure-G of the report are reproduce below.]

The Securities and Exchange Board of India (SEBI) constituted a Committee under the Chairmanship of Y.H. Malegam to review the existing disclosure requirements in offer documents and recommend additions thereto and modifications thereof so that disclosures assist in achieving the objects for which SEBI has been set up, namely to protect the interest of investors and to promote the development of and regulate the securities market. This Committee finalized its report towards the end of June 1995. Summary of the Recommendations of the Committee as given in Annexure-G to the Report is reproduced hereunder:-

1. All of SEBI's requirements on disclosure should be consolidated in a single document issued in loose-leaf form which can be periodically updated in a systematic fashion.

2. The Prospectus should disclose the actual expenditure incurred on the project upto the date of filing the draft prospectus with SEBI or upto a date falling two months before the date of filing the prospectus with the Registrar of Companies whichever is the later and the sources from which such expenditure is financed as also a year-wise break-up of the expenditure remaining to be incurred on the project.

3. The Prospectus should disclose the "bridge

loan" or other financing arrangement, if any, to incur expenditure on the project and which is expected to be repaid out of the proceeds of the issue.

4. In respect of financial information disclosed in the Prospectus, adjustments needed must, wherever possible, be made in the statement of assets and liabilities and in the statement of profit and loss itself and not indicated by way of notes. In particular: -

(i) All incorrect accounting practices or failures to make provisions or other adjustments which resulted in audit qualification should be rectified and accounting figures be recomputed;

(ii) the material amounts relating to adjustments relating to previous years be identified and adjusted in arriving at the profits of the years to which they relate irrespective of the year in which the event triggering the profit or loss occurred;

(iii) where there has been a change in accounting policy, the profits or losses of the earlier years and of the change be recomputed to reflect what the profits or losses of those years would have been if a uniform accounting policy had been followed in each of those years;

(iv) the statement of profit or loss should disclose the profit or loss before extraordinary items separately from the profit or loss after extraordinary items.

5. In the statement of profit or loss, the turnover disclosed should be bifurcated into: (i) turnover of products manufactured by the company and, (ii) turnover of products traded in by the company, and if the turnover of traded products is in respect of products not normally dealt in by the company the same should be separately discussed.

6. The Prospectus should disclose details of 'Other Income' in all cases where such income (net of related expenses) exceeds 20% of the net profit before tax.

7. The prospectus should disclose the significant factor affecting tax provisions in any year.

8. The statement of assets and liabilities disclosed in the prospectus should be prepared after deducting the amount of 'revaluation reserve' from both fixed assets and reserves to arrive at the Net Worth.

9. The Prospectus should disclose material changes (with quantification wherever possible) in the activities of the issuer which may have had a material effect on the statement of profit/ loss for the five years disclosed in the prospectus.

10. The Prospectus should disclose all significant accounting policies followed in the preparation of the financial statements.

11. The Prospectus should disclose sales or purchases between companies in the promoter group when such sales or purchases exceed in value in the aggregate 10% of the total sales or purchases of the issuer and also material items of income or expenditure arising out of transaction in the promoter group.

12. The Prospectus should disclose specified accounting ratios for each of the accounting periods for which financial information is given.

13. All financial information given in the Prospectus including accounting ratios should be audited.

14. In respect of all companies embarking on major expansions or new projects, the Prospectus should make disclosure regarding (i) Technology, (ii) Market, (iii) Competition, (iv) Managerial competence, and (v) capacity build-up.

15. Normally the Prospectus should not disclose projections of future profits. Disclosure may be made in respect of:-

(i) New companies, (ii) Existing companies embarking on a new project, (iii) Existing companies embarking on an expansion which is disproportionately large in relation to the existing business.

16. Where projections of future profits are disclosed in the prospectus, such disclosure must be governed by specified conditions.

17. The Prospectus should contain a statement by the directors whether there have, in their opinion, arisen since the date of the last financial statements disclosed in the prospectus any circumstances that materially adversely affect the trading or profitability of the issuer or the value of its assets or its ability to pay its liabilities within the next twelve months.

18. The Prospectus should contain a forecast of the estimated profits for the financial year ending immediately before the date of the offer document (if such information is not already given in the prospectus) and for the financial year ending immediately after the date of offering

document duly supported by an auditors' certificate which lists the major assumptions on which the forecast is based and gives assurance on the arithmetical calculations derived from such assumptions.

19. The terms 'Promoter' and 'Promoter Group' should be defined for the purposes of the disclosure requirements in the Prospectus.

20. The Prospectus must disclose - (i) the aggregate shareholding of the Promoter Group and of the directors of the Promoter, (ii) the aggregate number of shares traded in by the Promoter Group and the directors during the six months prior to the date on which the Prospectus is filed with the Registrar of Companies together with the maximum and minimum price at which purchase and sales were made and the date on which such minimum and maximum prices were determined.

21. When disclosure is made in the Prospectus of the aggregate holding of the Promoter Group, a list of the persons who constitute the Promoter Group and their individual share holdings should be filed with SEBI.

22. The disclosure required in the Prospectus regarding other ventures/companies promoted by the promoter should be restricted to certain specified matters.

The Prospectus should disclose -

(i) stock market data separately for each period which commences with a change in capital structure.

(ii) the market value immediately after the date on which the resolution of the Board of Director concerning the issue was passed,

(iii) the volume of business for each month during the six months preceding the issue.

23. The disclosure required in the Prospectus concerning outstanding litigation should be confined to -

(i) litigation against the company or against any other company whose outcome could have a materially adverse effect on the financial position of the company.

(ii) litigation against the promoters or directors involving violation of statutory regulations or criminal offence.

24. The bifurcation of disclosure in the Prospectus of "risk factors" into "internal" and "external factors" on the one hand and "management perceptions" on the other should be prohibited.

25. Projected Earnings should not be used as a justification for the price.

26. The Prospectus should disclose as justification for the issue price -

(i) EPS pre-issue for the last three years (as adjusted for changes in capital),

(ii) P/E pre-issue and comparison thereof with industry P/E where available,

(iii) average return on net worth in the last three years,

(iv) minimum return on increased networth required to maintain pre-issue EPS,

(v) NAV based on last balance sheet,

(vi) NAV after issue and comparison thereof with the issue price.

27. The accounting ratios disclosed in the Prospectus in justification of the issue price should be calculated after giving effect to the consequent increase of capital on the assumption that the option to subscribe for additional capital will be exercised.

28. The Prospectus must disclose specified information regarding parties with whom technical and financial agreements have been entered into.

29. The Prospectus should disclose Managements' discussion and analysis of the financial condition and results of the operations presented in the financial statements.

30. The Prospectus should disclose a Capitalisation Statement. Where there has been a change in the share capital since the date as of which the financial information has been disclosed in the prospectus, there should be a note explaining the nature of the change.

31. The Prospectus should disclose all "buy-back" and "standby" and similar arrangements.

32. There should be special disclosure requirements in the Prospectus for specialised industry groups. For the time being specified disclosures should be required for financial services companies.

33. The Prospectus should disclose specified details regarding major shareholders.

34. Every prospectus should have an index which identifies the contents of prospectus.

35. The draft Abridged Prospectus should be filed with SEBI and scrutinised by SEBI before an acknowledgment card is issued.

36. The Abridged Prospectus should disclose specified items presently required to be disclosed in the Prospectus.

37. The Abridged Prospectus should also disclose specified items, disclosure whereof in the Prospectus has been suggested.

38. The Abridged Prospectus need not disclose specified information regarding associated companies.

39. The disclosure of financial information in the Abridged Prospectus should be in the same manner as in the Prospectus.

40. Companies should be authorised to levy to the brokers a nominal fee for every copy of the Abridged Prospectus.

41. The Application Form should in all cases be a perforated part of the Abridged Prospectus.

42. The reproduction in an advertisement of any information or language contained in the offer document should be reasonably complete disclosing all relevant facts included in the offer document and not restricted to certain extracts or restricted information only from the offer documents in relation to that item.

43. The guidelines on advertisement should apply to all advertisements issued after the acknowledgment card is issued by SEBI.

44. It should be clarified that:-

(i) no advertisement regarding the closure of an issue can be issued unless prior to the issuance of the advertisement the lead manager is satisfied on the basis of a certificate issued by the Registrar that at least 90 per cent of the issue has been subscribed for;

(ii) no advertisement that the issue is oversubscribed can be issued until the issue has actually closed.

45. A provision similar to the provision governing issue advertisement in The Securities Regulation, 1983, in New Zealand be introduced in the Securities (Regulation) Act, 1956, but until this is done:-

(i) the publishers of a newspaper or magazine, the advertising agents and other media should be required to be registered with SEBI like any other intermediary;

(ii) after an acknowledgment card is issued by SEBI, the issuer must be required to issue advertisements only through such registered intermediaries;

(iii) no advertisement can be issued by the registered intermediary unless a certificate in the prescribed form signed by a director of the company and the lead manager is filed with the intermediary.

46. In the case of a rights issue, disclosures should be confined to specified items

47. With a view to eliminating unnecessary detail, the disclosure requirements in the Prospectus for specified item be modified as under:-

(i) details regarding underwriters be given only for major underwriters;

(ii) disclosure regarding rights of members and restrictions on transfer be confined to those articles of association which are at material variance with the provisions of the regulations contained in Table-A.

48. Disclosure required in the Abridged Prospectus in terms of Clause V(h)(ii) and Clause V(i) of Form 2A be not required.

49. The Lead Manager should be required to file with SEBI the following certificates:-

(i) a "due diligence" certificate when filing the draft prospectus;

(ii) A "due diligence" certificate that all the amendments suggested by SEBI on the basis of the observation letters have been made in the Offer Documents;

(iii) A final "due diligence" certificate when filing the document with the Registrar of Companies or before issuing the "letter of offer" as the case may be;

(iv) a certificate immediately before the opening of the issue that no corrective action is needed;

(v) A final "compliance certificate" before the issue is closed.

50. SEBI should examine the Annual Reports issued by the issuer for the two financial years ending after the date of Offer Document to determine whether there is anything therein which is inconsistent with what is stated in the Offer Document or anything is stated there in which should have been stated in the Offer Document but was not stated.

51. The time taken by SEBI for vetting of the draft prospectus should be reduced to 21 days.

52. The period of notice to be given to the Stock Exchange for the fixation of a 'record date' in the case of a rights issue should be reduced to 30 days.

53. In the case of a public issue the period which must elapse between the date on which the prospectus is approved by the Registrar of Companies and the opening of the issue should be reduced to 14 days.

54. Where SEBI has evidence that certain banks or certain branches of banks have been consistent defaulters in processing applications, it should refuse to approve such banks or branches as authorised agencies for collection of application forms and monies.

55. For rights issues, the mandatory period provided in the listing agreement for issue of share certificates should be reduced to 30 days.

56. There should be an undertaking by the issuer that transactions in shares by the 'promoter' the 'promoter group' and the immediate relatives of the 'promoter during the period between the date of filing the prospectus with the Registrar of Companies or the letter of offer is issued and the date of closure of the issue' should be reported to the concerned Stock Exchange within 24 hours of the transaction.

57. (i) As soon as a draft prospectus or letter of offer is filed with SEBI, an intimation should be sent by SEBI to the concerned stock exchanges where the share is listed with a request that transactions in the shares be monitored and all unusual movements in volume or price promptly reported to SEBI.

(ii) As soon as the above intimation is received by the concerned stock exchange, trading in the share should be put on the screen based trading system.

(iii) In respect of stock exchanges where screen based trading has not yet been introduced, trading in the share should be allowed only on a 'spot' basis.

58. All proceeds of an issue should be separately invested outside the business in any form which is decided by the Board of Directors and disclosed in the Prospectus but which provides liquidity needed to ensure that the funds will be available for use when required for the objects specified in the issue.

All unutilised monies out of the issue must be separately disclosed in the Balance Sheet of the Company indicating the form in which such univested funds have been invested.

There should be an annual auditors' certificate confirming, that funds have been utilised only for the specified objects and indicating the funds remaining to be utilised and how the same have been invested.

59. Funds which cannot be used for the purpose specified can be used for other purposes only with the prior approval of the shareholders.

60. SEBI should publish periodically the names of the Companies and details of the issue for which a draft prospectus or letter of offer is filed with SEBI.

61. The minimum share capital to be offered to the public for obtaining a listing on the stock exchange should be 25 percent of the issued capital or capital of a face value of Rs. 1.8 crores (but not exceeding Rs 5 crores of issue value) whichever is higher.

62. An Issuer which has a capital of less than Rs. 10 crores and which has not been in commercial operation for more than 2 years or which makes an issue with the object of financing a new line of business which has not been in commercial operation for more than 2 years should not be allowed to make a public issue except through the OTC Exchange of India or it must be required to first place the offering with a group of underwriters who will subsequently offer the shares in the market.

63. Where authority is given to the Board of Directors to fix a price at which the issue should be made within a specified price band, the price should be fixed by a resolution to be passed by the Board of Directors at a meeting of the Board of which 48 hours notice is given to the Stock Exchange.

64. The right to an unlisted Company to make a first issue at a premium should be available only when the net worth of the company before the issue represents not less than 20 per cent of the net worth of the company as it would be after the issue is made and the unlisted company has a net worth before the issue of not less than Rs. 3 crores.

65. The right to an unlisted Company to issue

shares at a premium should also be available where a division of a company is spun off into a separate company and the track record of profitability of the division (established of the basis of an auditor's certificate) should be considered in the same manner as for a partnership converted into a company.

66. SEBI should, in consultation with the Press Council of India, evolve a code of conduct for financial journalists.

67. SEBI should in consultation with the stock exchanges and the Association of Merchant Bankers evolve a code of conduct for brokers, lead. managers, etc., in respect of communications to clients on new issues and rights issues.

68. The offer documents should be required to carry a clear warning to the reader that the issuer accepts no responsibility for statement made otherwise then in the offer document or in the advertisement issued by the issuer and that anyone placing reliance on any other source of information does so at his peril.

69. When an unlisted company has merged with a listed company the continuance of the listing of the merged company should be made subject to specified conditions.

Source: Chartered Secretary, Vol. XXV, No. 8, August 1995, Pp. 759-762.

Table-A not included here.

SECURITIES AND EXCHANGE BOARD OF INDIA (FOREIGN INSTITUTIONAL INVESTORS) REGULATIONS, 1995

[These regulations as amended upto October 7, 1999 are reproduced from Securities and Exchange Board of India website: File fii13.html

CHAPTER I. PRELIMINARY

Short title and commencement

1. (1) These regulations may be called the Securities and Exchange Board of India (Foreign Institutional Investors) Regulations , 1995.

(2) They shall come into force on the date of their publication in the Official Gazette Definitions

2. In these regulations, unless the context otherwise requires, -

(a) "Act" means the Securities and Exchange Board of India Act, 1992 (15 of 1992);

(b) "certificate" means a certificate of registration granted by the Board under these regulations;

(c) "designated bank" means any bank in India, which has been authorised by the Reserve Bank of India to act as a banker to Foreign Institutional Investors;

(d) "domestic custodian" includes any person carrying on the activity of providing custodial services in respect of securities;

(e) "enquiry officer" means any officer of the Board, or any other person appointed by the Board under Chapter V of these regulations;

(f) "Foreign Institutional Investor" means an institution established or incorporated outside India which proposes to make investment in India in securities;

(g) "form" means a form specified in the First Schedule to these regulations;

(h) "Government of India Guidelines" means the guidelines dated September 14, 1992 issued by the Government of India for Foreign Institutional Investors, as amended from time to time;

(i) "institution" includes every artificial juridical person;

(j) "schedule" means a schedule to these regulations;

(k) "sub-account" includes those institutions, established or incorporated outside India and those funds, or portfolios, established outside India, whether incorporated or not, on whose behalf investments are proposed to be made in India by a Foreign Institutional Investor.

CHAPTER II.
REGISTRATION OF FOREIGN INSTITUTIONAL INVESTOR

Application for certificate

3. (1) No person shall buy, sell or otherwise deal in securities as a Foreign Institutional Investor unless he holds a certificate granted by the Board under these regulations.

(2) An application for the grant of certificate shall be made to the Board in form A.

(3) Notwithstanding anything contained in sub-regulation (2), any Foreign Institutional Investor who has made an application for the grant of a certificate to the Board prior to the commencement of these regulations shall be deemed to have made an application under sub-regulation (2) and the application shall be accordingly dealt with under these regulations.

(4) Notwithstanding anything contained hereinabove, any person who has before the commencement of these regulations, made an application for registration and has been granted registration by the Board under the Government of India Guidelines to act as a Foreign Institutional Investor shall be deemed to have made an application under sub-regulation (2) above may continue to buy, sell or otherwise deal in securities subject to the provisions of these regulations, till the grant or refusal of a certificate under these regulations.

Furnishing of information, clarification, and personal representation

4. (1) The Board may require the applicant to furnish such further information or clarification as the Board considers necessary regarding matters relevant to the activities of the applicant for grant of certificate.

(2) The applicant or his authorised representative shall, if so required by the Board, appear before the Board for personal representation in connection with the grant of a certificate.

Application to conform to the requirements

5. Subject to the provisions of sub-regulation (3) and sub-regulation (4) of regulation 3, any application, which is not complete in all respects and does not conform to the instructions specified in the form or is false or misleading in any material particular, shall be rejected by the Board. Provided that, before rejecting any such application, the applicant shall be given a reasonable opportunity to remove, within the time specified by the Board, such objections as may be indicated by the Board.

Consideration of application

6. For the purpose of the grant of certificate the Board shall take into account all matters which are relevant to the grant of a certificate and in particular the following, namely:-

(a) the applicant's track record, professional competence, financial soundness, experience, general reputation of fairness and integrity;

(b) whether the applicant is regulated by an appropriate foreign regulatory authority;

(c) whether the applicant has been granted permission under the provisions of the Foreign Exchange Regulation Act, 1973 (46 of 1973) by the Reserve Bank of India for making investments in India as a Foreign Institutional Investor;

(d) whether the applicant is -

(i) an institution established or incorporated outside India as Pension Fund or Mutual Fund or Investment Trust; or

(ii) an Asset Management Company or Nominee Company or Bank or Institutional Portfolio Manager, established or incorporated outside India and proposing to make investments in India on behalf of broad based funds *and its proprietary funds, if any*;[1] or

(iii) a Trustee or a Power of Attorney holder, incorporated or established outside India, and proposing to make investments in India on behalf of broad based funds *and its proprietary funds, if any.*[2]

(iv)[3] [*university fund, endowments, foundations or charitable trusts or charitable societies. Provided that while considering the application from the applicants under clause (iv) the Board may take into account the following namely :-*

(a) Whether the applicant has been in existence for a period of at least 5 years.

(b) Whether it is legally permissible for the applicant to invest in securities outside the

country of its incorporation or establishment;

(c) Whether the applicant has been registered with any statutory authority in the country of their incorporation or establishment;

(d) Whether any legal proceeding has been initiated by any statutory authority against the applicant].[3]

Explanation:

For the purposes of this regulation, "broad based fund" means a fund, established or incorporated outside India, which has at least ~~fifty~~ [twenty][33] investors, with no single individual investor holding more than ~~five~~ [ten][33] per cent of the shares or units of the fund. Provided that if the broad based fund has institutional investor(s) it shall not be necessary for the fund to have ~~fifty~~ [twenty][33] investors: Provided further that if the broad based fund has an institutional investor who holds more than five [ten] 33 percent of the shares or units in the fund, then the institutional investor must itself be a broad based fund; or

(e) Whether the grant of certificate to the applicant is in the interest of the development of the securities market.

(f) Whether the applicant is a fit and proper person.[4]

Procedure and grant of certificate

7. Where an application is made for grant of certificate under these regulations, the Board shall, as soon as possible but not later than three months after information called for by it is furnished, if satisfied that the application is complete in all respects, all particulars sought have been furnished and the applicant is found to be eligible for the grant of certificate, grant a certificate in form B, subject to payment of fees in accordance with the Second Schedule.

[5]*["Provided that the Board may exempt from the payment of fees, an applicant such as the World Bank and other institutions established outside India for providing aid, and which have been granted privileges and immunities from the payment of tax and duties by the Central Government. Provided further that the Board shall refund the fees already collected from the institutions which are exempted from the payment of fees by the proviso mentioned above."]*

Validity of certificate

8. The certificate and each renewal thereof shall be valid for a period of five years from the date of its grant or renewal, as the case may be.

Application for renewal of certificate

9. (1) Three months before the expiry of the period of certificate, the Foreign Institutional Investor, if he so desires, may make an application for renewal in form A.

(2) The application for renewal under sub-regulation (1) shall, as far as may be, be dealt with in the same manner as if it were an application made under sub-regulation (2) of regulation 3 for grant of a certificate.

(3) The Board shall, on such application, if satisfied that the applicant fulfils the requirements specified in regulation 6, grant a certificate in form B, subject to payment of fees in accordance with the Second Schedule.

Conditions for grant or renewal of certificate to foreign institutional investors

10. The grant or renewal of certificate to the Foreign Institutional Investor shall be subject to the following conditions, namely:

(a) he shall abide by the provisions of these regulations;

(b) if any information or particulars previously submitted to the Board are found to be false or misleading, in any material respect, he shall forthwith inform the Board in writing;

(c) if there is any material change in the information previously furnished by him to the Board, which has a bearing on the certificate granted by the Board, he shall forthwith inform the Board;

(d) he shall appoint a domestic custodian and before making any investments in India, enter into an agreement with the domestic custodian providing for custodial services in respect of securities;

(e) he shall, before making any investments in

India, enter into an arrangement with a designated bank for the purpose of operating a special non-resident rupee or foreign currency account;

(f) before making any investments in India on behalf of a sub-account, if any, he shall obtain registration of such sub-account, under these regulations.

Procedure where certificate is not granted

11. (1) Where an application for grant or renewal of a certificate does not satisfy the requirements specified in regulation 6, the Board may reject the application after giving the applicant a reasonable opportunity of being heard.

(2) The decision to reject the application shall be communicated by the Board to the applicant in writing stating therein the grounds on which the application has been rejected.

(3) The applicant, who is aggrieved by the decision of the Board under sub- regulation (1) may, within a period of thirty days from the date of receipt of communication under sub-regulation (2), apply to the Board for reconsideration of its decision.

(4) The Board shall, as soon as possible, in the light of the submissions made in the application for reconsideration made under sub-regulation (3) and after giving a reasonable opportunity of being heard, convey its decision in writing to the applicant.

Application for registration of sub-accounts

12. (1) A Foreign Institutional Investor shall seek from the Board registration of each sub-account on whose behalf he proposes to make investments in India.

(2) Notwithstanding any thing contained in sub regulation (1) above, any sub-account which has been granted approval prior to the commencement of these regulations by the Board shall be deemed to have been granted registration as a sub-account by the Board under these regulation.

(3) An **application** for registration as a sub-account shall contain particulars specified in ~~sub-para (b) of para 5 of form A.~~[6] *[Para 1 of Annexure B to Form A of the First Schedule].*

Procedure and grant of registration of sub-accounts

13. (1) For the purpose of grant of registration the Board shall take into account all matters which are relevant to the grant of such registration to the sub-account and in particular the following, namely-

(a) the applicant is an institution or fund or portfolio established or incorporated outside India and proposes to make investment in India;

(b) the applicant is a broad based fund *[or proprietary fund]*[7]

*[bb) the applicant is a **fit and proper person.**]*[8]

(c) the Foreign Institutional Investor through whom the application for registration is made to the Board holds a certificate of registration as Foreign Institutional Investor; and

(d) the Foreign Institutional Investor through whom an application for registration of sub-account is made, is authorised to invest on behalf of the sub-account.

(e) *[The foreign institutional investor through whom the application for registration is made, has submitted undertakings that the sub-account fulfils the criteria referred to in this sub-regulation in a manner specified in para 2 of Annexure B to Form A of the First Schedule.*

(f) The sub-account has paid registration fees in accordance with the Second Schedule.][9]

(2) ~~The Board on being satisfied that the applicant is eligible for a grant of registration shall grant registration to the sub-account.~~

[10]*[The Board on receipt of the undertakings and the registration fees as referred to in sub-regulation (1), may grant registration to the sub-account.*]

(3) A sub-account granted registration in accordance with sub-regulation (2) of this regulation shall be deemed to be registered as a Foreign Institutional Investor with the Securities and Exchange Board of India for the limited purpose of availing of the benefits available to Foreign Institutional Investors under section 115 AD of Income Tax Act, 1961, (43 of 1961).

CHAPTER III.
INVESTMENT CONDITIONS AND RESTRICTIONS

Commencement of investment

14. A Foreign Institutional Investor shall not make any investments in securities in India without complying with the provisions of this Chapter.

Investment restrictions

15. (1) A Foreign Institutional Investor may invest only in the following:-

(a) securities in the primary and secondary markets including shares, debentures and warrants of companies *[unlisted]*[11] listed or to be listed on a recognised stock exchange in India; and

(b) units of schemes floated by domestic mutual funds including Unit Trust of India, whether listed on a recognised stock exchange or not.

(c) *[dated Government Securities.]*[12]

(d) *[derivatives traded on a recognised stock exchange.]*[13]

(2) Notwithstanding anything contained in sub-regulation (1) of this regulation, the total investments in equity and equity related instruments (including fully convertible debentures, convertible portion of partially convertible debentures and tradable warrants) made by a Foreign Institutional Investor in India, whether on his own account or on account of his sub-accounts, shall not be less than seventy per cent of the aggregate of all the investments of the Foreign Institutional Investor in India, made on his own account and on account of his sub-accounts.

[Provided that nothing contained in sub-regulation (2) shall apply to any investment of the foreign institutional investor either on its own account or on behalf of its sub-accounts in debt securities which are (unlisted)[14] *or listed or to be listed on any stock exchange if the prior approval of the Board has been obtained for such investments.*

Provided further that the Board may while granting approval for the investments impose conditions as are necessary with respect to the maximum amount which can be invested in debt securities by the foreign institutional investor on its own account or through its sub accounts.][15]

[Explanation; for the purpose of the provisos to this sub-regulation, the expression "debt securities" shall include dated Government securities and[16] ***{treasury bills}***[17]]

(3) In respect of investments in the secondary market, the following additional conditions shall apply:-

(a) the Foreign Institutional Investors shall transact business only on the basis of taking and giving deliveries of securities bought and sold and shall not engage in short selling in securities;

[Provided that nothing contained in clause (a) shall apply in respect of transactions in derivatives traded on a stock exchange][18]

(b) no transaction on the stock exchange shall be carried forward;

(c) the transaction of business in securities

(d) shall be only through stockbrokers who has been granted a certificate by the Board under sub section (1) of section 12 of the securities and Exchange Board of India Act, 1992;

[19]*[Provided that the transactions in government securities* ***including treasury bills***[20] *shall be carried out in a manner specified by the Reserve Bank of India]*

[21]*[Provided further that in case of an open offer by a company to buy-back its securities , the foreign institutional investors may sell the securities held by it to such company in accordance with the Securities and Exchange Board of India (Buy-Back of securities Regulations, 1998)]*

[22]*[Provided further that nothing contained in clause (c) shall apply to sale of securities by a Foreign Institutional Investor in response to a letter of offer sent by an acquirer in accordance with the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997.]*

[23]*[(d) a Foreign Institutional Investor or a sub account having an aggregate of securities which are worth rupees ten crores or more, as on the latest balance sheet data, shall, subject to such* instructions as may be issued from time to *time by the Board, settle their transactions entered on or after January 15, 1998 only through dematerialised securities.]*

(4) Unless otherwise approved by the Board, securities shall be registered -

(a) in the name of the Foreign Institutional Investor, provided the Foreign Institutional Investor is making investments on his own behalf; or

(b) in his name on account of his sub-account, or in the name of the sub-account, in case he is investing on behalf of the sub-account:

Provided that the names of the sub-accounts on whose behalf the Foreign Institutional Investor is investing are disclosed to the Board by the Foreign Institutional Investor.

(5) The purchase of equity shares of each company by a Foreign Institutional Investor investing on his own account shall not exceed ~~five~~ *[ten]*[24] percent of the total issued capital of that company.

(6) In respect of a Foreign Institutional Investor investing in equity shares of a company on behalf of his sub-accounts, the investment on behalf of each such sub-account shall not exceed ~~five~~ *[ten]*[25] percent of the total issued capital of that company.

(7) The investment by the Foreign Institutional Investor shall also be subject to Government of India Guidelines.

[A Foreign Institutional Investor or sub-account may lend securities through an approved intermediary in accordance with stock lending scheme of the Board][26]

CHAPTER IV.
GENERAL OBLIGATIONS AND RESPONSIBILITIES

Appointment of domestic custodian

16. (1) A Foreign Institutional Investor or a global custodian acting on behalf of the Foreign Institutional Investor, shall enter into an agreement with a domestic custodian to act as custodian of securities for the Foreign Institutional Investor.

(2) The Foreign Institutional Investor shall ensure that the domestic custodian takes steps for

(a) monitoring of investments of the Foreign Institutional Investor in India;

(b) reporting to the Board on a daily basis the transactions entered into by the Foreign Institutional Investor;

(c) preservation for five years of records relating to his activities as a Foreign Institutional Investor; and

(d) furnishing such information to the Board as may be called for by the Board with regard to the activities of the Foreign Institutional Investor and as may be relevant for the purpose of this regulation.

(3) A Foreign Institutional Investor may appoint more than one domestic custodian with prior approval of the Board, but only one custodian may be appointed for a single sub-account of a Foreign Institutional Investor.

Appointment of designated bank

17. A Foreign Institutional Investor shall appoint a branch of a bank approved by the Reserve Bank of India for opening of foreign currency denominated accounts and special non-resident rupee accounts.

Maintenance of proper books of accounts, records, etc.

18. (1) Every Foreign Institutional Investor shall keep or maintain, as the case may be, the following books of accounts, records and documents, namely:

(a) true and fair accounts relating to remittance of initial corpus for buying, selling and realising capital gains of investment made from the corpus;

(b) accounts of remittances to India for investments in India and realising capital gains on investments made from such remittances;

(c) bank statement of accounts;

(d) contract notes relating to purchase and sale of securities; and

(e) communication from and to the domestic custodian regarding investments in securities.

(2) The Foreign Institutional Investor shall intimate to the Board in writing the place where such books, records and documents will be kept or maintained.

Preservation of books of accounts, records, etc.

19. Subject to the provisions of any other law, for

the time being in force, every Foreign Institutional Investor shall preserve the books of accounts, records and documents specified in regulation 18 for a minimum period of five years.

Information to the Board

20. Every Foreign Institutional Investor shall, as and when required by the Board or the Reserve Bank of India, submit to the Board or the Reserve Bank of India, as the case may be, any information, record or documents in relation to his activities as a Foreign Institutional Investor as the Board or as the Reserve Bank of India may require.

CHAPTER V.
PROCEDURE FOR ACTION IN CASE OF DEFAULT

Cancellation or suspension of certificate

21. (1) A Foreign Institutional Investor who -

(a) fails to comply with any condition subject to which certificate has been granted; or

(b) contravenes any of the provisions of the Act or these regulations, shall be liable to the penalty of-

(i) suspension of certificate for a specified period; or

(ii) cancellation of certificate, after an enquiry as provided for in these regulations has been held.

(2) The provisions of these regulations shall be without prejudice to those of regulations 22 and 23.

Suspension of certificate

22. A penalty of suspension of certificate of a Foreign Institutional Investor may be imposed if he -

(a) indulges in fraudulent transactions in securities;

(b) fails to furnish any information related to his transaction in securities as required by the Board or the Reserve Bank of India;

(c) furnishes false information to the Board; or

(d) does not co-operate in any enquiry conducted by the Board.

Cancellation of certificate

23. A penalty of cancellation of certificate of a Foreign Institutional Investor may be imposed if he -

(a) indulges in deliberate manipulation or price rigging or cornering activities prejudicially affecting the securities market or the investors' interest;

(b) is guilty of fraud or a criminal offence, involving moral turpitude;

(c) does not meet the eligibility criteria laid down in these regulations;

(d) violates the provisions of the Securities and Exchange Board of India (Insider Trading) Regulations, 1992 or of the Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Markets) Regulations, 1995, made under the Act; or

(e) is guilty of repeated defaults of the nature mentioned in regulation 22. Explanation: In this regulation, "fraud" shall have the same meaning as is assigned to it in section 17 of the Indian Contract Act, 1872.

Manner of making order of suspension and cancellation of certificate

24. No order of penalty of suspension or cancellation of certificate shall be imposed on the Foreign Institutional Investor except after holding an enquiry in accordance with the procedure specified in regulations 25 and 26.

Manner of holding enquiry

25. (1) For the purpose of holding the enquiry referred to in regulation 24, the Board may appoint an enquiry officer.

(2) The enquiry officer shall issue to the Foreign Institutional Investor a notice at the principal place of business of the Foreign Institutional Investor setting out the default alleged to have been committed by the Foreign Institutional

Investor and calling upon him to show cause why the penalties specified in regulation 21 should not be imposed on him.

(3) The Foreign Institutional Investor may, within thirty days from the date of receipt of such notice, furnish to the enquiry officer a reply, together with copies of documentary or other evidence relied on by him in support of its reply: Provided that the enquiry officer may call upon him to supply further information.

(4) The enquiry officer shall, give a reasonable opportunity of hearing to the Foreign Institutional Investor to enable him to make submission in support of his reply under sub-regulation (3) of this regulation.

(5) Before the enquiry officer, the Foreign Institutional Investor may either appear in person or through any person duly authorised by him in writing.

(6) If it is considered necessary, the enquiry officer may ask the Board to appoint a presenting officer to present its case.

(7) The enquiry officer shall, after taking into account all relevant facts and submissions made by the Foreign Institutional Investor and by the presenting officer, if appointed under sub-regulation (6) above, submit a report to the Board and recommend the penalty if any to be awarded along with the justification for such penalty.

Show cause notice and order

26. (1) On receipt of the report from the enquiry officer, the Board shall consider the same and issue a show-cause notice to the Foreign Institutional Investor as to why the penalty, which it considers appropriate and which shall be specified in the notice should not be imposed.

(2) The Foreign Institutional Investor shall within twenty-one days of the date of the receipt of the show-cause notice referred to in sub-regulation (1), of this regulation send to the Board a reply to the notice.

(3) The Board after considering the reply to the show-cause notice, if received in time, shall as soon as possible but not later than thirty days from the receipt of the reply, if any, pass such order as it deems fit.

(4) Every order passed under sub-regulation (3) of this regulation shall be self-contained and give reasons for the conclusions stated therein including the justification for the penalty, if any, imposed by that order.

Effect of suspension and cancellation of certificate

27.(1) On and from the date of the suspension of certificate, if ordered under this Chapter, the Foreign Institutional Investor shall cease to buy, sell or otherwise deal in securities in India during the period of suspension.

(2) On and from the date of cancellation of certificate, if ordered under this Chapter, the Foreign Institutional Investor shall cease to buy, sell or otherwise deal in securities in India, except for the purpose of liquidating the existing investments.

Publication of order of suspension and cancellation of certificate

28. The order of suspension or cancellation of certificate under this Chapter shall be published by the Board in at least two daily newspapers.

Appeal

29. Any Foreign Institutional Investor aggrieved by an order of the Board under the regulations may prefer an appeal to the Central Government under the provisions of the Securities and Exchange Board of India (Appeal to the Central Government) Rules, 1993.

Source: Securities and Exchange Board of India website: File: fii2.html

FOREIGN INSTITUTIONAL INVESTMENT
ELIGIBILITY CRITERIA FOR REGISTRATION OF FOREIGN INSTITUTIONAL INVESTORS

The following categories of institutional investors are eligible for registration as Foreign Institutional Investors:

Pension Funds
Mutual Funds
Investment Trusts
Insurance or reinsurance companies
Endowment Funds
University Funds
Foundations or Charitable Trusts or Charitable

Societies who propose to invest on their own behalf, and
Asset Management Companies
Investment Advisers
Nominee Companies
Institutional Portfolio Managers
Trustees
Power of Attorney Holders
Bank who propose to invest their proprietary funds or on behalf of "broad based" funds, which are registered with SEBI as sub-accounts of the Foreign Institutional Investors.

As per Regulation 6 of SEBI (Foreign Institutional Investors) Regulations, 1995, Foreign Institutional Investors are required to fulfil the following conditions to qualify for grant of registration: The applicant is required Regulation 6 (a) requires the Foreign Institutional Investor to have a track record, professional competence, financial soundness, experience, general reputation of fairness and integrity; The applicant should be regulated by an appropriate foreign regulatory authority such as a securities regulator, central bank or government ministry, agency or department. Registration with authorities, which are responsible for incorporation, is not adequate to qualify as Foreign Institutional Investor. The applicant is required to have the permission under the provisions of the Foreign Exchange Regulation Act, 1973 from the Reserve Bank of India. The applicant has to satisfy the "Fit and Proper" Guidelines issued by SEBI. The applicant's activities and its registration with their regulatory authority should enable it to be categorised in the eligible categories as mentioned above. The applicant has to appoint a local custodian and enter into an agreement with the custodian. Besides it also has to appoint a designated bank to route its transactions. Besides the above, SEBI would also consider whether the grant of registration is in the interest of the development of the securities market.

Custodian and Designated Bank for Foreign Institutional Investors Transactions

Custodians are regulated by SEBI under the SEBI (Custodian of Securities) Regulations, 1996. Regulation 16(1) of the SEBI (Foreign Institutional Investors) Regulations, 1995 requires an Foreign Institutional Investor to appoint a domestic custodian for safe custody of securities and settlement of transactions on its behalf and to have a designated bank to route its foreign exchange and Indian rupee transactions. While several custodians in India are branches of domestic and foreign commercial banks, there are others who provide custody and settlement services with respect to securities, but are not banks. Foreign Institutional Investors are free to open accounts with banks who are not acting as their custodian. Where Foreign Institutional Investors are investing on behalf of sub-accounts, Foreign Institutional Investors may use different custodians and banks for different sub-accounts. However, for one sub-account, only one custodian may be used.

In case the Foreign Institutional Investor has an agreement with a global custodian which provides for appointment of local custodians, then it is not necessary for the Foreign Institutional Investors to again enter into an agreement with the local custodian. In such cases the global custodians have an agreement with the local custodians.

The custodian for an Foreign Institutional Investors or sub-account may be changed at any time after initial approval by writing to SEBI and providing a copy of the agreement with the new domestic custodian.

List of registered custodians

The general permission granted by the Reserve Bank of India under the Foreign Exchange Regulation Act permits Foreign Institutional Investors to do the following:
to open a foreign currency denominated account with a designated bank
to open a Special Non Resident Rupee Account to which could be credited all receipts arising out

of capital inflows, sales proceeds of shares and other securities, corporate benefits

to transfer sums from the foreign currency account to the rupee account and vice versa at the market rates of exchange

to make investments in the securities as indicated in the guidelines for investment by Foreign Institutional Investors out of the balances in the rupee account

to transfer repatriable (after payment of tax) proceeds from the rupee account to the foreign currency account

to repatriate the capital, capital gains, dividends, incomes received by way of interest, etc., and by compensation received towards sale/renouncements of rights offerings of shares, etc., subject to the designated branch of a bank/the custodian being authorised to deduct withholding tax on capital gains and arranging to pay such tax and remitting the net proceeds at the market rates of exchange.

The Special Non-Resident Rupee Account shall be used only for genuine investment transactions permitted.

Source: Securities and Exchange Board of India website. File: fii3.html

GUIDELINES FOR DETERMINATION OF FIT AND PROPER ENTITY

1. In determining whether an applicant is a fit and proper person, the Board shall take into consideration the following, namely :-

whether the applicant is financially sound.

Whether the applicant has been convicted by a Court for any offence involving moral turpitude or fraud and sentenced in respect thereof to imprisonment for a period not less than six months:

whether any winding up orders have been passed against the applicant;

whether any orders under the Insolvency Act have been passed against the applicant or any of its directors, or person in management in the preceding five years;

whether any order suspending or debarring the applicant from permanently carrying on activities in the financial sector has been passed by any other regulatory authority;

whether any order, withdrawing or refusing to grant any licence/approval to the applicant which has a bearing on the capital market, has been passed by any other regulatory authority in the preceding five years;

any other reason (to be recorded in writing by the Board) which adversely affects the reputation or character of the applicant which has a bearing on the capital market so as to deny it the certificate or renewal thereof.

2. Where the penalty imposed (including a monetary penalty) by any other regulatory authority has been carried out, then subject to compliance with other requirements specified in the relevant rules and regulations, the applicant may be considered to be a fit and proper person for the grant of certificate of registration.

FOOTNOTES

1. Inserted by SEBI (Foreign Institutional Investors) Amendment Regulations, 1997 dated February 12, 1997.

2. as above.

3. Inserted by SEBI (Foreign Institutional Investors) Amendment Regulations, 1996 dated October 9, 1996.

4. Inserted vide SEBI (Foreign Institutional Investors) (Third Amendment) Regulations, 1997 dated December 5, 1997.

5. Inserted by SEBI (Foreign Institutional Investors) Amendment Regulations, 1996 dated October 9, 1996.

6. Amended vide SEBI (Foreign Institutional Investors) (Third Amendment) Regulations, 1998 dated June 30, 1998.

7. Inserted by SEBI (Foreign Institutional Investors) Amendment Regulations, 1997 dated February 12, 1997.

8. Inserted vide SEBI (Foreign Institutional Investors) (Third Amendment) Regulations, 1997 dated December 5, 1997.

9. Amended vide SEBI (Foreign Institutional Investors) (Third Amendment) Regulations, 1998 dated June 30, 1998.

10. Amended vide SEBI (Foreign Institutional Investors) (Third Amendment) Regulations, 1998 dated June 30, 1998.

11. Inserted vide SEBI (Foreign Institutional Investors) Amendment Regulations, 1996 dated October 9, 1996.

12. Inserted vide SEBI (Foreign Institutional Investors) Amendment Regulations, 1998 dated April 20, 1998.

13. Inserted vide SEBI (Foreign Institutional Investors) (Amendment) Regulations, 1998 dated June 30, 1998.

14. Inserted vide SEBI (Foreign Institutional Investors) (Second Amendment) Regulations, 1996 November 19, 1996.

15. Inserted by SEBI (Foreign Institutional Investors) (Third Amendment) Regulations, 1998 dated June 30, 1998

16. Inserted by SEBI (Foreign Institutional Investors) Amendment Regulations, 1997 dated February 12, 1997.

17. Inserted by SEBI (Foreign Institutional Investors) (Second Amendment) Regulations, 1998 dated May 18, 1998.

18. Inserted by SEBI (Foreign Institutional Investors) (Third Amendment) Regulations, 1998 dated June 30, 1998.

19. Inserted by SEBI (Foreign Institutional Investors) (Second Amendment) Regulations, 1997 dated July 10, 1997.

20. Inserted by SEBI (Foreign Institutional Investors) (Second Amendment) Regulations, 1998 dated May 18, 1998.

21. Inserted by SEBI (Foreign Institutional Investors) (Amendment) Regulations, 1999 dated April 16, 1999.

22. Inserted by SEBI (Foreign Institutional Investors) (Third Amendment) Regulations, 1998 dated June 30, 1998.

23. Inserted by SEBI (Foreign Institutional Investors) (Third Amendment) Regulations, 1997 dated December 5, 1997.

24. Inserted vide SEBI (Foreign Institutional Investors) Amendment Regulations, 1996 dated October 9, 1996.

25. Inserted vide SEBI (Foreign Institutional Investors) Amendment Regulations, 1996 dated October 9, 1996.

26. Inserted vide SEBI (Foreign Institutional Investors) Amendment Regulations, 1998 dated April 20, 1998.

REPORT OF THE COMMITTEE ON CORPORATE GOVERNANCE (Chairman: Kumar Mangalam Birla, Mumbai, Security and Exchange Board India, 1999.)

[Selected portions of the Report and its recommendations excepting the Preface and the chapter on the Constitution of the Committee and Setting for the Report as also the Annexures, are reproduced below]

The Recommendations of the Committee

3.1 This Report is the first formal and comprehensive attempt to evolve a Code of Corporate Governance, in the context of prevailing conditions of governance in Indian companies, as well as the state of capital markets. While making the recommendations the Committee has been mindful that any code of Corporate Governance must be dynamic, evolving and should change with changing context and times. *It would therefore be necessary that this code also is reviewed from time to time, keeping pace with the changing expectations of the investors, shareholders, and other stakeholders and with increasing sophistication achieved in capital markets.*

Corporate Governance-the Objective

4.1 Corporate governance has several claimants - shareholders and other stakeholders - which include suppliers, customers, creditors, the bankers, the employees of the company, the government and the society at large. This Report on Corporate Governance has been prepared by the Committee for SEBI, keeping in view primarily the interests of a particular class of stakeholders, namely, the shareholders, who together with the investors form the principal constituency of SEBI while not ignoring the needs of other stakeholders.

4.2 *The Committee therefore agreed that the fundamental objective of corporate governance is the "enhancement of shareholder value, keeping in view the interests of other stakeholder".*

4.3 *The Committee is thus of the firm view,* that the best results would *be achieved when the companies begin to treat the code not as a mere structure, but as a way of life.*

Applicability of the Recommendations

Mandatory and non mandatory recommendations

5.2 The Committee felt that some of the recommendations are absolutely essential for the framework of corporate governance and virtually form its core, while others could be considered as desirable. *The Committee therefore felt that the recommendations should be divided into mandatory and non-mandatory categories and those recommendations which are absolutely essential for corporate governance, can be defined with precision and which can be enforced through the amendment of the listing agreement could be classified as mandatory. Others, which are either desirable or which may require change of laws, may, for the time being, be classified as non-mandatory.*

Applicability

5.3 *The Committee is of the opinion that the recommendations should be made applicable to the listed companies, their directors, management, employees and professionals associated with such companies, in accordance with the time table proposed in the schedule given later in this section.*

5.4 *The recommendations will apply to all the listed private and public sector companies, in accordance with the schedule of implementation. As for listed entities, which are not companies, but body corporates (e.g. private and public sector banks, financial institutions, insurance companies, etc.) incorporated under other statutes, the recommendations will apply to the extent that they do not violate their respective statutes, and guidelines or directives issued by the relevant regulatory authorities.*

Schedule of Implementation

5.6 *The Committee recommends that while the recommendations should be applicable to all the listed companies or entities, there is a need for phasing out the implementation as follows:*

* *By all entities seeking listing for the first time, at the time of listing.*
* *Within financial year 2000-2001, but not later than March 31, 2001 by all entities, which are included either in Group 'A' of the BSE or in S&P CNX Nifty index as on January 1, 2000.* However to comply with the recommendations, these companies may have to begin the process of implementation as early as possible. These companies would cover more than 80 per cent of the market capitalisation.
* *Within financial year 2001-2002, but not later than March 31, 2002 by all the entities which are presently listed, with paid up share capital of Rs 10 crore and above, or networth of Rs 25 crore or more any time in the history of the company.*
* *Within financial year 2002-2003, but not later than March 31, 2003 by all the entities which are presently listed, with paid up share capital of Rs 3 crore and above*

This is a mandatory recommendation.

Board of Directors

6.1 The board of a company provides leadership and strategic guidance, objective judgement independent of management to the company and exercises control over the company, while remaining at all times accountable to the shareholders. The measure of the board is not simply whether it fulfils its legal requirements but more importantly, the board's attitude and the manner it translates its awareness and understanding of its responsibilities. An effective corporate governance system is one, which allows the board to perform these dual functions efficiently. The board of directors of a company, thus directs and controls the management of a company and is accountable to the shareholders.

Composition of the Board of Directors

6.3 The Committee is of the view that the composition of the board of directors is critical to the independent functioning of the board. There is a significant body of literature on corporate governance, which has guided the composition, structure and responsibilities of the board. The Committee took note of this while framing its recommendations on the structure and composition of the board.

The composition of the board is important in as much as it determines the ability of the board to collectively provide the leadership and ensures that no one individual or a group is able to dominate the board. The executive directors (like director-finance, director-personnel) are involved in the day to day management of the companies; the non-executive directors bring external and wider perspective and independence to the decision making. Till recently, it has been the practice of most of the companies in India to fill the board with representatives of the promoters of the company, and independent directors if chosen were also handpicked thereby ceasing to be independent. This has undergone a change and increasingly the boards comprise of following groups of directors - promoter director, (promoters being defined by the erstwhile Malegam Committee), executive and non executive directors, a part of whom are independent. A conscious distinction has been made by the Committee between two classes of non-executive directors, namely, those who are independent and those who are not.

Independent directors and the definition of independence

6.5 It was agreed that "material pecuniary relationship which affects independence of a director" should be the litmus test of independence and the board of the company would exercise sufficient degree of maturity when left to itself, to determine whether a director is independent or not. *The Committee therefore agreed on the following definition of "independence". Independent directors are directors who apart from receiving director's remuneration do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in the judgement of the board* may affect their independence of judgement. Further, all *pecuniary relationships or transactions of the non-executive directors should be disclosed in the annual report.*

6.6 *The Committee is of the view that the non-executive directors, i.e., those who are independent and those who are not, help bring an independent judgement to bear on board's deliberations especially on issues of strategy, performance, management of conflicts and standards of conduct. The Committee therefore lays emphasis on the calibre of the non-executive directors, especially of the independent directors.*

6.7 Good corporate governance dictates that the board be comprised of individuals with certain personal characteristics and core competencies such as recognition of the importance of the board's tasks, integrity, a sense of accountability, track record of achievements, and the ability to ask tough questions. Besides, having financial literacy, experience, leadership qualities and the ability to think strategically, the directors must show significant degree of commitment to the company and devote adequate time for meeting, preparation and attendance. The Committee is also of the view that it is important that adequate compensation package be given to the non-executive independent directors so that these positions become sufficiently financially attractive to attract talent and that the non executive directors are sufficiently compensated for undertaking this work.

6.9 *The Committee recommends that the board of a company have an optimum combination of executive and non-executive directors with not less than fifty percent of the board comprising the non-executive directors. The number of*

independent directors (independence being as defined in the foregoing paragraph) would depend on the nature of the chairman of the board. In case a company has a non-executive chairman, at least one-third of board should comprise of independent directors and in case a company has an executive chairman, at least half of board *should be independent.*
This is a mandatory recommendation.

6.10 The tenure of office of the directors will be as prescribed in the Companies Act.

Nominee Directors

7.3 Clearly when companies are well managed and performing well, the need for protection of institutional interest is much less than when companies are badly managed or under-performing. The Committee would therefore recommend that institutions should appoint nominees on the boards of companies only on a selective basis where such appointment is pursuant to a right under loan agreements or where such appointment is considered necessary to protect the interest of the institution.

7.4 The Committee also recommends that when a nominee of the institutions is appointed as a director of the company, he should have the same responsibility, be subject to the same discipline and be accountable to the shareholders in the same manner as any other director of the company. In particular, if he reports to any department of the institutions on the affairs of the company, the institution should ensure that there exist Chinese walls between such department and other departments which may be dealing in the shares of the company in the stock market.

Chairman of the Board

8.1 The Committee believes that the role of Chairman is to ensure that the board meetings are conducted in a manner which secures the effective participation of all directors, executive and non-executive alike, and encourages all to make an effective contribution, maintain a balance of power in the board, make certain that all directors receive adequate information, well in time and that the executive directors look beyond their executive duties and accept full share of the responsibilities of governance. The Committee is of the view that the Chairman's role should in principle be different from that of the chief executive, though the same individual may perform both roles.

8.2 Given the importance of Chairman's role, the Committee recommends that a non-executive Chairman should be entitled to maintain a Chairman's office at the company's expense and also allowed reimbursement of expenses incurred in performance of his duties. This will enable him to discharge the responsibilities effectively.

This is a non-mandatory recommendation.

Audit Committee

9.3 A proper and well functioning system exists therefore, when the three main groups responsible for financial reporting - the board, the internal auditor and the outside auditors - form the three-legged stool that supports responsible financial disclosure and active and participatory oversight. The audit committee has an important role to play in this process, since the audit committee is a sub-group of the full board and hence the monitor of the process. Certainly, it is not the role of the audit committee to prepare financial statements or engage in the myriad of decisions relating to the preparation of those statements. The committee's job is clearly one of oversight and monitoring and in carrying out this job it relies on senior financial management and the outside auditors. However it is important to ensure that the boards function efficiently for if the boards are dysfunctional, the audit committees will do no better. The Committee believes that the progressive standards of governance applicable to the full board should also be applicable to the audit committee.

9.4 The Committee therefore recommends that a qualified and independent audit committee should be set up by the board of a company. This *would go a long way in enhancing the credibility of the financial disclosures of a company and promoting transparency.*

This is a mandatory recommendation.

9.5 The following recommendations of the Committee, regarding the constitution, functions and procedures of audit committee would have to be viewed in the above context. But just as there is no "one size fits all" for the board when it comes to corporate governance, same is true for audit committees. The Committee can thus only lay down some broad parameters, within which each audit committee has to evolve its own guidelines.

Composition

9.6 The composition of the audit committee is based on the fundamental premise of independence and expertise.

The Committee therefore recommends that

* *the audit committee should have minimum three members, all being non executive directors, with the majority being independent, and with at least one director having financial and accounting knowledge;*
* *the chairman of the committee should be an independent director;*
* *the chairman should be present at Annual General Meeting to answer shareholder queries;*
* *the audit committee should invite such of the executives, as it considers appropriate (and particularly the head of the finance function) to be present at the meetings of the Committee but on occasions it may also meet without the presence of any executives of the company. Finance director and head of internal audit and when required, a representative of the external auditor should be present as invitees for the meetings of the audit committee;*
* *the Company Secretary should act as the secretary to the committee.*

These are mandatory recommendations.

Frequency of Meetings and Quorum

9.7 The Committee recommends that to *begin with the audit committee should meet at least* thrice a year. One meeting must be held before *finalisation of annual accounts and one necessarily every six months.*

This is a mandatory recommendation

9.8 The quorum should be either two members or one-third of the members of the audit committee, whichever is higher and there should be a minimum of two independent directors.

This is a mandatory recommendation.

Powers of the Audit Committee

9.9 Being a committee of the board, the audit committee derives its powers from the authorisation of the board. The Committee recommends that such powers should include powers:

* *To investigate any activity within its terms of reference.*
* *To seek information from any employee.*
* *To obtain outside legal or other professional advice.*
* *To secure attendance of outsiders with relevant expertise, if it considers necessary.*

This is a mandatory recommendation.

Functions of the Audit Committee

9.10 As the audit committee acts as the bridge between the board, the statutory auditors and internal auditors, the Committee recommends that its role should include the following:

* *Oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible.*

* *Recommending the appointment and removal of external auditor, fixation of audit fee and also approval for payment for any other services.*
* *Reviewing with management the annual financial statements before submission to the board, focussing primarily on:*
    * *Any changes in accounting policies and practices.*
    * *Major accounting entries based on exercise of judgement by management.*
    * *Qualifications in draft audit report.*
    * *Significant adjustments arising out of audit.*
    * *The going concern assumption.*
    * *Compliance with accounting standards.*
    * *Compliance with stock exchange and legal requirements concerning financial statements.*
    * *Any related party transactions, i.e., transactions of the company of material nature, with promoters or the management, their subsidiaries or relatives, etc., that may have potential conflict with the interests of company at large.*
* *Reviewing with the management, external and internal auditors, the adequacy of internal control systems.*
* *Reviewing the adequacy of internal audit function, including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure, coverage and frequency of internal audit.*
* *Discussion with internal auditors of any significant findings and follow-up thereon.*
* *Reviewing the findings of any internal investigations by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the board.*
* *Discussion with external auditors before the audit commences, of the nature and scope of audit. Also post-audit discussion to ascertain any area of concern.*
* *Reviewing the company's financial and risk management policies.*
* *Looking into the reasons for substantial defaults in the payments to the depositors, debenture holders, share holders (in case of non-payment of declared dividends) and creditors.*

This is a mandatory recommendation

Remuneration Committee of the Board

10.1 The Committee was of the view that a company must have a credible and transparent policy in determining and accounting for the remuneration of the directors. The policy should avoid potential conflicts of interest between the shareholders, the directors, and the management. The overriding principle in respect of directors' remuneration is that of openness and shareholders are entitled to a full and clear statement of benefits available to the directors.

10.2 For this purpose the Committee recommends that the board should set up a remuneration committee to determine on their behalf and on behalf of the shareholders with agreed terms of reference, the company's policy on specific remuneration packages for executive directors including pension rights and any compensation payment.

This is a non-mandatory recommendation.

10.3 The Committee however recognised that the remuneration package should be good enough to attract, retain and motivate the executive directors of the quality required, but not more than necessary for the purpose.

Composition, Quorum, etc., of the Remuneration Committee

10.4 The Committee recommends that to avoid conflicts of interest, the remuneration committee, which would determine the remuneration packages of the executive directors should comprise of at least three directors, all of whom should be non-executive directors, the chairman of committee being an independent director.

10.5 *The Committee was of the view that it should not be difficult to arrange for a date to suit the convenience of all the members of the committee. The Committee therefore recommends that all the members of the remuneration committee should be present at the meeting.*

10.6 The Committee also recommends that the *Chairman of the remuneration committee should be present at the Annual General Meeting, to answer the shareholder queries. However, it would be up to the Chairman to decide who should answer the queries.*

All the above recommendations in paragraphs 10.4 to 10.6 are non-mandatory.

10.7 The Committee recommends that the board of directors should decide the remuneration of non-executive directors.

This is a mandatory recommendation.

Disclosures of Remuneration Package

10.8 It is important for the shareholders to be informed of the remuneration of the directors of the company. *The Committee therefore recommends that the following disclosures should be made in the section on corporate governance of the annual report:*

* *All elements of remuneration package of all the directors, i.e., salary, benefits, bonuses, stock options, pension, etc.*
* *Details of fixed component and performance linked incentives, along with the performance criteria.*
* *Service contracts, notice period, severance fees.*
* *Stock option details, if any - and whether issued at a discount as well as the period over which accrued and over which exercisable.*

This is a mandatory recommendation.

Board Procedures

11.1 The measure of the board is buttressed by the structures and procedures of the board. The various committees of the board recommended in this report would enable the board to have an appropriate structure to assist it in the discharge of its responsibilities. These need to be supplemented by certain basic procedural requirements in terms of frequency of meetings, the availability of timely information, sufficient period of notice for the board meeting as well as circulation of agenda items well in advance, and more importantly, the commitment of the members of the board.

11.2 The Committee therefore recommends that board meetings should be held at least four times in a year, with a maximum time gap of four months between any two meetings. The minimum information as given in Annexure 2 should be available to the board.

This is a mandatory recommendation.

The Committee further recommends that to ensure that the members of the board give due importance and commitment to the meetings of the board and its committees, there should be a ceiling on the maximum number of committees across all companies in which a director could be a member or act as Chairman. The Committee recommends that a director should not be a member in more than 10 committees or act as Chairman of more than five committees across all companies in which he is a director. Furthermore it should be a mandatory annual requirement for every director to inform the company about the committee positions he occupies in other companies and notify changes as and when they take place.

This is a mandatory recommendation.

Accounting Standards and Financial Reporting

12.1 *The Committee took note of the discussions of the SEBI Committee on Accounting Standards referred to earlier and makes the following recommendations:*

* *Consolidation of Accounts of subsidiaries*

The companies should be required to give consolidated accounts in respect of all its subsidiaries in which they hold 51 % or more of the share capital. The Committee was informed that SEBI was already in dialogue with the Institute of Chartered Accountants of India to bring about the changes in the Accounting *Standard on consolidated financial statements. The Institute of Chartered Accountants of India should be requested to issue the Accounting Standards for consolidation expeditiously.*

* *Segment reporting where a company has multiple lines of business.*

Equally in cases of companies with several businesses, it is important that financial reporting in respect of each product segment should be available to shareholders and the market to obtain a complete financial picture of the company. *The Committee was informed that SEBI was already in dialogue with the Institute of Chartered Accountants of India to introduce the Accounting Standard on segment reporting. The Institute of Chartered Accountants of India has already issued an Exposure Draft on the subject and should be requested to finalise this at an early date.*

* *Disclosure and treatment of related party transactions.*

This again is an important disclosure. The Committee was informed that the Institute of Chartered Accountants of India had already issued an Exposure Draft on the subject. *The Committee recommends that the Institute of Chartered Accountants of India should be requested to finalise this at the earliest. In the interim, the Committee recommends the disclosures set out in Clause 7 of Annexure-4.*

* *Treatment of deferred taxation*

The treatment of deferred taxation and its appropriate disclosure has an important bearing on the true and fair view of the financial status of the company. *The Committee recommends that the Institute of Chartered Accountants of India be requested to issue a standard on deferred tax liability at an early date.*

Management

13.1 In the view of the Committee, the overriding aim of management is to maximize shareholder value without being detrimental to the interests of other stakeholders. The management however, is subservient to the board of directors and must operate within the boundaries and the policy framework laid down by the board. While the board is responsible for ensuring that the principles of corporate governance are adhered to and enforced, the real onus of implementation lies with the management. It is responsible for translating into action, the policies and strategies of the board and implementing its directives to achieve corporate objectives of the company framed by the board. It is therefore essential that the board should clearly define the role of the management.

Functions of the Management

13.2 The management comprises the Chief Executive, Executive-directors and the key managers of the company, involved in day-to-day activities of the company.

13.3 The Committee believes that the management should carry out the following functions:

* *Assisting the board in its decision making process in respect of the company's strategy, policies, code of conduct and performance targets, by providing necessary inputs.*
* *Implementing the policies and code of conduct of the board.*
* *Managing the day to day affairs of the company to best achieve the targets and goals set by the board, to maximize the shareholder value.*
* *Providing timely, accurate, substantive and material information, including financial matters and exceptions, to the board, board-committees and the shareholders.*
* *Ensuring compliance of all regulations and laws.*

* *Ensuring timely and efficient service to the shareholders and to protect shareholder's rights and interests.*
* *Setting up and implementing an effective internal control systems, commensurate with the business requirements.*
* *Implementing and complying with the Code of Conduct as laid down by the board.*
* *Co-operating and facilitating efficient working of board committees.*

13.4 As a part of the disclosure related to Management, the Committee recommends that as part of the directors' report or as an addition there to, a Management Discussion and Analysis report should form part of the annual report to the shareholders. This Management Discussion & Analysis should include discussion on the following matters within the limits set by the company's competitive position:

* *Industry structure and developments.*
* *Opportunities and Threats.*
* *Segment-wise or product-wise performance.*
* *Outlook.*
* *Risks and concerns.*
* *Internal control systems and their adequacy.*
* *Discussion on financial performance with respect to operational performance.*
* *Material developments in Human Resources /Industrial Relations front, including number of people employed.*

This is a mandatory recommendation

13.5 Good corporate governance casts an obligation on the management in respect of disclosures. *The Committee therefore recommends that disclosures must be made by the management to the board relating to all material financial and commercial transactions, where they have personal interest, that may have a potential conflict with the interest of the company at large (for e.g. dealing in company shares, commercial dealings with bodies, which have shareholding of management and their relatives, etc.)*

This is a mandatory recommendation.

Shareholders

14.1 The shareholders are the owners of the company and as such they have certain rights and responsibilities. But in reality companies cannot be managed by shareholder referendum. The shareholders are not expected to assume responsibility for the management of corporate affairs. A good corporate framework is one that provides adequate avenues to the shareholders for effective contribution in the governance of the company while insisting on a high standard of corporate behaviour without getting involved in the day to day functioning of the company.

Responsibilities of Shareholders

14.2 The Committee believes that the General Body Meetings provide an opportunity to the shareholders to address their concerns to the board of directors and comment on and demand any explanation on the annual report or on the overall functioning of the company. It is important that the shareholders use the forum of general body meetings for ensuring that the company is being properly stewarded for maximising the interests of the shareholders. This is important especially in the Indian context. It follows from the above, that for effective participation shareholders must maintain decorum during the General Body Meetings.

14.3 The effectiveness of the board is determined by the quality of the directors and the quality of the financial information is dependent to an extent on the efficiency with which the auditors carry on their duties. The shareholders must therefore show a greater degree of interest and involvement in the appointment of the directors and the auditors. Indeed, they should demand complete information about the directors before approving their directorship.

14.4 The Committee recommends that in case of the appointment of a new director or re-appointment of a director the shareholders must be provided with the following information:

* *A brief resume of the director;*
* *Nature of his expertise in specific functional areas; and*
* *Names of companies in which the person also holds the directorship and the membership of Committees of the board.*

This is a mandatory recommendation

Shareholders' Rights

14.5 The basic rights of the shareholders include right to transfer and registration of shares, obtaining relevant information on the company on a timely and regular basis, participating and voting in shareholder meetings, electing members of the board and sharing in the residual profits of the corporation.

14.6 The Committee therefore recommends that as shareholders have a right to participate in, and be sufficiently informed on decisions concerning fundamental corporate changes, they should not only be provided information as under the Companies Act, but also in respect of other decisions relating to material changes such as takeovers, sale of assets or divisions of the company and changes in capital structure which will lead to change in control or may result in certain shareholders obtaining control disproportionate to the equity ownership.

14.7 The Committee recommends that information like quarterly results, presentation made by companies to analysts may be put on company's web-site or may be sent in such a form so as to enable the stock exchange on which the company is listed to put it on its own web-site. This is a mandatory recommendation.

14.8 The Committee recommends that the half-yearly declaration of financial performance including summary of the significant events in last six-months, should be sent to each household of shareholders.

This is a non-mandatory recommendation.

14.11 Currently, although the formality of holding the general meeting is gone through, in actual practice only a small fraction of the shareholders of that company do or can really participate therein. This virtually makes the concept of corporate democracy illusory. It is imperative that this situation which has lasted too long needs an early correction. In this context, for shareholders who are unable to attend the meetings, there should be a requirement which will enable them to vote by postal ballot for key decisions. A detailed list of the matters which should require postal ballot is given in Annexure 3. This would require changes in the Companies Act. The Committee was informed that SEBI has already made recommendations in this regard to the Department of Company Affairs.

14.12 The Committee recommends that a board committee under the chairmanship of a non-executive director should be formed to specifically look into the redressing of shareholder complaints like transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends, etc. The Committee believes that the formation of such a committee will help focus the attention of the company on shareholders' grievances and sensitise the management to redressal of their grievances.

This is a mandatory recommendation.

14.13 The Committee further recommends that to expedite the process of *share transfers the board of the company should delegate the power of share transfer to an officer, or a committee or to the registrar and share transfer agents. The delegated authority should attend to share transfer formalities at least once in a fortnight.*

This is a mandatory recommendation.

Institutional Shareholders

14.14 Institutional shareholders have acquired large stakes in the equity share capital of listed Indian companies. They have or are in the process of becoming majority shareholders in many listed companies and own shares largely on behalf of the retail investors. They thus have a special responsibility given the weightage of their votes and have a bigger role to play in corporate governance as retail investors look upon them for positive use of their voting rights.

14.15 Given the weight of their votes, the institutional shareholders can effectively use their powers to influence the standards of corporate governance. Practices elsewhere in the world have indicated that institutional shareholders can sufficiently influence because of their collective stake, the policies of the company so as to ensure that the company they have invested in, complies with the corporate governance code in order to maximise shareholder value. What is important in the view of the Committee is that, the institutional shareholders put to good use their voting power.

14.16 The Committee is of the view that the institutional shareholders

* Take active interest in the composition of the Board of Directors.
* Be vigilant.
* Maintain regular and systematic contact at senior level for exchange of views on management, strategy, performance and the quality of management.
* Ensure that voting intentions are translated into practice.
* Evaluate the corporate governance performance of the company.

Manner of Implementation

15.1 The Committee recommends that SEBI writes to the Central Government to amend the Securities Contracts (Regulation) Rules, 1957 for incorporating the mandatory provisions of this Report.

15.2 The Committee further recommends to SEBI, that as in other countries, the mandatory provisions of the recommendations may be implemented through the listing agreement of the stock exchanges.

15.3 The Committee recognises that the listing agreement is not a very powerful instrument and the penalties for violation are not sufficiently stringent to act as a deterrent. The Committee therefore recommends to SEBI, that the listing agreement of the stock exchanges be strengthened and the exchanges themselves be vested with more powers, so that they can ensure proper *compliance of code of Corporate Governance. In this context the Committee further recommends that the Securities Contract (Regulation) Act, 1956 should be amended, so that in addition to the above, the concept of listing agreement be replaced by listing conditions.*

15.4 The Committee recommends that the Securities Contracts (Regulation) Act, 1956 be amended to empower SEBI and stock exchanges to take deterrent and appropriate action in case of violation of the provisions of the listing agreement. These could include power of levying monetary penalty both on the company and the concerned officials of the company and filing of winding-up petition, etc.

15.5 The Committee also recommends that SEBI write to the Department of Company Affairs for suitable amendments to the Companies Act in respect of the recommendations which fall within their jurisdiction.

15.6 The Committee recommends that there should be a separate section on Corporate Governance in the annual reports of companies, with a detailed compliance report on Corporate Governance. Non-compliance of any mandatory recommendation with reasons thereof and the extent to which the non-mandatory recommendations have been adopted should be specifically highlighted. This will enable the shareholders and the securities market to assess for themselves the standards of corporate governance followed by a company. A suggested list of items to be included in the compliance report is enclosed in Annexure 4.

This is a mandatory recommendation.

15.7 The Committee also recommends that the company should arrange to obtain a certificate from the auditors of the company regarding compliance of mandatory recommendations and annex the certificate with the directors' report, which is sent annually to all the shareholders of the company. The same certificate should also be sent to the stock *exchanges along with the annual returns filed by the company.*

This is a mandatory recommendation

REVIEW ARTICLE*

RULES, LAWS AND CONSTITUTION

S.B. Wad

This book is a collection of essays by Satish Saberwal and friends. The flagship essay is by Satish Saberwal, advocating the concept of context free rules for being adopted by society. In this review article, we shall examine mainly the Saberwal thesis. We shall refer to him as the 'author', since he is the author of the thesis.

I

According to the author the over-arching concept is his poser in the issue of '*Seminar*' on 'Rules and Laws' in October 1995. It was felt in that seminar that although political and social ideologies pose difficulties in the application of the concept of general rules, the study of historical experiences in different countries would provide a basis for forming judgements on this crucial issue. The author states 'The papers in this volume will on the whole argue that rules, laws and constitutions - at least good rules, laws and constitutions - are desirable not because they are *morally* better but because these can enable societies to run themselves more efficiently...' (p. 16). The general rules are more versatile. Of this larger categories of general rules, modern legal rules are a subset, constitutions being a subset of legal rules.

After briefly setting out A. K. Ramanujan's analysis, where Ramanujan contrasts between context sensitive behaviour and rules in India, and the effort in Europe in the last few centuries to search for context free concepts and rules, the author observes that historically Indian society did not work on impersonal general rules. The rules were context sensitive such as prescription of punishment depending upon culprits' caste, status in Manu's codes. The author then advocates the use of terms 'rules' and 'laws' only for the context free formulations. He has taken serious note of the criticism by Bishnu Mohapatra that in a society racked by hierarchy and segmentation, to speak of effective rule of Law, context free rules, and the like may seem quixotic (p. 24). The author therefore advocates a collective 'U' turn, socially speaking, to get around or override this hierarchy and segmentation. He then poses a question, probably expressive of his doubt regarding the acceptability of the general rules. The author states 'The habits of seeking and working with general, context free rules and laws are an important, potential resource for persons and societies... Granting that, the question remains: where and how to find constituencies for these modes of thought?' (p. 31).

In a separate essay, 'Enlargement of Scales, Plural Traditions, and Rule of Law', the author tries to argue that with the traditional caste hierarchies collapsing, recourse to general legal rules may again be optimal for achieving social order. Similar result would be achieved by larger scale of commerce, manufacture, travel, etc. Here again he seems to be upset because the conceptions he is advocating have little grass roots support. He repeats the earlier question: 'How to reach, and to rework the ground level ideas and world-views? What agencies? What time-scales?' (p. 79).

The author has referred to the foreign experiences for forming the judgement on application of general laws. There are two essays, one on Constitutionalism - Meaning, Endangerment, Sustainability. Another is an essay on Homogeneity and Constitutional Democracy: Speaking on Group Rights as an Answer to Identity Conflicts. These two essays are by two German Contributors, U.K. Preuss and Claus Offe. The third essay entitled Rule of Law versus Rule of Man, by Giri Deshingkar describes the state of affairs in China including the adoption of market

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*Saberwal Satish and Heiko Sievers (Eds.), *Rules, Laws, Constitutions*, Sage Publications India Private Ltd., New Delhi, 1998, Pp. 289, Price Rs 350/-.

economy. These articles have nothing to do with the main theses of context free laws. Constitutions, as would be demonstrated, are a combination of general rules and context sensitive rules. Rule of law has a definite legal connotation. It represents a concept that even the rulers are bound by and must work under law because all are equal before law. It is an anti-thesis of arbitrariness, both in substantive and procedural law.

Then there is an article by a German writer, D. Conrad on 'Rule of Law and Constitutional Problems of Personal Laws in India'. To get over the difficulties of acceptance of a Uniform Civil Code, he has advocated that it should be made optional. Vasudha Dhagamwar in her essay, 'Rule of Law: Squaring the Circle', has tried to explain the difficulties in the concept of Rule of Law as an instrument of justice. By referring to Emergency declared by Indira Gandhi, when Rule of Law as constitutional governance was temporarily suspended, she has advocated vigilance to avoid the repetition. She is not referring to general law as context free law. There are other essays which do not directly deal with the main theme of the author. In fact, Shri Sumit Guha, in his essay, 'Power and Law in Past and Present', has demonstrated, with reference to Maratha Administration of Justice, that the Marathas never felt any need for general context free law or even the rule of law. He has quoted Lord Elphinstone, the Governor of Bombay, who governed the region after its conquest by the British. Elphinstone observed, 'the situation of lower orders was very comfortable, and that of the upper, prosperous'. Guha has further pointed out that modern China has reached a double digit growth rate with minimalist legal regime. His observation 'Perhaps the Rule of Law needs to be defended as good in itself, and not as a means to some other good' (p. 95), appears to be a total denial of the validity of the author's thesis.

In order to illustrate a context sensitive rule, the author has referred to distinct punishments on the basis of caste status in Manu's code. But there are several provisions in Manu's code which are of general application. Apart from the substantive provisions, the Code also lays down rules of procedure and evidence. They are in the nature of a context free law, as they are in all other legal systems. The rule of status based punishment is a logical extension of the social organisation based on *vernas* and Caste by birth and definite social hierarchy. Greek and Roman evolution of general laws and constitution was not general since it was not applicable to the slaves, women and foreigners for most of the period of these civilisations. Sociologists should answer the question why Indian society survived the test of time while the other societies and civilisations collapsed. What judgement can be passed on this historical fact?

II

In support of the thesis of the extension of general law and enlargement of scales, the present efforts at unification of Europe are cited; but when Europe is being unified, the erstwhile Soviet Union has disintegrated. Even in England there is a growing movement for independence in Scotland, Welsh and northern Ireland.

There is a good deal of misconception about the English legal system. It is assumed that it is also based on Roman Law. But it is not so. Only Scotish Law has Roman Law as a model before it. The English system of law known as common law, consists of Parliamentary laws, precedents evolved by courts, equity and immemorial customs. This common law system detests codification of laws, although the same was advocated by the noted jurist Bentham in the 18th century. England has produced great judges, not jurists. The reason is that the English system favours empirical evolution of law to theoretical development through jurisprudence. England does not have a written constitution. Supremacy of

Parliament and independence of courts are historical facts arising out of the tussle for supremacy between monarchy and the parliament in the 17^{th} century.

English and American legal systems are broadly described as common law systems. Although the legal source is same, the historical development of the two systems shows a very wide cleavage between the two systems. A comparative study of the two systems is done in an American book. It is pointed out that the English legal system is based on formal reasoning while the American System is based on substantive reasoning. A substantive reason is reason based on moral, economic, political, institutional or other social considerations. This difference in methods of reasoning reflects a deep difference in legal style, legal culture and more generally the visions of law which prevail in each country. It is further pointed out that 'English judges tend to trust the rest of the legal - political establishment - governments, legislatures, officials, police - and in the elitist fashion to distrust the public at large and their representative, the jury. American judges, by contrast, distrust the establishments and trust the people and the jury. English judges are more likely to use formal reasoning in many sorts of cases where this means the substantive issues are left to others in the legal-political establishment. American judges, on the other hand, are more likely to use formal reasoning where they are laying down rules of conduct for other officials whom they do not trust, such as the police' [Atiyah and Summers, 1987, p. 39]. Another observation of the learned authors is also incisive. It is said that 'the free wheeling substantive reasoning in America, ignoring a statute, and high level of judicial activism seems to substitute Government by judiciary for Government by peoples' elected representatives'.

Judicial activism, as an instrument of social change, is now a well-entrenched fact in the legal history of India. Existing textual provisions of the Constitution and laws are overturned by the courts if the public interest so required.

The above discussion of the western systems of law will demonstrate how the assumptions in the main thesis are not wholly correct.

III

A lawyer would be misled by the title of this book because he will not find any material for being used in the court for enforcement of the rights and obligations created by Rules, Laws and Constitution as they are understood in legal parlance. As he goes through the essays, he will realise that this is not a law book. It is an attempt by a sociologists to explain these legal concepts. But even then some confusion remains. Functionally speaking, Rules, Laws and Constitution perform the same function. They represent a general rule of conduct, which regulates the behaviour of individuals and groups in human society. They have no distinct connotation in terms of the social function they perform.

IV

The difficulty with the thesis propounded in the book starts with the concept of context free rules. What is meant by context is not defined in the book. Contexts may be historical, territorial or based on social classification. It is impossible to imagine a legal system of any society where rules and laws are completely context free.

To test the author's thesis, let us examine some provisions of the Indian Constitution. The Constitution of India contains several provisions which are context specific and are not of general application. Article 15 incorporates a principle of equality before law. It states that the State shall not discriminate against any citizen on the grounds of religion, race, caste, sex, place of birth or any of them. However, the same article clarifies that this provision shall not prevent the State from making any special provision for the advancement of any socially and educationally backward classes of citizens or Scheduled Castes and Scheduled Tribes. Similarly, in regard to equality of opportunity in matters of public employment, article 16 provides that nothing in the said article shall prevent the state from making any provision for reservation in employment and promotion in any class or classes of posts in the services under the state in favour of scheduled castes and scheduled tribes, which, in the opinion of the state, are not adequately represented in the services under the state. The Mandal Commission's recommendations for the reservation in public employment are specific in terms of the backward classes, scheduled castes and scheduled tribes. Article 17 is a very direct provision for protecting a class. Article 17 prescribes that 'untouchability' is abolished and its practice in any form is forbidden. The enforcement of any disability arising out of 'untouchability' shall be an offence punishable in accordance with the law.

Articles 29 and 30 afford special protection to the minorities and to their educational institutions. These provisions of the Constitution stated above pertain to specific social groups. The minorities mentioned in the articles cover religious and linguistic minorities. Therefore, a Hindi medium school run by a Hindu is a minority educational institution in the state of Nagaland where the population is mostly Christian and the language of the state is English. There is a special provision for the state of Jammu and Kashmir incorporated in article 370 of the Constitution. The laws passed by the Parliament are not applicable to the state of Jammu & Kashmir unless the state legislature approved the same. Similarly, article 371A has a special provision regarding the state of Nagaland. It provides that no Act of Parliament in respect of religious or social practices of Nagas, Naga Customary Law and Procedure, Administration of Civil and Criminal Justice and ownership and transfer of land and its resources, shall be applicable in Nagaland. Similarly, there is a special provision for the state of Assam incorporated in article 371B of the Constitution. There is also a special provision in the Sixth Schedule of the Constitution for administration of tribal areas in the state of Assam, Meghalaya, Tripura and Mizoram. These are the examples of context sensitive provisions of the Constitution in terms of a territory and states.

All these special provisions stated above are equally binding and have the same legal status in matters of enforceability as the other provisions of the Constitution, which have general applicability.

The Third Schedule to the Constitution provides for the form of oath or affirmation to be taken by the judges of the superior courts, Ministers, Members of Legislature, etc. The form of oath states that 'I shall bear true faith and allegiance to the Constitution of India as by law established'. According to the strict legal theory, the Constitution is a supreme sovereign law and a repository of all powers and functions of the State. There cannot be any law higher than the Constitution of India and there cannot be any legal source of the Constitution of India. The only context of the reference to law, mentioned in the oath, is historical. The India Independence Act passed by the British Parliament created two Dominions of India and Pakistan leaving them free to frame their own Constitutions. This is an example of a historical political context.

In order to maintain legal and administrative continuity after India became free, a special provision was incorporated in Article 372 of the Constitution. This article provides that all laws enforced in the territory of India immediately before the commencement of the Constitution shall continue in force until altered or repealed or amended by Indian legislature or other competent authority. The only caveat is that such laws should not be contrary to the provisions of the Constitution of India. By virtue of Article 372, the Muslims and Christians Personal Laws continue as valid provisions of law applicable to the said communities. The Supreme Court has ruled that the special provision of Muslim personal laws do not violate the principle of equality enshrined in Article 14 of the Constitution. The Court has held that historically, the classification of personal laws applicable to different communities was legally permitted and Article 372 further permits the continuance of such personal laws. The classification of personal laws on the basis of religion is reasonable. Therefore, there was no violation of the rule of equality.

Article 44 of the Constitution enjoins the State to endeavour to secure for the citizens a Uniform Civil Code throughout the territory of India. This is a provision in the Directive Principles of State Policy. These principles are not enforceable by any court of law but these provisions are fundamental in the governance of the country and it will be the duty of the State to apply these principles in making laws. The provision regarding uniform civil code envisaged by Article 44 of the Constitution is an example of context free law. Yet, there is a perennial on-going controversy regarding the implementation of this Directive with the result the Parliament is not able to frame the uniform civil code applicable to all citizens. However, there is a partial codification of civil laws applicable to Hindus. They cover areas of marriage, succession to property, adoption and guardianship. The Muslim community and the Christian community are not only opposing the uniform civil code but are averse to any alteration in the personal laws to give it a modern look.

The codification of the Hindu Personal Civil Law is entirely based on the model of western concepts and laws. The old Hindu law laid down by the *Smritis* is given a complete go by except in a small area. For example, in the law of succession, the principle of nearness of relationship as against the principle of blood relationship, has been incorporated for the purposes of succession. Women have been given full right as men in succession. As regards succession amongst males, the *Mitashkara* Law laid down by *Smritis* was preserved, but recently the four southern States and Maharashtra have completely done away with the difference between males and females in matters of succession. The women have been recognised as coparcenors along with males in succession to ancestral properties.

Part XVI of the Constitution provides for special provisions relating to certain classes. The provisions include reservation of seats for Scheduled Castes, Scheduled Tribes and the Anglo-Indian community in Parliament and State Legislatures. It also includes the Presidential Order specifying castes, races or tribes or parts of groups within castes, races and tribes to be called Scheduled Castes and Scheduled Tribes. Parliament can include or exclude castes, races and tribes from such a Presidential Order. Similarly, for the Backward Classes which are socially and economically backward, the President of India can recommend measures for removal of their backwardness. The President can constitute a commission for that purpose. The Mandal Commission's recommendations for reservation for the Backward Classes falls under this provision. These special provisions in the Constitution serve the social purpose of the empowerment and economic opportunities for the Backward Classes and for Scheduled Castes and Scheduled Tribes.

The non-definition of the concept of 'context' or difficulties in defining 'context' (which is socially and legally relevant.) is at the root of the confusion of the thesis propounded in the book.

The Hindu Marriage Act, 1955 makes provision for marriage, divorce and similar provisions applicable to Hindus. This appears to be a context free law. Section 2(2) excludes Scheduled Tribes from the definition of the word 'Hindu'. It also excludes Muslims, Christians, Parsis and Jew religions from the application of the law. Yet, there is a further provision which states that if by custom or usage the provisions of Hindu law were being followed by Muslims, Christians, Parsis or Jews, then Hindu Marriage Act, 1955 would be applicable to them. The definition of the word 'Hindu' is an inclusive definition which includes Buddhists, Jains and Sikhs and the followers of Arya Samaj, Brahmo Samaj, Prarthana Samaj or those persons who belong to Virashaiva or Lingyat Sects. Considering these provisions of the Act, it would be impossible to call the Hindu Marriage Act as a context free enactment.

The present controversy regarding the legislation for 33 per cent reservation of women in Parliament and state assemblies further illustrates that a general context free law is impossible to be adopted. The Backward Classes, Scheduled Castes, Scheduled Tribes and even Muslims are claiming reservation within the 33 per cent reservation for women.

These two illustrations fully demonstrate the difficulty in identifying the 'context'. Since personal laws for different religions are different, Hindu law would have a definite context. The next context is that of Scheduled Tribes to which the Act is not applicable and there is a third context of Buddhists, Jains, Arya Samajis, etc. Then there is the next sub-context amongst the Muslims, Christians and Parsis who had been, as a matter of custom or usages, following Hindu law so far. The question is, at what point in this assortment or hierarchy the term 'context' would be applicable to decide whether the rule is context free or context specific.

Similarly, in matters of representation to the Parliament and Legislatures, the general statutory rule is that all adult citizens are entitled to become Members of Parliament or Member of State legislature. The division in this category is being carved out for reservation of women. The sub-division of this class of women is in terms of backward classes, scheduled castes and scheduled tribes. At what stage should we stop to identify a 'context free' law?

V

The main thesis of the book completely ignores the law created by the superior courts through precedents. It is now uniformly accepted in all modern legal systems that the superior courts not only interpret and apply law but they also create new law. Article 141 of the Constitution recognises the said principle. It lays down that the law declared by the Supreme Court shall be binding on all Courts in the territory of India and Article 142 gives further power to the Supreme Court whereby the orders passed by it for doing complete justice in any case are legally enforceable throughout the territory of India and bind all authorities under the State.

In Keshavananda Bharati v. *State of Kerala,* [AIR, 1973, SC, p. 1,461], the Supreme Court has laid down that it has a power to quash even the constitutional amendment made by the Parliament in its sovereign capacity, if such an amendment violates the basic features/structures of the Constitution. This revolutionary decision has enabled the Supreme Court to preserve the Republican, Democratic and Secular nature of the Constitution and to protect the principles of equality and judicial supremacy not only from the executives but also from the Parliament expressing itself in a sovereign capacity by amending the Constitution. In a written Constitution, the question arises as to how far the conventions of British Constitution are applicable. The Supreme Court has ruled that President of India is legally bound by the advice of the Cabinet. Where the President of India did not take any decision as to whether death sentence should be commuted or not, the Supreme Court has intervened and commuted death sentence to life imprisonment. Supreme Court has laid down substantive law for foreign adoptions, sexual harassment at work places and service conditions of district judiciary. Recently, the Supreme Court, through its judgement, has arrogated to itself the power to appoint and transfer of judges of superior courts. There are several decisions of the courts in the area of pollution laws where the original text is supported with new contents.

Existing textual rules, laws or Constitution are not treated by superior courts as a sacrosanct resource. Courts are equally not concerned whether a rule is context free or not. Judicial decisions by their very nature are problem specific, or individual/group specific.

VI

Another problem for the author's definition of law (namely, context free law) is that it does not consider the role of 'Customs & Usages' in the social life and in the legal system. The definition of 'Customs & Usages' in Section 3 of the Hindu Marriage Act, 1955 further illustrates the division and sub-division of customs. The custom or usage may be one which is followed in a local area or by a tribe or a community or group or family. Thus, even family custom is recognised as having the force of law.

According to Section 5 of the Hindu Marriage Act, 1955, the parties to a marriage should not be within the degrees of prohibited relationship and should not be *sapindas* of each other. The Act further provides that if a custom or usage governing each of the parties permits such a marriage, the marriage would be a valid marriage. The law requires that a bridegroom should not be below 21 years of age and the bride should not be below the age of 18 years. But if this requirement is not followed, the marriage is not void under the Hindu law. In large parts of India, child marriages are still common because of the local customs and religious beliefs. Not only are such child marriages accepted by society as legal marriages but the children of such marriage are also accepted as legitimate and their property rights are decided according to the normal law of property.

VII

Let us now refer to some attempts made by jurists in the past to evolve a formal general theory of law. The author has cited Kelsen's *Pure Theory of Law* (1967) in his bibliography. Has he drawn inspiration from Kelsen in propounding his theory? According to Kelsen, a theory of law must be free from ethics, politics, sociology, etc. It must be 'pure'. Propositions of science describe what does happen 'is'. Propositions of law lay down 'oughts', backed up by force of State. Law is the primary norm, which stipulates sanction. Law is a hierarchy of 'oughts' traceable to the fundamental 'ought' - 'Grundnorm'. Although at intermediate stage law is 'pure', Kelsen had to admit that when we reach 'Grundnorm', factors outside law come into play. The revolution of 1689 in England established supremacy of Parliament and the rule that precedents must be obeyed. Apart from these facts of minimum effectiveness, the critics have pointed out that Kelsen had to accept the role of morals - of society and judges - as another fact of effectiveness.

Before Kelsen, Austin propounded a formal theory of law - law being a command of the sovereign enforced by force of the State.

None of these formal theories are found adequate in jurisprudence to explain the complex concepts of law.

VIII

Distinction between general law and special/particular law is well known. Common law and Indian law recognize general law and special law as valid and enforceable varieties of law. However, in a conflict between them, special law prevails over general law. This is exactly opposite to what the author has propounded. A law applicable to a locality or to a class of cases or individuals is a special law as distinguished from a general law which applies to the whole community. Prior particular or special law is not held to be impliedly repealed by later general enactment. Industrial Disputes Act, 1947, bars legal practitioners from appearing in Labour Courts unless the court permits. Subsequent general Act, viz., Advocates Act, 1961, entitles an Advocate to practice in all courts. Both laws are simultaneously in force and the earlier special law is not impliedly repealed by subsequent general law. But a subsequent special law will prevail over prior general law if they operate in the same field. Civil Procedure Code generally provides where civil suits can be filed. A subsequent provision of Railways Act provides a separate forum for compensation for civil liability in case of loss of life or injury. The Railway Act prevails over the prior Civil Procedure Code.

IX

To sum up, the Constitution is the supreme fundamental law, representing State sovereignty and backed up by monopoly of public physical force. Constitution empowers legislatures to create 'law' within defined limits. Similarly, laws empower rule-making authorities to frame 'rules'. They are linked together by a definite hierarchy on which depends the degree of their validity and enforcement. They are applied and enforced because of their self-evident validity. Individuals and groups forming society order their conduct under the same because of their legal validity - not because of their 'versatility' or because they are 'context free'. A social/political explanation of the supremacy of law is discernable in the preamble of the Constitution of India - 'We, the people of India, hereby adopt, enact and give to ourselves this Constitution'.

Kelsen tried to construct a 'pure' theory of law. But, as he has admitted and the critics have emphasised, he could not ignore historical, political contexts, nor free himself of the role of morals in the administration of justice. The main thesis in this book is a pale and halting sociological appropriation of Kelsen's 'pure' theory of law, turning a Nelson's eye to the pitfalls pointed out by Kelsen's critics.

The thesis proceeds on the premise that legal Rules are clearly a subset of a larger category of general rules - Constitutions are a subset of legal rules. This self- serving sociological construct ignores the well-entrenched hierarchy and mandatory character of legal rules. Legal rules are qualitatively different from 'laws' of the physical world and general social norms. Sociological discourse describes what 'is', does not prescribe what 'ought' to be - akin to discourse in physical sciences. Occasionally, it is structural - functional. But it is never normative/prescriptive. The main thesis in the book over-steps the limits of the description of sociology and transgresses the field of law on the premises as alien to law. The result is neither sociology nor law - neither an animal nor a bird.

Another departure from the scientific approach in the thesis is the reference to morals in the definition of 'law'. It is legitimate, nay, a requirement of scientific enquiry to keep moral considerations out. In every legal system, there are some rules which reflect the moral expectation of society. Many of the Ten Commandments now form part of modern penal codes. When Harshad Mehta is convicted by courts for financial scam, society feels vindicated. But, when an accused in a bride burning case is acquitted, social conscience feels frustrated and angry. Exclusion of morals completely from the legal regime is contrary to the social reality.

The most serious weakness of the thesis is the absence of any definition of 'context'. The only glimpse of the concept is to be seen in two references, one to morals and the second to personal aspects. It is silent about the entire range of historic, social and political or geographic facts. Even, family custom and sub-groups of castes are recognised in modern Indian law. What is the unit or hierarchy or stage of a social group where context becomes relevant or irrelevant, is the question. Even the example of punishment on caste-status in Manu's Code can also be described as general context free law; if we state that for all Brahmins, the law was same. It did not vary with each sub-caste amongst Brahmins.

The author submits that for the purposes of that essay, only context free law will be treated as 'law'. It is a well-known legislative practice to define a concept for the purposes of that enactment. For example, for the purposes of income-tax, incorporated companies, unincorporated companies and partnership firms are all treated as one, although they are quite distinct for other laws. The next question is, whether context free law alone can be described as 'law'. The author's assertion, therefore, begs the question. It is assumed that only 'context free' laws can be called laws; then logically it would follow that such laws alone can be designated as 'Good Laws'. It is then difficult to comprehend what the author means when he states 'at least good rules, laws and constitutions are desirable not because they are morally better ....' (but because they are context free laws). The logical question arising from the main thesis is whether context free laws alone can be called good laws. Begging the question again.

The object of the comparative study of experiments of different countries, according to the author, is to form 'judgements' on the crucial issues. What is the place of value judgements in a sociological enquiry like this? The only judgement logically deducible from the thesis is if the countries under review do not have all their laws which are context free, then their legal system is not good. Sumit Guha in his essay has referred to Lord Elphinstone's (the Governor of Bombay) observation of how prosperous the Maratha Kingdom was in spite of absence of Rule of Law. He has also adverted to double-digit economic growth of China where there is minimal legal regime. We have earlier reproduced large number of context sensitive provisions of The Indian Constitution. Can the Indian Constitution be described as bad law (not good law)?

The author then asserts that 'traditional caste hierarchies are collapsing' and exhorts society to have collective 'U' turn for the optimum success of context free laws. A formidable 'U' turn was taken by Buddhism and thereafter by various reformist sects and social thinkers. Indian Penal Code, enacted in 1860, made substantive provisions of offences and punishment equally applicable to all section of Hindus, Muslims, Christians, etc. The Constitution of India took a quantum leap to enshrine Rule of Law and Equality before Law. Yet, there are no signs of caste hierarchies collapsing. In fact, Mandal has taken a reverse turn to further consolidate the caste system.

Regrettably, the thesis propounded by the author is not socially and legally valid. It is also not useful. Sumit Guha has summarised his review on the thesis saying 'perhaps the rule of law needs to be defended as in itself and not as a means to some other good'. The plight of context free law is worse. Bishnu Mohapatra has described it as quixotic. No wonder, the author is in a fix to find the constituency.

X

In a vast country like India, which is almost a sub-continent, there are various territorial sub-divisions, which have peculiar problems of their own. All the religions of the world are being freely practised in different parts of India. There are castes and tribes which is very basic to the social fact of Indian society. At least 40 per cent of the population in India is below the poverty line and is socially, economically and educationally backward. Any social, political, economic or legal programme is required to address the multiplicity of interests represented by the above factors. Therefore, a context free law is almost an impossibility in a country like India. The social and legal norms in India are always a combination of context free and context specific norms. That is the reason why although the Constitution of India is, generally speaking, a Federal Constitution, in its content it is a highly unitary Constitution. K.C. Wheare, an authority on Federal Constitution, has found that no constitution in a democratic world is wholly federal or wholly unitary. In the practical administration, there are features of centralisation and de-centralisation simultaneously operating. Although laws are intended to be of a general and universal application, their implementation leaves an enormous discretion in the hands of the administrator. Therefore, at a given time, the administrative system cannot work only by rules or only by discretion. There is a combination of both. If the author's definition of law as a context free rule is to be accepted, not only Indian but no other system of law will qualify for being called a law.

But, has the author propounded any theory at all? He says (I repeat), 'At least good rules ... are desirable ... because these can enable societies to run more efficiently'. This is at best an affectionate exhortation like, अच्छे बच्चे ऐसे नहीं करतें ।

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BOOK REVIEWS

Kumar, Vinita, *Economic Growth and Rural Poverty - The Indian Experience 1960-1995*, Concept Publishing Company, New Delhi, 1997, Pp. 282, Rs 400/-.

This is a study focussed on the nexus between economic growth and rural poverty in India covering the period 1960 to 1995. More specifically it examines the distributional impact of growth given the structural characteristics of the economy and the prevailing institutional framework and the changes that have taken place in them over this period. The choice of the period enables comparison between the pre- and post-Green Revolution phases, highlighting the fundamental changes in the sources of agricultural growth as well as the related policy responses of the Government to emerging problems and situations.

A rather striking limitation of the study is that it is conducted at the all-India level and therefore highly aggregative in nature. The purpose of such aggregation is however explicitly stated - 'to evaluate the net impact of factors influencing poverty at the *macro* level in order to derive policy conclusions for the country as a whole'.

A notable feature of the analysis is that the factors affecting incomes of farmers have been considered separately from the factors affecting the incomes of agricultural labourers. So too the factors affecting crop production from those from closely allied occupations such as dairying, poultry and fisheries.

There is, to begin with, an attempt to assess the trend in rural poverty over the period covered by the study. While several estimates are available, the only ones which cover the entire period are those computed by the Planning Commission. They indicate that, while the percentage of the rural population below the poverty line was fluctuating over time without any trend, there was a perceptible decline from a little over one-half of the rural population in the closing years of the 1970s to around one-third towards the end of the 1980s and that this trend continued during the 1990s lowering the poverty ratio to a little over one-fifth of the rural population by 1993-94. The evidence of decline appears incontrovertible from the beginning of the 1980s.

The author has also estimated the trend in poverty independently by computing decline-wise real expenditure levels over time. They show that not only did they rise in the rural sector as a whole but the level of expenditure of the bottom 30 per cent of the rural population registered a notable increase from the mid-1970s.

On almost indisputable evidence of this nature, the study attempts to identify the factors responsible for these trends in the latter half of the period covered by it and their relative importance. The analysis shows that despite inequitable land distribution, biased tenurial relationships, growing population pressure and diminishing size of land holdings, there was evidently some decline in poverty among small and marginal farmers. Since the main factors underlying this decline is identified as the increased use of basic inputs such as water, HYV seeds chemical fertilizer, etc., and the nature of agricultural growth has been land-saving and scale-neutral, it is inferred that the new technology could not have had any inherent bias against farmers with small holdings. Moreover, government intervention to provide essential inputs to farmers at highly subsidized rates could have helped small and marginal farmers to adopt the new technology and raise their income levels.

The author is however careful to take into account other features of the agricultural environment and note realistically the inherent limitations of whatever could be achieved. '....... since agricultural growth was superimposed on a highly unequal distribution of land holdings, even with notable growth in productivity the increase in income levels in absolute terms was small. In addition, the high rate of increase in population also ate into part of the welfare gains due to growth. As a result, a substantial number of marginal farmers continued to subsist below the poverty line even during the eighties notwithstanding a slight reduction in the intensity of poverty among them. Hence, though it is possible that the processes of agricultural growth and government interventions in this regards resulted in an over-all reduction in rural poverty, it is likely that hard-core poverty among marginal farmers persisted and may have even become more acute in some pockets'.

Moreover, it is not small and marginal farmers but agricultural labourers who form the largest poverty group in the rural sector. They formed well over two-fifths of the total number below the poverty line in rural areas towards the close of the 1980s. Rural labourer households below the poverty line at about this time has been reported (by the National Labour Commission) to have been nearly three-fifth of all such households. The author observes that 'poverty among agricultural labourers is sometimes rooted in the institutional, social and attitudinal rigidities prevailing in rural areas' and 'economic growth may not always be the solution to poverty' but chooses to analyse the problem solely from the economic view point as reflected in the income of this occupational category. The income of agricultural labourer is in turn analysed in a 'simplistic demand-supply framework'.

Changes in the wage rate have been examined in some detail as a part of the analysis. While wage rate before the Green Revolution is found to have been stable without a notable trend, 'the new technology brought about significant cropping pattern changes, area and crop shifts and rising yield levels which could absorb the growing labour force to some extent'. To this is attributed a notable increase in the wage rate of unskilled labourers in agriculture after 1975 despite fairly high rate of growth of labour supply. However, it is also noted that 'changes in the pattern of agricultural growth with greater reliance on yield as a source of increase in productivity rather than increase in cropped area, coupled with growing mechanisation of agricultural operations, resulted in declining labour absorption rate'; and that, consequently, while agricultural growth did help to sustain living standard of a sizable labour population dependent on agriculture, 'it did not provide any major impetus to push non-agricultural labourers outside the poverty trap'.

It is the growth in the non-agricultural sector that is identified as having given a major thrust to poverty reduction among agricultural labourers. The impact of non-agricultural growth on employment and income levels of the rural population has been examined in some detail. The conclusion is that it was basically the higher rate of growth in non-crop production which provided additional employment opportunities and made it possible to contract 'the negative impact of declining labour absorption in agriculture' and contribute to the upward pressure on rural wages and income levels of the poor during the 1980s. The study also covers in some detail the efforts made by the Government to bring about direct and indirect income transfers through expansion of wage and self-employment opportunities.

Ms Vinita Kumar has made a competent and quite sophisticated analysis of the factors relevant to the trends in rural poverty covering the period 1960-1995. As it covers the entire country, the light it throws on inter-state and inter-regional differences is not as much as one might wish, but that would require a much larger effort than could have been undertaken by an individual scholar. Since Ms Kumar is an official working in the Ministry of Rural Areas and Employment, one hopes she will have opportunities to pursue her scholarly interests in this and other related areas.

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Kumar, Arun, *Black Economy in India*, Penguin India Books Limited, New Delhi, Pp. 314, Price Rs 250.00.

A theme running through Arun Kumar's book is the parallel between the traffic on roads and the economy. He takes as given the laws which govern traffic; these laws are supposed to ensure, smooth flow of traffic, protect the interest of all users of roads, whatever their size. If laws are followed voluntarily, traffic flows smoothly. However, since there are always violations of law, traffic police must ensure that law-breakers are penalised. So long as the number of violators is not large, the normal course of traffic is not affected. However, as the number of violators increases, the police are unable to monitor all violations of law. Smooth flow of traffic gets badly affected. Should the police collude with law-breakers, the situation is worsened even further. According to Kumar a similar process helps explain problems created by the black economy. So long as those violating laws in pursuit of incomes are an insignificant minority, the normal course of the economy need not be affected. But as the number of violators rises, as policing/enforcement of regulation becomes lax or discriminatory, the black economy starts to have a significant impact on the rest of the economy.

The simple parallel between traffic and the flow of the economy works up to a point. The example, however, ignores certain important aspects of law-making and political economy of law making and this, I believe, is a major lacuna of Kumar's analysis of the black economy in India. Kumar attaches a particular sanctity to existing laws and controls and will brook no criticism of the law on grounds of unfairness, capriciousness and, sometimes, pure stupidity.

The introduction of basic traffic laws for me is very similar to the introduction of a constitution in a society. Prior to the constitution, traffic on roads is pure chaos with size being the only factor that determines right of way. The existence of traffic laws, such as speed limits, lane driving, right of way, traffic lights, etc., is expected to smoothen the flow of traffic. However, this presumes that road users are fully aware of traffic laws, that there is regulation, operating in a predictable, impartial manner that determines the fitness of potential users of the roads. If this filter is inoperative, as it generally is in India, is it the fault of the users or the regulators? The filter may well be rendered inoperative out of pure indifference but it may also be deliberately destroyed for monetary consideration. In such a situation should one blame only potential users of roads for destroying the system or is the regulator implicated? And what is to make of traffic lights placed behind trees (p. 105)? Or, 'no-parking' signs with arrows extending indefinitely in either direction? These are laws or manifestation of laws, which are designed to make usage of roads difficult. Even if the motive behind such laws may not be to deliberately inconvenience users, the net effect is the same. Is it the road users' responsibility to accept the sanctity of these laws? Is this expected even when unclear laws become a source of harassment and there is the suspicion that laws are deliberately drafted in ways to torment users? Kumar does not question this and, like most, who have an enduring faith in flawless regulation, considers these as genuine aberrations and not a deliberate ploy to oppress individuals.

As a final aspect of the traffic example consider the following. It often happens in Bombay and I am certain it is far more frequent in Delhi, that the operation of traffic lights is suspended and manual intervention by the police organises flow of traffic. What has happened in this twist in the traffic example is the replacement of a rule-based system by one, which depends on discretion. Anyone who has been trapped in a traffic jam created by law-enforcers experiences first hand the superiority of rule-based, transparent regulation over discretionary, non-transparent interventions. The latter may succeed once in a while, when the information required for the intervention is available, when the regulators are competent and when the intention of regulators is promotion of welfare. Kumar's position is that all regulation is of such a nature and, if at all there is evidence to the contrary, it is specific *regulators* who are implicated but not *regulation* itself.

In many ways the central thesis of Kumar's book is covered in the traffic example and also, in many ways, my differences with his central thesis is also covered in my reactions and modifications to the example that I have listed above. However, for the benefit of potential readers of the book I will now discuss various aspects of it in slightly more detail. I will touch upon the following:

1. Consequences of black economy
2. Causes of black economy
3. Remedies for curbing the black economy

Consequences of Black Economy

If the size of the black economy were small, there would be very little reason to spend too much time either measuring it or considering its consequences on the rest of the economy. It is, however, commonplace that there is a substantial black economy in India and that efforts to measure it and study its effects are worthwhile. Depending on the methodology used, the size of the black economy can be as large as 50 per cent of GDP. Chapter 3 of the book gives a simple tour of the various approaches that have been employed to estimate the size of the black economy. While some of the complexities involved have been diluted, it is still an informative chapter for the lay (*i.e.* non-economist) reader. One of the important points made in this chapter is that the size of the black economy in 1995-96 (*i.e.* after the introduction of economic reforms) is larger than what it was in 1990-91 (*i.e.* before the introduction of economic reforms). The point being made is that liberalisation, far from reducing the growth of the black economy, in fact, has pushed it along. This is important for Kumar since one of his arguments is that neither controls nor excessive regulation nor excessive taxation can be important causes of the black economy. Of course, much later in the book (p. 209) Kumar does concede that post-1991 income tax rates have declined and that tax collections have risen sharply. He, however, hastens to deny any relationship between tax rates and tax evasion and implicates rising disparities for higher tax collections. The conjecture that tax collections have risen due to rising inequalities is, however, not conclusively established.

The principal consequences of black economy are to be found in the loss of control over policy and its failure, the unplanned internationalisation of the economy and growing illegality. In Chapter 6 Kumar gives a long list of the consequences of the black economy. The following is an indicative list, by no means exhaustive, of what Kumar believes are the effects of black economy:

1. *Policy Failure:* Tax evasion leads to inadequate resources being available to the government, which results in deficient social infrastructure.

2. *Criminalisation:* Deteriorating law and order are directly the result of black economy.

3. *Impact on Environment:* Environmental degradation is linked to the violation of laws and the growth of the black economy.

4. *Waste:* The existence of black economy results in increased transactions without social welfare rising. This includes dumping of effluents, demanding bribes, transport patterns in urban areas, bottled water, milk and edible oil in tetra packs, etc.

5. *Missing Professional Commitment to Work:* This is to be found among all professionals including teachers, doctors, sportspersons, and lawyers. A *Sab chalta hai* attitude is all pervasive (p. 170). In brief, professional commitment to work is missing. When an author makes such a sweeping statement it is especially important that the same charge not be levelled against his or her work. [In the event, what is one to make of the following sentence, which clearly shows poor drafting. 'Decision-making in the public sector is different in the public sector as compared to the private sector' (*sic.*, p. 217). By Kumar's logic this is carelessness and, going by his single-minded task of implicating the black, economy in all ills confronting the economy, must be the consequence of black economy! I, of course, write this in jest and realise that however careful one is, there is no such thing as a 100 per cent error-free manuscript].

6. *Crisis and Fiscal Policy:* The growing shares of black economy, property incomes and the tertiary sector (the latter two are responsible

for the growing black economy), would lead to a crisis, which fiscal policy would not be able to overcome.

7. *Stagnation:* Following from point 6, the economy would inexorably slip into stagnation.

There is much more that Kumar places at the doorstep of the black economy. As stated above I was presenting only an indicative list. For some of the consequences cited by Kumar, the links with black economy are direct, but for others the links get exceedingly tenuous and tend to strain the credibility. I am always reluctant to accept mono-causal explanations of complex social phenomena and that is what I have against Kumar's enumeration of the consequences of black economy. A little more circumspection in the list of consequences of black economy would have made the entire exercise far more credible.

Causes of Black Economy

One of the main objectives of Kumar's analysis of the black economy is to deny that controls, excessive tax rates, mindless rules and extensive regulation can be causes of black income generation. Consequently, he cannot accept any rationalisation of controls, tax rates, etc., as remedies for reducing the generation of black incomes.

Kumar presents a detailed discussion on the links between tax rates and tax evasion and concludes that the relationship between the two is not clear-cut. Quoting a theoretical study, he states that effective implementation may reduce tax evasion but lowering tax rates hardly guarantees it. In the minds of Kumar and his ilk there is some Utopian controlling agency, which will better implement rules, which will better monitor the activities of tax evaders, which will better regulate the markets and so on, and thereby rid the system of evils such as black economy. There is of course a major difference of views between those who believe in an omniscient, omnipotent and omnipresent State and those who believe that State is deficient in all of these qualities. If the State is not omniscient, it is possibly encumbered by insufficient knowledge and information like the rest of economic agents in society. Consequently, the rules it devises will, by definition, be inadequate. There will be failures of State intervention its writ will of an essential kind. If the State is neither omnipotent nor omnipresent, its writ will not run through the economy and hence its control will at best be loose.

If the powers of the State are circumscribed in this fashion the approach to intervention will have to use techniques which recognise these limitations. It will have to devise incentive-compatible mechanisms by which economic agents find it in their interest to obey laws and regulations. It is not the claim that this is an easy task; on the contrary, it will be extremely difficult to devise such economy wide incentive- compatible mechanism. But in the absence of infinite powers and knowledge, the State has no choice but to move away from complete regimentation and control of the economy. The instrument of choice of the State has to be, not the sledgehammer of planning and controls, but the carrot and stick of incentive compatible mechanisms and *implementable* regulation.

Such modesty in the powers attributable to the State is anathema for those like Kumar who seek the 'holy grail' of perfect controls and perfect regulation. They are unable to accept this limitation on the capability of the State and its functionaries. Thus Kumar writes: 'A Professionally run administration, proud of its role, would be able to administer even a complex system of rules'. Thus if State functionaries do not perform their duties properly, it is not because they *cannot* (due to limitation on its capability) do so, but rather they do not *wish* to perform well. All that is needed is to instil a sense of pride in the minds of State functionaries for the job that they are performing! Were life and its problems so simple!

Kumar's views about State functioning lead him into strange situations where he has to defend laws, which have become redundant. Once upon a time it was against the law to import gold and such activity, called smuggling, was illegal. For

Kumar it does not matter that gold imports are now legal: 'Gold imports still create BOP problems since it does not add to the official reserves. The economic impact of the activity continues, only illegality is reduced as compared to earlier. Today, social perceptions are changing so fast that legal or illegal hardly matters. Tomorrow, due to the inability to curb theft, suppose it is legalised, would it generate security for the citizens because illegality has declined' (Pp. 130-31).

What this means is that Kumar has in mind a list of activities which are 'undesirable' from the point of view of the economy. Such activities may be legal or illegal, so long as they are 'undesirable', they should be tightly controlled by the State. This again goes back to the assumption of an omniscient State: the State knows better than anyone else does what is good for society. I fear this is a deeply undemocratic position to take and even though Kumar writes at length about strengthening democracy (see later parts of Chapter 7), his views about the State tend to raise a significant amount of disquiet.

The distinction between black and white economy has to be one of legality and illegality; it cannot be about desirability and undesirability. If it is about legality then the basic consideration is whether an activity contravenes an existing law. If it does not contravene an existing law then the activity cannot be generating black incomes, however 'undesirable' the activity may be from some subjective point of view. I wonder how Kumar will treat incomes earned by the liquor industry. Till the time prohibition was widely prevalent, all incomes from producing and vending liquor would have been black. Now that prohibition is no more enforced in most states, it would be strange to frown upon that activity merely because it was illegal at some of point of time in the past.

Remedies for Curbing the Black Economy

The last chapter presents a long list of suggestions to reverse and even eliminate the problem of black economy. It includes the following:

1. There should be right to information
2. There should be accountability of the bureaucracy
3. Rules should be simple and clear
4. There should be swift action against those indulging in corruption
5. Judicial process must be simplified
6. Lawyers should introspect
7. Judges must keep distance from vested interests
8. Media needs autonomy from government and commercial interests
9. Tax laws must be simplified
10. Public sector should have autonomy in its functioning
11. Political system should be reformed
12. The voter should be made king
13. Elections should be held every two and half years
14. Democracy should be strengthened

Within each of the suggestions listed there are some more nested suggestions, yielding a comprehensive blueprint for what needs to be done. Of course, not a thought is given to *how* these changes can be brought about. Most people, who are aware of the problem of the black economy, are also aware of what needs to be done to reduce this problem. The real challenge lies, not in listing measures for curing the problem, but in articulating the steps, which need to be taken to solve the problem. Almost all of the suggestions that have been listed by Kumar are eminently sensible. For instance, who would deny that the voter should be made king. The proposition is so obvious as to be trite. The question is how do we go about making the voter king. Unfortunately, Kumar has no suggestions to offer towards operationalising the remedies he suggests.

Summing-up

Arun Kumar has made an attempt to put across to non-economist readers the complex problem of black economy and, I believe, he has, by and large, been successful in his endeavour. Kumar's writing style is simple and does not make too many demands on prior knowledge on the part of readers. The best chapters are the first four. His next three chapters, which deal with causes and consequences of the black economy, and remedies for curbing the black economy, in some ways, do too much *and* too little. They do too much because far too many ills facing the Indian economy are placed at the doorstep of black economy. As I stated earlier Kumar seems to have a mono-causal explanation for almost all problems facing the Indian economy. When a complex system is being studied, it is an oversimplification to blame one particular aspect of the economy, however important it might be, for all the problems in the rest of the system. On the other hand, the book does far too little in recommending workable solutions for overcoming the problem of black economy. I don't expect an individual to propose solutions, which will solve the problem overnight. But I do expect rather more from a distinguished academic than a long list of pious suggestions.

Kumar believes that the Indian democracy has been hijacked by the triad of business, politicians and bureaucrats. His remedy for solving this problem is (1) the political system should be reformed and (2) the voter should be made king. The trouble with such solutions is not that there will be disagreement; who could possibly deny that the Indian political system needs cleansing? The big question is: HOW? In the absence of any thoughts on operationalising his remedies, Kumar's suggestions seem like slogans. But sloganeering should really lie within the realm of politicians, not academics.

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Papola, T.S./Alakh N. Sharma (Eds.): *Gender and Employment in India*, Vikas Publishing House Pvt. Ltd., New Delhi, 1999, Pp. 439, Rs. 495/-.

Radhakrishna, R./Alakh N. Sharma (Eds.): *Empowering Rural Labour in India, Market, State and Mobilisation*, Institute for Human Development, New Delhi, 1998, Pp. xv+440, Rs. 195/-.

Discussions related to work and employment in developing countries lead automatically to issues such as poverty and gender inequalities. There has been a downward trend of poverty - though it has been slowing down since the beginning of the 1990s - and a decrease in gender inequalities in getting access to education and equal payment. Despite those positive changes, India, like several countries from the South Asian region, has faced major difficulties to tackle these problems effectively in order to reach the stage of a society, which is free from poverty and inequalities related to caste or to gender. This is the context in which the problems of the most vulnerable groups in this society, namely, rural labour and women, are addressed in the two volumes reviewed here.

Each book is a collection of numerous articles written by experts as well as activists. They provide, therefore, a broad understanding of and insight into the complexity of recent developments and processes at work. Discussions on the nature of operations of the market forces, state intervention and mobilisation by trade unions, political parties and non-governmental organisations (NGOs) are reflected in both the volumes, though they are put into the respective context of, (a) rural labour in India, and (b) women in the Indian labour market. This also includes critical assessments of foregone policies on poverty alleviation in rural India as well as gender specific programmes. Recent trends of employment are analysed within a long-term perspective and in the context of reform policies and structural adjustment during the last decade. The volume on gender related labour market analysis additionally provides an important reflection upon the limitations of the traditional ways to measure employment and workforce participation in labour force surveys, since they still tend to underestimate women's economic activities despite improvements in conceptualisation (Ghosh; Suryanarayanan; Visaria).

An important point, which emerges from the theoretical sections in both the volumes, is the lack of flexibility in India's labour markets. Several forms of inflexibility are identified: The extremely slow pace of change from an agricultural society into a modernised economy which bases its competitiveness on high labour productivity and on a highly skilled and educated labour force, is the most prominent. Next, the majority of the labour force is still employed in the agricultural sector in rural areas. Contrary to expectations, which had risen with the introduction of the reform policies, that they would boost the economic performance in the non-agricultural as well as in the agricultural sector, there has been a backlash in industries and employment (Rao). Till 1991, a trend was observed of labour moving out of agriculture towards non-agricultural activities, which went hand in hand with a continuous increase of real wages in the non-agricultural activities (Bhalla). This trend appears to have reversed since the introduction of economic reforms. In fact, labour has moved back to agricultural activities, women more than men. This reversal has led to deteriorating conditions for rural labour: the former farmers and self-employed have been shifted into casual labour (Ghosh; Unni) and have become more wage-dependent in the informal sector (Breman).

Although major efforts have been made in terms of targeted policies to increase women's labour force participation rate, mainly in urban areas (Hirway), and despite the fact that their share has significantly risen over time and growth rates in female employment might even exceed that of males in the formal sector (Srivastava), increase in work participation of women is predominantly in casual employment (Kundu; Unni). SAP and reforms have hit women's work and livelihood due to indiscriminate reduction in subsidies and due to liberalisation of trade (Hirway). In fact, growth in female employment has slowed down since the introduction of reforms. In the formal sector, job mobility is limited (Srivastava). In the unorganised sector, women enter the labour force predominantly driven by poverty in order to secure an additional income for their family. They enter at the lowest level of the occupational hierarchy and work under extremely exploitative conditions (Mukhopadhyaya). In certain industries, women have substituted men, accepting lower payment and poorer working conditions (Banerjee). This is also true for women working in EPZs (Banerjee; Ghosh). Several authors argue that an increase in women's remunerative activities can quantitatively be interpreted as a trend towards feminisation. In the context of feminisation, employment of women in industrialised countries means economic empowerment by taking up quality jobs. This is not the fact in developing countries (Banerjee). Additional economic activities have turned out to be additional workload, since most of the work is unrecognised and does not significantly improve their economic status. Therefore, focus should be on quality of employment, including recognition of work done by women (Ghosh).

It has also been mentioned that the shift out of traditional activities, which include agricultural work, has been much slower for women than for men. Since men shifted into non-agricultural activities, women stayed back in agriculture. It was also shown that in rural areas, the shift back into agricultural activities has been more intense for women than for men. Although there was a positive trend towards closing the wage gap between men and women earlier, in particular in agriculture, this has ceased since 1988 (Unni). Women still tend to have severe disadvantages in getting access to assets needed to survive in a competitive environment. As Hirway points out, there is a real deficit of female workers in terms of professional skills and technical capacities since most of them are small producers and home-based workers. Access to credit is still limited for women despite some major innovative efforts made by financial organisations provided by public institutions or self-help groups. Those schemes do not as yet meet the need of larger sections and wider regions.

Evidence also suggests that the existing labour markets discriminate against certain specific groups in the society such as women and people from low-caste, as well as tribal societies. Women and girls are still severely disadvantaged in getting access to quality education (Chaudhri; Deshpande/Deshpande), employment and health, as well as in getting jobs, and in occupational mobility and wages according to their education (Kingdon). Discrimination against low caste women is high (Kannan).

The existence of market failures resulting from rigidities seems to reflect the slow process of social and cultural change, which India has been undergoing. Those market failures have been stressed by some authors when they analyse the process of labour contracts and wage determination in rural areas (Bhalla; Jha; Krishnaiah; Radhakrishna and Sharma), discrimination against women in the context of access to jobs (Srivastava) or unequal returns to education (Kingdon). It leads them to the conclusion that labour markets as analytical categories are too complex to be explained by a clearing market model. Theoretical developments therefore need to strike new grounds beyond boundaries of mainstream economics, integrating power structures and social institutions, which shape the functioning of those markets significantly (Dev; Jha; Radhakrishna and Sharma).

To remove such market distortions, several authors aim at market interventions through governments, unions and NGOs. The effectiveness of most of the programmes, initiated by government which aim to alleviate poverty through rural development (IRDP), and generate sustainable income through self-employment (JRY) as well as wage employment (EGS), is far from satisfactory, except for some schemes in Kerala as argued by numerous authors using macro as well as micro level evidence (Datt; Kurien and Rajeev; Nayaar; Reddy and Swaminathan; Singh). It is mentioned that the initiatives were effective, but not as much as expected. They failed to reach the target groups, namely the most vulnerable persons and households, like women and workers from low castes and scheduled tribes, to lift them above the poverty line (Rao; Kurien and Rajeev). Similar results have been quoted for social security schemes provided by the government: they have not only failed in reaching the beneficiaries, but have also neglected women with respect to data collection and implementation of schemes (Dev). Overall, the authors agree that the existing state interventions, which are supposed to provide employment and regular income to the poor might be a valuable and effective fire-fighting measure, but do not contribute much to sustained development in the long run (Dev). Also these schemes tended to be too bureaucratic and weak to implement. Some authors advocate reconsideration of the IRDP/JRY programmes: they ask if resources would not be better allocated for capacity building of individuals through primary education, skill development and access to health facilities for the poor (Kurian and Rajeev). To overcome the obstacles of bureaucracy, Rao argues that instead of such programmes, relief-cum support measures should be provided, which react more sensitively to the different needs of the rural poor at the micro level. Public administration in India has to undergo radical reforms (Theral and Hirway). Planning and administration need to be decentralised at the Panchyati Raj level and should be continuously monitored and evaluated by independent participants (Dev; Nayyar; Parthasarthi; Rao). Those (latter) institutions, however, need to be strengthened. Employment generation schemes should finally be more skill development oriented (Dev). Providing minimum wages and minimum social security too is a crucial precondition for functioning implementation of such schemes (Dev; Theral and Hirway). Such minimum wages, however, need to be continuously adjusted and revised. In order to be successful, they need to be linked to employment generation schemes on the one hand and contribute to the strengthening of bargaining capacities of workers through unionisation on the other (Parthasarthy). The expansion of costs, as Theral and Hirway point out, could partly be financed through income taxation. They call for a World Social Security Fund which could provide resources for a coherent social security system. This would include guaranteed income support to those not able to work due to age, sickness or handicap, subsidies for credit-cum-training, and more general support of public expenditure for education and health for specific groups.

In contrast to the rather small success of government initiatives, various authors emphasize the relevance of organisation and social mobilisation of rural labourers and women workers through non-governmental initiative. Some analysis on traditional unionisation has focussed on the limited success of unions since they face difficulty in organising agricultural labour, which, in comparison to peasants, were in fact left unorganised. As Gill points out in her interesting analysis, unionisation of agricultural labourers is clearly caste determined and leaves women completely out (Gill; Kannan). The low level of organisation can be explained by the strong position of the farmers who, being better organised and in alliance with the government at the state or at the village level, avoid bilateral negotiations and employ migrant workers. This phenomenon however was not found in the micro study in Bihar (Jha), where the socio-economic framework of specific villages prevents employers from hiring migrant labour due to social pressure within the community.

Unionisation has increased segmentation along caste structures and therefore limited occupational mobility in rural areas. As Kannan points out for Kerala, unionisation was successful in intervening in distribution of employment, in particular for trade union members; on the other hand, unions were excluding non-members from the benefits of the negotiations. Such a "'closed shop' strategy followed by the unions resulted in negative effects on low caste workers by preventing inter-occupational mobility which could have also led to loosening the traditional nexus of caste and occupation" (Kannan, p. 367). Here, the state should provide the conditions conducive to the organisation of the rural workers and encourage the setting up of unions at the village level so that their organisational base and effectiveness in dealing with the most disadvantaged sections can be guaranteed. One successful experiment of organisation of women described in the volume on *Gender and Employment* was that of Self-Employed Women's Association (SEWA). This experiment combines struggle for rights and income generating support through self-help credit and social security with a view to improving women workers' conditions as major tools for their empowerment (Papola and Sharma). It is mentioned that this way of empowerment needs to be expanded and replicated.

Since the state has only limited capacities to reach the village level, it is argued that NGOs can provide a useful initiative to tackle the problems of the poor. It has been shown that social empowerment through organisation could be effectively reached, and the bargaining power of those organised lead to a significant improvement of economic and social conditions of rural labour (Breman; Chandra and Reddy). NGOs have been crucial actors in such initiatives.

On the whole, however, it is not an 'either - or solution' but rather a need for a co-existence of state interventions and private initiative (Radhakrishna and Sharma). It is seen that public action taken up by governments has so far fallen short of helping the rural poor in a sustained manner, since it has not reached the targets. On the other hand, social mobilisation of the rural poor without absorbing them through employment generation schemes or providing them education, would not be adequate either (Kannan). It is the role of the government, in a context like India with a huge population living under the poverty line, to guarantee their rights through providing education, wage-employment assistance as well as ensure empowerment through legal and economic means (Papola and Sharma). This becomes even more relevant in the context of the adverse impact reforms have on the rural population and on women in particular.

Both the volumes provide a solid and broad overview of the existing debates on rural labour as well as on gender and labour market related questions. In the introductory section, the editors of both books have provided a theoretical framework in the otherwise quite heterogeneous collection of articles. The variety of those articles makes both volumes extremely valuable for researchers, NGOs, students and teachers who are interested in the functioning of the Indian labour markets, with particular reference to rural employment or to gender specific questions. Both volumes, however, tend to over stress the macro perspective while using similar data. With some exceptions, micro-level processes, which would be extremely useful for a deeper understanding of the problems faced by labour, are rather neglected. Most articles do not go beyond a description of trends, be it the labour force, women's labour force participation, wage changes or interventions either by Governments, Unions or NGOs. Not only the theoretical questions, but also issues such as the effectiveness of government initiatives would be interesting when analysed on a qualitative basis so that we would get better insight into the dynamics of the labour markets and questions like change of inequalities at the community level or the intra-household level, and the exact reasons for difficulties in the implementation of specific initiatives have occurred and why these could not be removed till today.

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