The Path to Capital Market Reforms in India

by Narendra Chokshi

Background

Over the last decade and a half of financial reforms in India which started with Manmohan Singh's budget of 1991-92, one of the things that stood out in stark contrast to these developments was the rather dramatic development of the Indian equity markets.

With the financial reforms kicking in, the equity markets started to become more transparent and accessible to everyone in India, especially the growing middle class. During the 1990's, this showed up in an unprecedented growth in the number of trades that took place on the stock exchanges across India, the sharp decline in brokerage fees and the number of depository accounts that were opened. Millions of Indians, who were once just mute spectators and invested their money either in gold or mundane government-owned mutual funds, now became active participants in the equity markets.

The progress due to liberalization of the economy and the financial reforms was marred by episodes of market manipulation, most notably by Harshad Mehta during 1991-92 and then by Ketan Parekh in 2000-01. However, after each episode, the equity markets got back on its feet with the Securities Exchange Board of India ('SEBI') cracking the whip effectively on the offenders.

The Scam That Rocked A Nation - The Securities Scam of 1991-92

'Big Bull' Harshad Mehta rose from being an insurance clerk with the New India Assurance Company to become one of the most high-profile share brokers. He drove the market to dizzying heights at the same time when Manmohan Singh was unfolding his economic reforms. Mehta was the ultimate rags to riches story - a small town boy who became the undisputed king of Dalal Street with all the trappings of wealth such as a fabulous house, a fleet of cars and multiple stock exchange memberships. All this would come to an end in 1992, when an article by an investigative journalist exposed the multi-billion Rupee securities scam and rocked the bourses in India. A number of banks and financial institutions were allegedly involved in the scam.

Mehta had perfected the art of diverting money from the banks to the stock market by exploiting loopholes in the Indian banking system. He drew down huge amounts of money from banks and financial institutions without providing security and used it to for speculation in the share prices of several blue-chip companies.

In the wake of Sucheta Dalal's article in April 1992 exposing the scam, State Bank of India asked Mehta to return Rs.5.5 billion ($388 million)i he had illegally put to work in the stock markets. Soon afterwards, he was accused of diverting funds from a number of banks, financial institutions and even a government-owned car company to his own accounts. As a first reaction, the Bombay Stock Exchange Sensitive Index ('Sensex') crashed by over 570 points. At least 10 commercial banks, including the Standard Chartered Bank, State Bank of India and National Housing Bank (Reserve Bank of India subsidiary) were affected by the scam. The State Bank of India, India's largest bank, was the most severely affected bank and at the receiving end of regulatory authorities. The scam sent shock waves all over the country and saw many heads rolling as a result. Chairman of UCO Bank, KM Margbandhu, was sacked and arrested. Planning Commission member, V Krishnamurthy, and State Bank of India Managing Director, V Mahadevan, were forced to quit their offices.

In June 1992, a sustained furore in Parliament and a public outcry led to the formation of a Joint Parliamentary Committee, the Janakiraman Committee, to investigate the securities scam and identify how the nation's banking system was taken for a ride by a single crooked stock broker. After discovery of the scam, Mehta continued to make headlines by claiming that he had bribed then Prime Minister, PV Narasimha Rao by making a donation of Rs.10 million ($705,000)[i] for the Congress party in cash.

Despite the size and proliferation of the scam, it was a rather simple and uncomplicated con. Funds were being obtained illegally in collusion with bank insiders and were being used for speculation in select stocks. A few employees of the banks and financial institutions routinely siphoned off their employer's cash given the sorry state of the supervisory controls at these companies. For example, an employee of ANZ Grindlays Bank diverted a number of banker's checks worth Rs.228 million ($16.1 million)[i] favoring ANZ Grindlays Bank to Mehta's account at the expense of ANZ Grindlays Bank and other banks.

The committee's report soon provided a comprehensive and coherent picture of both the scale and mechanics of the securities fraud. The total size of the scam in 1991 was fixed at Rs.50 billion ($3.52 billion)[i]. After the scam, Mehta was arrested by the CBI in several cases registered against him for allegedly cheating banks and financial institutions to the tune of several billions of rupees.

Mehta faced trial in altogether 28 cases but was convicted in only one case involving use of Maruti Udyog funds to the tune of Rs 300 million ($21.1 million)[i] in the stock market. He was sentenced to five years rigorous imprisonment in the Maruti Udyog case although Mehta pleaded that the money had been returned to Maruti Udyog and the latter saying that it had not lost any amount. He filed an appeal in the Supreme Court which, along with most other cases against him, was still pending at the time of his death in 2001.

The Comeback and Demise of the 'Big Bull'

Although Mehta was barred from operating in the market, he was able to manipulate stock prices again in 1998, with the help of the management of the companies and the Bombay Stock Exchange. He set up his own website to dispense tips, built a network of media contacts for publicity and even became a newspaper columnist.

Mehta managed to build up a speculative bubble and was again at the center of investor attention when India's nuclear tests caused a collapse in equity prices and the speculative bubble burst. Mehta was infamously bailed out at the behest of the Bombay Stock Exchange by opening the trading system in the middle of the night to insert synchronized trades at manipulated prices.

Investigations by the SEBI following the market collapse revealed that Mehta had set up a network of investment companies to front his market operations, leading SEBI to impose a lifetime bar against him from entering the equity markets.

The final chapter in the Mehta story began in November 2001, with his arrest on fresh fraud charges on the sale of the 'benami' shares (shares held in other names). From 1992 through 2001, Mehta funded himself by selling part of his 1992 portfolio, which he had not declared. Mehta had claimed that he had either lost or misplaced 2.7 million shares in 90-odd companies, valued at Rs.2.5 billion ($176 million)[i] and got them restored to him along with benefits accrued over the years. Investigations revealed that Mehta laundered the original shares, by transferring them to friends and relatives, who in turn introduced them back into the markets making a killing.

In the wee hours of December 31, just before the year 2001 came to a close, Mehta passed away in a jail in suburban Bombay due to lack of medical attention. It was a tragic and unceremonious end for the man who became a mega-star of the Indian capital markets. Mehta left behind a tarnished image and will always be remembered as the architect of the Rs.50 billion ($3.52 billion)i scam, India's biggest securities scam.

The Media and Technology Stocks Scam of 2000

Ketan Parekh came from a family of stock brokers and was a third generation stock broker. A Chartered Accountant by profession, Parekh manipulated the Indian stock markets through media and technology stocks, a favorite of investors across the globe then. In India, a major stock market scam cannot take place without the assistance of the banks. With the Ketan Parekh scam, it was again the broker-banker nexus that fuelled the scam.

Whilst Mehta was active in old economy stocks in pre-electronic trading days with comparatively lesser volumes, Parekh operated in an online environment which witnessed much higher trading volumes. Like Mehta, Parekh bought stocks at rock-bottom prices and then pushed it up using the funds illegally obtained from the conspiring banks, often in collusion with the company's promoters and close cronies. Once these tainted media and technology stocks peaked, he would sell them making a killing for his close circle.

On his arrest in connection with securities scam, his favored technology stocks collapsed dramatically and the Sensex plunged 147 points in a single day. This time around, Bank of India, Punjab National Bank, State Bank of India, Madhavapura Bank and Classic Co-operative Bank were the affected banks with Parekh owing approximately Rs 1.3 billion ($91.6 million) to Bank of India alone.

The biggest losers in the scam were the small investors with the losses due to the scam being much more widespread this time. The Unit Trust of India ('UTI'), a government mutual fund company mobilized small savings by offering tax breaks for investment in UTI mutual funds. UTI's flagship scheme, US64 had invested heavily in the Ketan Parekh stocks during the scam and reported a large drop in its NAV after the collapse. The Government put up Rs.18 billion ($1.27 billion) of taxpayer's money to bail it out. The scam led to the eventual redemption and closure of US64 that affected almost every investor in the country.

Lessons from the US

In contrast to the slow progress in disposing of the 1992 securities fraud cases, experiences elsewhere in the world hold out interesting lessons. Hours before leaving the White House, United States President Bill Clinton pardoned a number of convicts. One who failed to obtain a pardon, despite lobbying and charitable contributions of over $100 million was Michael Milken. Milken had been charged in 1988 by the Securities and Exchange Commission of market manipulation and insider trading that cost investors more than $1 billion.

Milken's rise and fall, documented in Oliver Stone's film Wall Street, was greater in scale than that of the Harshad Mehta's. Milken was for years reputed to be the highest-paid individual in the US, with the securities firm Drexel Burnham Lambert paying him a record bonus of $550 million in 1987. Soon thereafter, Milken pleaded guilty to market manipulation and was sentenced to 10 years in prison along with fines in excess of $ 1 billion.

Out of prison on parole after serving 22 months, Milken went back on a deal he had made never to engage in the security business. The Securities and Exchange Commission went after him aggressively and the episode ended in Milken settling out of court with a $47 million fine to avoid confrontation in a criminal court.

Milken's ability to evade a longer prison sentence and renewed prosecution shows that in the US, as in India, money talked. However, 22 months in jail and over a billion dollars in fines are surely better than no justice at all. The sad fact is that Harshad Mehta and Ketan Parekh paid little for their crimes, a lesson their protégés in India have learnt only too well.

Key Capital Market Reforms

The key capital market reforms that were implemented in India partly as a response to the securities scams are enumerated as follows and discussed at length:

Reforms	**Issue addressed**
Removal of Control over Issue of Capital	Allows efficient allocation of capital
Establishment of a Market Regulator	Monitors the markets and prosecutes offenders
Screen Based Trading	Increases transparency
Risk management	
Trading cycle and Derivatives	Reduces speculation
Dematerialization	Addresses the issue of 'benami' shares and frauds due to physical shares
Settlement Guarantee	Reduces transaction risk
Other reforms	

Removal of Control Over Issue of Capital

Control of Capital Issues ('CCI') was introduced through the Defence of India Act, 1939 to channel financial resources to support the war effort. The control was retained even after the war with some modifications as a means of controlling the raising of capital by companies and to ensure that national resources were channeled to serve the goals and priorities of the Government. The provisions in the Defence of India Act were replaced by the Capital Issues (Continuance of Control) Act in 1947, with the act being administered by the CCI. The CCI decided the prices, premium, and number of shares that firms could issue and rates of interest on debenture issues.

The CCI was designed to help the Government control and direct the flow of funds for uses favored by it. CCI helped the Government to tap savings at low costs. Further, CCI allocated funds from the securities market to competing enterprises and decided the terms of allocation based on political factors. This resulted in capital being directed to projects favored by the Government instead of to the best project. Under these circumstances capital accumulation meant little as the rate of return on a number of projects were negative while remunerative investment projects were foregone. This kept the average rate of return from investments lower than it would otherwise have been and, given the cost of savings, the resulting investments were less than optimum. Thus, it was necessary to do away with interventions that hindered the optimum allocation of capital in the capital markets.

A major initiative of financial reforms was the repeal of the Capital Issues (Control) Act in 1992 with the Government abolishing the CCI altogether. SEBI was granted the legal authority to register and regulate all security market intermediaries. Guidelines issued by SEBI allowed issuers of debt and equity securities to issue them at market rates.

Establishment of a Market Regulator - Securities Exchange Board of India ('SEBI')

The Securities and Exchange Board of India was established by the Government in 1988 and was converted into a fully autonomous body in 1992 with the passing of the Securities and Exchange Board of India Act on the line of the US Securities and Exchange Commission. In place of Government control, an autonomous board with defined responsibilities and independent powers was set up. Paradoxically this was a positive outcome of the Securities Scam of 1991-92. The objectives of SEBI were identified as protection of the interests of investors and development and regulation of the securities market in India.

Setting up of the National Stock Exchange ('NSE') and Electronic Integration

A significant step in the reform process was the setting up of the National Stock Exchange in late 1992 and the commencement of electronic networking of stock exchanges with brokers and the introduction of on-line screen based trading. NSE has been able to radically transform the Indian capital market since its inception and has changed the mindset of market players, building investor confidence in the secondary markets. During 1995 all stock exchanges switched over from the open outcry system to screen-based online trading. This enabled both NSE and BSE to spread their operations to every nook and corner of India and allowed a large number of investors, irrespective of their location, to trade improving the depth and liquidity of the market – over 10,000 terminals in over 400 cities and towns in India.

The advantages of the screen based trading system are as follows:

- Electronic matching of orders cuts down on time, cost and risk of error and fraud increasing the operational efficiency of the capital markets.
- It allows for faster incorporation of price-sensitive information into prices making the capital markets more efficient.
- It enables participants to see the market on a real-time basis increasing market transparency.
- It provides full anonymity by accepting orders of all sizes from members without revealing their identity, thus providing equal access to all investors.
- It provides an audit trail, which helps to resolve disputes among participants.

After shifting the trading platform from the exchanges to brokers' premises, it then shifted to personal computers in residences and then to hand-held devices through WAP. This made a huge difference in terms of equal access to investors in a geographically vast country like India.

Surprisingly, the market makers in US exchanges have been able to successfully resist fully automated execution capabilities and a centralized limit order book, which they believe would lower their profitability. The New York Stock Exchange ('NYSE') was able to offer the lowest price deals, even though execution was slower without full automation. The SEC "best price" stock handling rules helped NYSE lock-in users. But after the wave of trading and governance scandals at NYSE, SEC is leveling the playing field by allowing automated markets that execute trades automatically to bypass a better price on a "slow" exchange within defined limits. This has forced NYSE to set itself on the road to full automation of the exchange with its recent merger with electronic exchange operator, Archipelago.

Trading Cycle and Derivatives – Rolling Settlement and the Ban on Badla

From 1994 to 1996, the capital markets experienced significant changes in the technology of trading, but the basic structure of the markets was unchanged. The markets continued to trade over an 'account period' of 14 to 30 days, followed by settlement after a fortnight. This once-a-fortnight settlement was optional and not adhered to because the capital markets were still running 'badla', the practice of borrowing money to trade in stocks with the interest depending upon the security in which badla trading takes place.

One of the chief roles of a capital market is to take in the views of all the investors in the market, and provide a clear signal of the value of the share. In a market where account period settlement and badla co-exist, market prices became a mixture of the value of the share and the future price of the share as badla traders take a forward position on the share. The market prices were distorted and reduced the efficiency of the capital markets as the price discovery mechanism cannot function that way it should.

Further, there was a substantial time lag between entering into a trade and its settlement, creating incentives for either of the parties to go back on its promise. This had, on several occasions, led to defaults and risks in settlement.

In 2001, two important changes took place that took care of these problems. First, all exchanges moved to rolling settlement for the largest stocks in India. In order to reduce large open positions, the trading cycle was reduced over a period of time to a week initially. Rolling settlement on T+5 basis was introduced in phases. All scrips moved to rolling settlement from December 2001. T+5 gave way to T+3 from April 2002 and T+2 from April 2003. With rolling settlement in place, all those who bought or sold shares were able to reliably get their shares purchased or realize the money from their sales in exactly two days from the day of the trade.

Second, SEBI banned badla in the market and exchanges moved into trading derivatives by starting trading in options. Both futures and badla system allow investors to buy stocks without huge cash outflow. In other words, both help in leveraged trades. Due to this similarity, SEBI decided to ban badla and introduce futures in line with the trends in developed countries. With the ban on badla and a separate derivatives market, the prices in equity markets moved towards reflecting a more accurate picture of the demand and supply of investors who want to buy and hold investments. Those with a shorter-term view moved to using the derivatives markets because it was a more cost-effective market to take speculative views on securities.

Dematerialization – The Depositories Act, 1996

Earlier, trades were settled by physical movement of paper securities which was a time consuming process and involved the risk of significant delays. Theft, forgery, mutilation of certificates and other irregularities were common place in the process. All this added to costs, delays in settlement, restricted liquidity and made investor grievance redressal time consuming and at times difficult.

To obviate these problems, The Government passed the Depositories Act in 1996. In order to streamline both the stages of settlement process, the Act envisages transfer of ownership of securities electronically by book entry without making the securities move from person to person. This was followed by the establishment of National Securities Depository and the Central Depository Services, both with the purpose of holding shares in electronic account form.

Buying and selling shares in electronic form in the market made transacting much simpler and safer as compared to transacting in physical shares. This enabled securities to be held electronically instead of physical documents. The introduction of electronic depositories provided several benefits to market participants:

- safety and convenience in holding securities;
- immediate transfer of securities;
- no stamp duty on transfer of securities;
- elimination of risks associated with physical certificates such as bad delivery, fake securities, delays, thefts etc.;
- reduction in paperwork involved in transfer of securities;
- reduction in transactions cost; and
- elimination of the odd lot problem.

Currently 99% of the Indian market capitalization is dematerialized and 99.9% of trades are settled by delivery.

Settlement Guarantee

A variety of measures were taken to address the risk in the market. Clearing corporations have been set up to assume counter party risk. Trade and settlement guarantee funds have been set up to guarantee settlement of trades irrespective of default by brokers. These funds provide full guarantee and work as central counter party. Most exchanges / clearing corporations in India monitor the positions of the brokers on real time basis.

Other Reforms

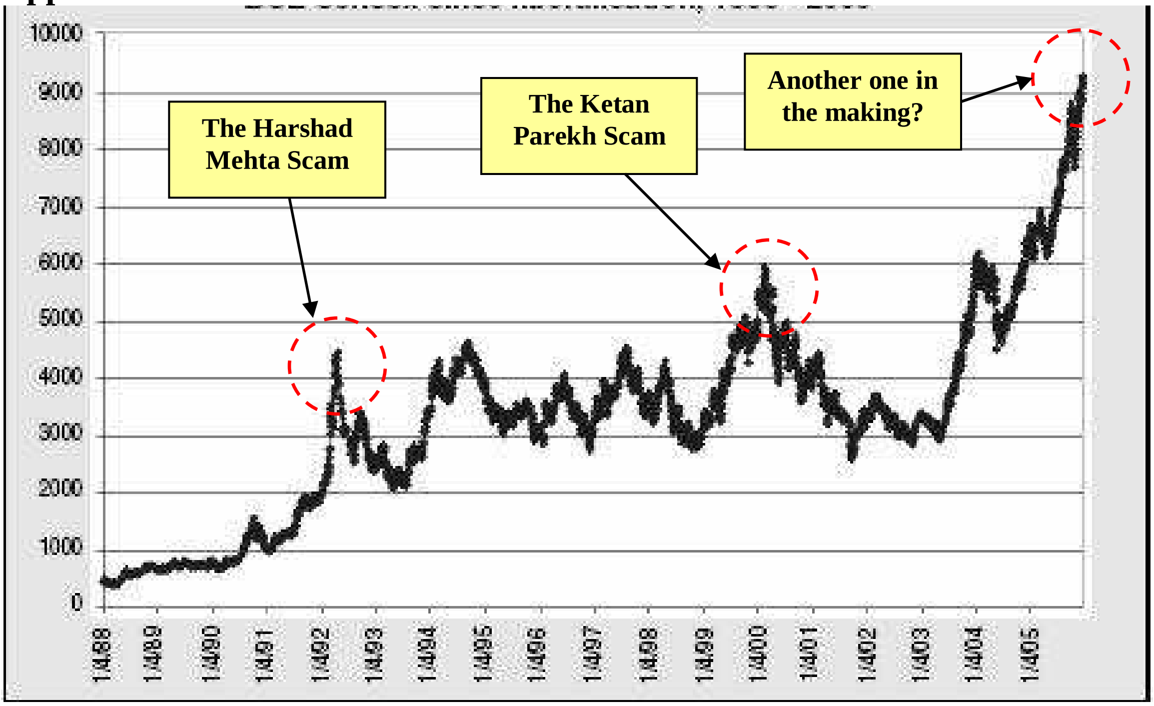
Since its conversion into an autonomous body, SEBI has been attending to its objectives with commendable zeal. Other significant measures taken to promote investor security and reduce market risk include the establishment of registration norms, eligibility criteria, code of obligations and code of conduct for market intermediaries, comprehensive system of margins, intra-day trading and exposure limits, capital adequacy norms for brokers, and trade/settlement guarantee funds for each exchange. SEBI issued regulations for venture capital funds that allowed them to invest in unlisted companies, finance turnaround companies and provide loans. SEBI, based on the recommendations of an expert committee, modified takeover code to introduce new procedures that better protect the interests of minority shareholders and facilitate hostile takeovers. It also introduced model bye-laws, risk identification and risk management systems for clearing houses of stock exchanges and surveillance system that have made dealing in securities both safe and transparent to the investor.

Conclusion – The Road Ahead

SEBI continues to work in close co-ordination with market intermediaries and the Government to improve the capital markets to bring in further efficiency and transparency. Some of the initiatives on which SEBI is currently working on which will bear fruit in future are as follows:

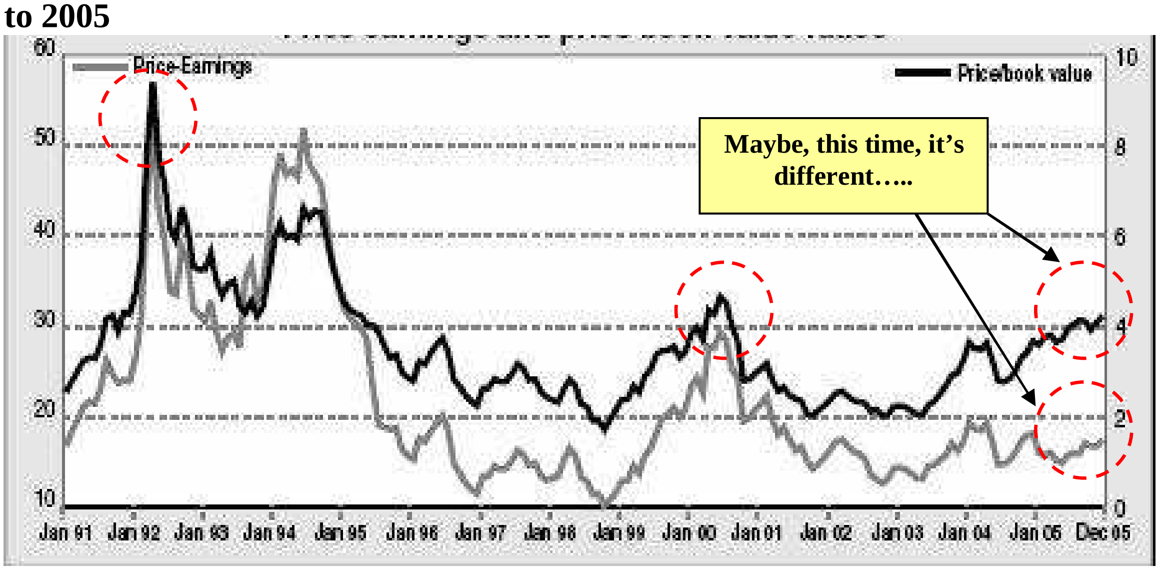
- Set up a national institute to build a cadre of professionals to man the specialized functions in the securities market.
- Nationwide certification system to ensure that people working with market intermediaries have the necessary knowledge and skills to render quality intermediation.
- Corporatization and demutualization of exchanges whereby ownership, management and trading rights would be with three different sets of people to avoid conflicts of interest.
- Migrate to T+1 rolling settlement.
- Continuously review and upgrade accounting standards, disclosures and corporate governance practices.
- Continuously review and amend the SEBI regulations to bring them in tune with dynamics of market requirements.
- Introduce new products in the market to meet all kinds of needs of market participants.

Appendix 1 - The BSE Sensex – 1988 to 2005



Source: The Hindu Business Line

Appendix 2 - Price-Earnings and Price-Book Value Ratios of the BSE – 1991 to 2005



Source: The Hindu Business Line

Appendix 3 –Kindleberger's (Fisher/Minsky) Model of Financial Crisis

Stage	1991-92 Securities Scam	2000 Securities Scam
Displacement	The financial reforms initiated by the Congress government and the Finance Minister, Manmohan Singh.	A dot-com acquisition that created an overnight multi-millionaire in 1998 started the technology stock boom.
Boom	The stock markets reacted positively to the first budget of the Congress government.	The dot-com boom and the frenzy in technology stocks across countries. Indian software services companies were growing at phenomenal growth rates.
Speculation	Funds were channeled from the banking system illegally into the stock markets fuelling a speculative rally.	Funds were channeled from the banking system illegally into the stock markets fuelling a speculative rally.
Mania	Retail investors jumped onto the bandwagon as prices continued to rise with no end in sight.	Technology stocks became the darlings of the average investor. Several companies that IPO'd during this period changed their name to include 'Technologies', 'E' or 'Software' before the respective IPOs.
Distress, Revulsion and Panic / Crash	The arrest of the architect of the scam, Harshad Mehta led to a collapse in the market and ended the speculative bubble.	The arrest of Ketan Parekh led to a collapse in the market and burst the bubble. The collapse took the Madhavpura Bank and US64 mutual fund down with it.
Depression	The Sensex did not touch the pre-scam highs for a number of years after the scam.	The Sensex touched lows of 3,000 after the bubble burst.

Appendix 4 – The Journey of the Sensex from 1,000 to 12,000

1,000	Jul 1990	The Sensex touched the magical four-digit figure for the first time and closed at 1,001 in the wake of a good monsoon and excellent corporate results.
2,000	Jan 1992	The Sensex crossed the 2,000-mark and closed at 2,020 followed by the liberal economic policy initiatives undertaken by the then Finance Minister and current Prime Minister Dr Manmohan Singh.
3,000	Feb 1992	The Sensex surged past the 3,000 mark in the wake of the market-friendly Budget announced by the then Finance Minister, Dr Manmohan Singh.
4,000	Mar 1992	The Sensex crossed the 4,000-mark and closed at 4,091 on the expectations of a liberal export-import policy. It was then that the Harshad Mehta scam hit the markets and Sensex witnessed unabated selling.
5,000	Oct 1999	The Sensex crossed the 5,000-mark as the BJP-led coalition won the

		majority in the 13th Lok Sabha election.
6,000	Feb 2000	The infotech boom helped the Sensex to cross the 6,000-mark and hit and all time high of 6,006.
7,000	Jun 2005	News of settlement between the Ambani brothers boosted investor sentiments and helped the Sensex crossed 7,000 points for the first time.
8,000	Sep 2005	The Sensex crossed the 8,000 level following brisk buying by foreign and domestic funds.
9,000	Nov 2005	The Sensex crossed the figure of 9,000 to touch 9000.32 points on the back of frantic buying spree by foreign institutional investors, local operators as well as retail investors.
10,000	Feb 2006	The Sensex touched 10,003 points during mid-session.
11,000	Mar 2006	The Sensex crossed the figure of 11,000 and touched a life-time peak of 11,001 points during mid-session for the first time.
12,000	Apr 2006	The Sensex crossed the figure of 12,000 and closed at a life-time peak of 12,040 points for the first time.
Source: rediff.com		

Appendix 5 – Capital Market Indicators

Year	Market capitalization bse, % of GDP	New cap. Issues non-G pub. Ltd. Cos. % of GDP	BSE sensitive index, annual average	Shares and debentures as a % of change in financial assets of households
1990-91	16.0	0.8	1049.5	8.4
1991-92	49.5	0.9	1879.5	10.0
1992-93	25.1	2.6	2895.7	10.3
1993-94	42.8	2.2	2898.7	9.2
1994-95	43.0	2.6	3974.9	9.3
1995-96	44.3	1.3	3288.7	7.1
1996-97	33.9	0.8	3469.3	4.2
1997-98	36.8	0.2	3812.9	2.6
1998-99	31.3	0.3	3294.8	2.5
1999-00	47.1	0.3	4658.6	6.4
2000-01	27.2	0.2	4269.7	2.8
2001-02	26.7	0.2	3331.9	3.0
2002-03	28.64*		3206.3	
2003-04			5800**	

Source: Reserve Bank of India

Note the market capitalization of the Bombay Stock Exchange as a % of GDP before and after the securities scams are dramatically different from that during the scam years.

Appendix 6 – Investigations by SEBI

Particulars	1992-1993	1993-1994	1994-1995	1995-1996	1996-1997	1997-1998	1998-1999	1999-2000	2000-2001	2001-2002	2002-2003	Total
Cases taken up for investigation	2	3	2	60	122	53	55	56	68	111*	125	657
Cases completed	2	3	2	18	55	46	60	57	46	21	106	424

Source: Sebi (2003) Table 2.71.
Note: * of these 111 cases 86 involved market manipulation and price rigging, 16 insider trading.

Select Sources:

Personal website of R Kannan, retired banker - www.geocities.com/kstability/

Rediff news – www.rediff.com

The Securities Exchange Board of India website – www.sebi.gov.in

"Regulation and De-regulation of the Stock Market in India" – Ashima Goyal, Professor, Indira Gandhi Institute of Development Research

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[i] All USD figures mentioned in parenthesis are INR amounts of respective years adjusted for inflation and converted into USD at the 2006 exchange rates, thus comparing the INR amounts with the USD in today's value.