S

SESTERTER-III
SKILL BASED ELECTIVE PAPER – I
CAPITAL MARKET

UNIT – I

Introduction: Indian capital market and its functions- International Market- Financial innovations in Indian and International Market.

UNIT - II

Investors protection- The role of SEBI- Investors investment attitude.

UNIT - III

Rating agencies- Indian and Global- CRISIL, ICRA, CARE, ONICRA, FITCH & SMERA. Moody's Investors Service and Standard & Poor's (S&P), Fitch ratings, Egan Jones, DBRS.

UNIT - IV

Indian Capital market trade practices- BSE, NSE, Sensex, Nifty, fundamental and technical analysis- Demat Trading and Role of Depositories.

UNIT - V

Stock price movement and Indian economy system- Inflation and GDP.

TEXT BOOK:

1. Merchant Banking and Financial services – Dr.S.Gurusamy, Vijay Nicole Imprints Pvt Ltd, Chennai.

ASSOCHAM

The Indian capital market:
Growth with governance*

Contents

Preface

Indian Capital Markets have shown tremendous growth in the post Liberalization era. It remains one of the most resilient globally and poised to be one of the Top destinations for domestic and global businesses to expand and invest into. As global economy moves for imminent recovery, India has shown extraordinary strength to bounce back with greater stability and sustainability. **Raising capital is a strategic priority** across India and role of Capital Markets has assumed far greater importance and urgency. The Debt market still needs to be developed to invite capital inflows needed for massive infrastructure development. The frontiers of global markets are not only increasing but also moving towards process of convergence. FIIs inflows into the Indian equity markets have touched US$ 17 billion during 2009 and the steep rise in number of retail investors has brought into focus further issues of corporate governance and investors protection more prominently. The efforts of the Regulators and the Government to protect the interests of investors in securities and to promote the development of, and to regulate the securities market towards enlightened Governance, has bee lauded by all stake holders. There is huge potential for the capital markets growth as at present just 2% of the population, account for retail investors and the lowest strata of the pyramid still remains untapped. The real inclusive growth also needs penetration of capital market to the last mile.

The National Conference on **"Capital Market – Growth with Governance"** aims to assemble investors, practitioners, policy makers and other stake holders of the Indian capital market Eco-system to provide them an excellent platform to share views, experiences and research results on every aspect of Indian capital market such as Governance in Security Market, Investors protection; Vulnerability of Capital Market to FII Inflows, PSU Divestment, Role of Pension Fund, and Need for SME Exchanges.

I not only wish the conference a great success but also assume that ASSOCHAM shall continue to organize such programs for larger public benefits with great degree of excellence. ASSOCHAM extends earnest thanks to PricewaterhouseCoopers as our knowledge partner in this conference and also thanks to industry partners, Ministry of Corporate Affairs, SEBI, RBI, Conference Sponsors, Magazine Partner and Electronic Media & Online Media Partners for supporting this initiative.

D. S. Rawat
Secretary General
ASSOCHAM

We are pleased to present the PricewaterhouseCoopers-ASSOCHAM joint thought leadership study on Indian Capital Markets- Growth with Governance. The Indian economy has undergone significant change in the last two decades. From the closed economy of the 1980s, the 1990s was a decade of liberalization of the economy and in the 2000s, the economy witnessed unprecedented growth.

The growth in the economy was duly supplemented by a significant increase in the capital markets activity. There were significant changes to the legal framework, with Securities Exchange Board of India (SEBI) being entrusted with the regulatory power to govern the capital markets to ensure compliance. There was also technological advancement in the capital markets with the introduction of terminal based trading replacing the open outcry system and launch of the integrated market surveillance system, to monitor market malpractices, by the regulator.

The Corporate Governance framework was also strengthened through a series of amendments to the existing governance structure, by introduction of Clause 49 to the Listings Agreement and setting up of committees like the Naresh Chandra Committee Report on Corporate Audit and Governance. So far India has risen up to the challenge of a growing economy by ensuring that the requisite infrastructure is put in place to ensure market best practices and restore investor confidence.

The story of growth is incomplete without the presence of governance. The strong fundamentals of an economy are based on the virtues of good governance and ethical practices. This thought leadership study makes an attempt to chart the course of the Indian capital markets through the last two decades of growth with governance.

Bharti Gupta Ramola
Leader, Transactions
PricewaterhouseCoopers

01 Executive summary

Much has happened in the Indian capital market in the last 17 years. With its foundations laid in socialist based economy of four decades, with strict government control over private sector participation, foreign trade and foreign direct investment, India opened its gates to the outside world in the early 1990s. Since then its economy and financial markets underwent radical changes, largely in response to the economic crisis of the late 1980s. The government control on foreign trade and investment were loosened and the barriers to entry in the days of the license raj were relaxed.

The emergence of Securities and Exchange Board of India (SEBI) as the supreme capital market regulator showed India's commitment to come across as a strong economic force, through establishing market best practices of enhanced corporate disclosure and increased investor protection.

The establishment of National Stock Exchange (NSE), a state-of-the art exchange, with sophisticated technology to improve trading practices and reduce unethical dealings, supported by a strong legal framework and technological base to strengthen the governance structure, has been the highlight of the Indian capital market in the last decade. The opening up of the economy has increased the flow of Foreign Direct Investment (FDI) and has put India on the global map, as a new-age economic force to reckon with.

The increased level of sophistication in the market has been duly supported by increasingly complex instruments like derivatives and other structured products. While, the recent global meltdown has made us aware of the perils of sophisticated markets, the learning has been to follow a path of caution while maintaining a steady pace.

Several steps have been taken by the regulator to enhance the level of corporate governance and reporting requirements of the Indian stock market. Significant legislation has taken place in this area to curb market malpractices. The large scams and frauds have taught us that growth without a robust governance structure falls short of global expectations. The regulators have been active in responding to such events and in certain cases have undertaken proactive measures to stop such events from recurring.

This paper attempts to discuss the journey of the Indian capital market from the pre-reform era to the current era of liberalisation and enhanced governance.

02

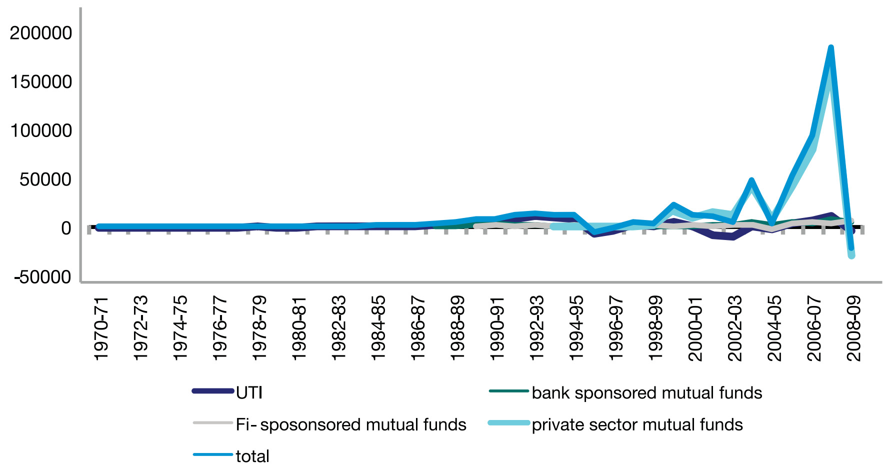
Capital markets – Pre-reform

The depleting foreign currency reserves in 1991 forced India to start the process of economic liberalisation. The reforms were accomplished by allowing increasing competition and greater foreign participation to provide fillip to the troubled economy.

The capital markets reforms in 1991 were preceded by a regime which ensured almost complete control of the state over the financial markets. Initial Public Offerings (IPO) were controlled through the Capital Issues Control Act. The Controller of Capital Issues (CCI) controlled the price and quantity of IPO and trading practices were short of transparency. The banking sector too was significantly controlled. There were few private banks and those faced challenges on their expansion plans. The banking sector suffered from lack of competition, low capital base, low productivity and high intermediation cost. After the nationalisation of large banks in 1969 and 1980, the government-owned banks dominated the banking sector. The Reserve Bank of India (RBI) controlled the interest rates and the financial sector was replete with entry barriers, significantly restricting opportunities for the establishment of new banks, insurance companies, mutual funds and pension funds.

The Unit Trust of India (UTI) created in 1964 was the only mutual fund and it enjoyed complete monopoly of the mutual fund business up until 1988. The resource mobilisation by mutual funds demonstrates UTI's dominance in the early 1990s.

The early 1990s therefore, was a time when the primary role of the financial system in India was to channel resources from the excess to the deficit. The role of technology was limited and customer relationship and service was not a priority. Risk management procedures and prudential norms were weak, affecting asset portfolio and profitability.



Stock exchange

The Bombay Stock Exchange (BSE), the oldest and the largest stock exchange in India, traded for two hours in a day with an open outcry system. The exchange was managed in the interests of individual members, a majority of whom had inherited their seats. A large proportion of stocks listed on the exchange were not actively traded. There was minimum supervision from the exchanges and speculation was rampant. There were regional exchanges which were unconnected and engaged in open outcry sysem of trading. Each exchange had a board representative nominated from the Capital Markets division of the Minstry of Finance, the then regulator of the capital markets.

03 Capital markets reforms

The capital market reforms were based on improving two fundamental aspects. First, the improvement in the legal reporting framework and second the improvement in the technology framework.

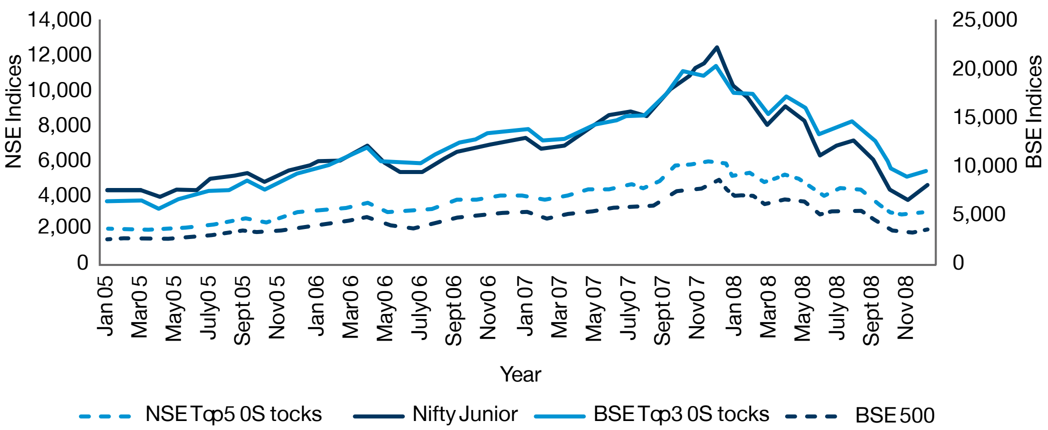
Legal framework

There have been significant reforms in the regulation of the securities market since 1992 in conjunction with the overall economic and financial reforms. A key element of the reform strategy was building a strong independent market regulator. The SEBI Act, which came into force in early 1992, established SEBI as an autonomous body. The apex capital market regulator was empowered to regulate the stock exchanges, brokers, merchant bankers and market intermediaries. The Act provided SEBI the necessary powers to ensure investor protection and orderly development of the capital markets.

The introduction of free pricing in the primary capital market has significantly de-regulated the pricing control instituted by the erstwhile CCI regime. While, the issuers of securities can now raise capital without seeking consent from any authority relating to the pricing, however the issuers are required to meet the SEBI guidelines for Disclosure and Investor Protection, which, in general, cover the eligibility norms for making issues of capital (both public and rights) at par and at a premium by various types of companies.

The freeing of the pricing of issues led to an unprecedented upsurge of activity in the primary capital market as the corporate mobilised huge resources. However, it did expose the inadequacies of the regulations. In order to address these inadequacies, SEBI strengthened the norms for public issues in April 1996. The graph below shows the BSE index movement from 1990 to 2006.

Movement of indices of NSE and BSE



Source: Bloomberg

The disclosure standards were enhanced to improve transparency and uphold the objective of investor protection. The issuers are now required to disclose information on various aspects, such as, the track record of profitability, risk factors, etc. Issuers now also have the option of raising resources through fixed price floatations or the book building process.

Clearing houses have been established by the stock exchanges and all transactions are mandatorily settled through these clearing houses and not directly between the members, as was practiced earlier.

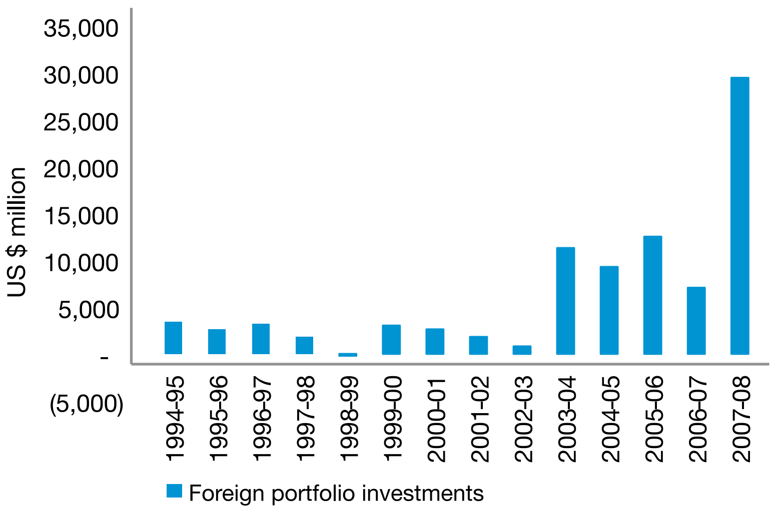
The practice of holding securities in physical form has been replaced with dematerialised securities and now the transfer is done through electronic book keeping, thereby eliminating the disadvantages of holding securities in physical form. There are two depositories operating in the country.

The margin system, limits on intra-day, trade and settlement guarantee fund are some of the measures that have been undertaken to ensure the safety of the market. The trading and settlement cycles have been significantly reduced. The cycles were initially shortened from 14 days to 7 days. The settlement cycles were further shortened to T+3 for all securities in 2002. The settlement cycle is now T+2.

Listed companies are required to furnish unaudited financial results to the stock exchanges and also publish the same on a quarterly basis. To enhance the level of disclosure by the listed companies, SEBI decided to amend the Listing Agreement to incorporate the segment reporting, accounting for taxes on income, consolidated financial results, consolidated financial statements, related party disclosures and compliance with accounting standards.

The last few years have seen significant interaction with the international capital markets. A major step towards that was the inclusion of Foreign Institutional Investors (FIIs) such as mutual funds, pension funds and country funds to operate in the Indian markets. As a quid pro quo, Indian firms have also raised capital in international markets through issuance of Global Depository Receipts (GDRs), American Depository Receipts (ADRs), Euro Convertible Bonds (ECBs), etc.

Foreign Portfolio Investments



Source: RBI

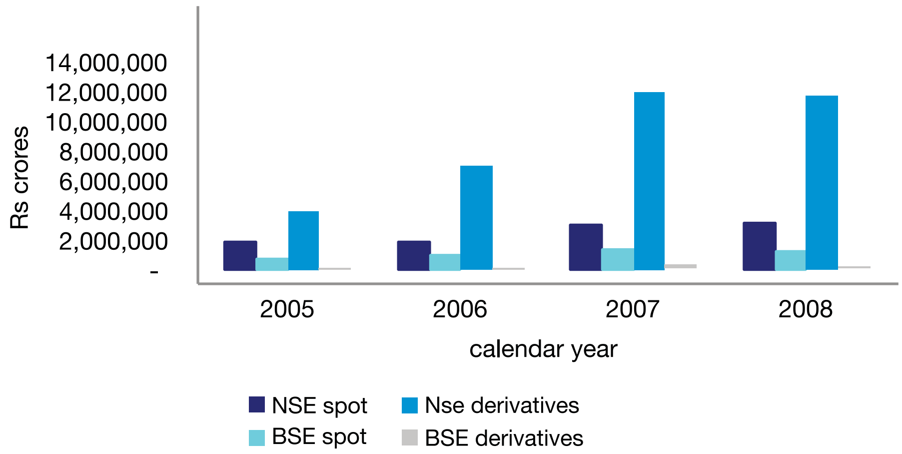
The SEBI's regulatory realm stretches beyond the stock exchanges to merchant bankers, registrars, share transfer agents, underwriters, mutual funds and various other advisors and market intermediaries. There have been efforts made to increase transparency in the takeover process and interests of minority shareholders.

Derivative market

One of the most noteworthy achievements of the Indian capital markets over the past 17 years has been the development of the derivative market. It has significantly enhanced the sophistication and maturity of the market. In India, derivative trading began in June 2000, with trading in stock index futures. By the fourth quarter of 2001, each of India's two largest exchanges had four equity-derivative products: futures and options for single stocks, and futures and options for their respective stock indices. The NSE has become the largest exchange in single stock futures in the world, and by June 2007, it ranked fourth globally in trading index futures, a sign of an evolving and maturing market.

Market liquidity too has increased greatly since 1992. This was primarily attributed to settlement rules (discussed below) and the introduction of derivatives trading. The move from fixed period to rolling settlements, shortened settlement periods, and a dramatic increase in derivatives trading contributed to steadily increasing market liquidity.

Derivatives market turnover



Source: BSE and NSE

Technology framework

The advent of technology to the markets has been largely attributed to the National Stock Exchange (NSE). NSE introduced the screen based trading and settlement system, supported by a state-of-the –art technology platform. To fulfill the commitment to adopt global best practices and bring about more transparency to the capital markets functioning, SEBI also assumed the responsibility of monitoring the markets and stock exchanges. A significant step towards that initiative was the launch of the Integrated Market Surveillance System (IMSS) in 2006.

The IMSS equipped the regulator to identify doubtful market activity. The IMSS's primary objective is to monitor the market activities across various stock exchanges and market segments including both equities and derivatives. IMSS collects and analyses data not only from the stock exchanges but also from National Securities Depository, Limited. (NSDL), Central Depository Services (India) Limited. (CDSL), clearinghouses, and clearing corporations.

The RBI introduced the electronic funds transfer system, "The Reserve Bank of India National Electronic Funds Transfer System" (referred to as "NEFT System" or "System"). The objective of the system is two-fold. First, is to establish an electronic funds transfer system to facilitate an efficient, reliable, secure and economical system to funds transfer and clearing in the banking sector throughout India. Second, is to relieve the stress on the paper based funds transfer and clearing system.