

# **SECURITIES LAWS AND MARKETS – GLOBAL BENCHMARKING**

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“ Whatever is not there in India, it is not there in the World.” This adage cannot be truer for the Indian Securities Market.

## **INTRODUCTION**

Benchmarking is a management exercise of systematically identifying the best practices and standards followed by the leaders and endeavouring to meet or even surpass such standards. The leader may be an individual, an entity, a market or a system which is the best today at some functions and tasks, and not necessarily in all areas and for all times to come. Hence, benchmarking continuously searches for the today's leaders in each area and identifies today's best practices / standards. Global benchmarking means searching for global leaders in each area to identify the global best practices / standards. It may, however, be noted that the best standard / practice followed by the leader may not be the best in the absolute sense or for all the environments. In such a case, the best practice may not be adopted at all or may be adopted with suitable modifications to match the host environment.

In the context of securities laws and markets, while the laws and the markets as a whole are benchmarked against the best jurisdictions, each practice or standard is benchmarked against the best practice / standard across the jurisdictions. The benchmarking is generally done against three main planks, namely other domestic laws and markets, overseas securities laws and markets, and the international standards. For example, domestic laws provide for a system of ombudsman or consumer fora to redress consumer grievances and a scheme of compensating depositors if a bank goes bankrupt. Some overseas jurisdictions have a practice of plea bargaining, which lets off an offender who simply pays up without admitting the offence. The IOSCO and other international agencies have laid down international standards such as the 'IOSCO Objectives and Principles of Securities Regulation', 'Recommendations for Securities Settlement Systems (SSS)' etc. The benchmarking identifies the best standards and practices from these three sources and adopts them, with or without modifications, keeping in view the uniqueness of the host market. For example, net worth determines the exposure of the brokers in some jurisdictions. A modified practice is, however, in vogue in the Indian securities market where the deposits with the exchanges determine the exposure of the brokers. This paper attempts to benchmark the Indian securities laws and markets against overseas securities laws and markets and the international standards to identify the best practices and standards followed elsewhere or recommended by the international standard setting agencies. It benchmarks the Indian securities laws and markets in respect of securities laws, securities regulations, market design and market outcome and makes a few suggestions to bring the Indian securities laws and markets to the global standards.

Given the importance of the securities market in the economy and the need of the Indian economy to grow at projected 8% per annum, the authorities have been promoting the securities market as an engine of growth to provide an alternative but efficient means of resource mobilization for the corporate sector and the government. The Government, the regulator and the market participants have been continuously benchmarking the systems, laws and regulations and practices and standards to improve the safety and efficiency of the market. They have ushered in as many as nine special legislative interventions during the last decade to which there is no parallel anywhere in the world. The Indian securities market gave birth to the first ever demutualised stock exchange in the world and today all stock exchanges in India are corporatised and demutualised. It used the satellite based

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communication technology for securities transactions for the first time. It started the real time on line position monitoring system for brokers. It is the first to introduce the straight through processing in securities transactions. It is the first major market to have implemented T + 2 rolling settlement. In many areas such as biometric based identification of market participants, corporate governance rating, etc. Indian market is the best in the world. These have yielded considerable benefits to the market as evidenced by the growth in the number of market participants, growth in volumes in securities transactions, increasing globalization of the Indian market, reduction in transaction costs, significant improvements in efficiency, transparency and safety, and level of compliance with international standards and have earned for the Indian securities market a place of respect amongst the comity of securities markets in the world. By benchmarking itself during the last one decade, it has now become a benchmark for many overseas markets.

The striking manifestations of the benchmarking are:

- (a) All participants as well as their activities have a sound legal basis.
- (b) The laws and regulations substantially comply with the 30 IOSCO Principles of Securities Regulations.
- (c) The market is a complete market in the sense that it offers all kinds of securities and derivatives thereon to meet every possible need of issuers and investors.
- (d) The market uses information technology intensively and extensively, while most of the operations are automated.
- (e) An estimated 20 million investors invest through the securities market.
- (f) The securities are issued, traded and settled in demat form.
- (g) The securities are issued through book building process.
- (h) All stock exchanges are corporatised and demutualised. All of them provide screen based trading system and guarantee settlement of all trades. Most of the trades are cleared and settled through a clearing corporation.
- (i) It ranks first in terms of number of companies listed on the exchanges.
- (j) The market capitalization of listed securities far exceeds the aggregate deposits with the banking system. According to Global Stock Markets Factbook 2005, India ranked 18th among the securities markets in terms of market capitalization as at end December, 2004.
- (k) According to Global Stock Markets Factbook 2005, India ranked 18th among the securities markets in terms of turnover and 15th in terms of turnover ratio during 2004. It accounted for 0.96% of world turnover and 9.6% of emerging markets turnover in 2004.
- (l) Though the trading in derivatives on securities commenced in 2000, the volume in derivatives far exceeds the volumes in cash market.
- (m) NSE and BSE rank among the top 5 exchanges in the world in terms of number of transactions in the equity cash market. NSE is the largest exchange in the world in stock futures and the third largest in index futures.
- (n) The Nifty impact cost reduced to 0.09% in 2004 reflecting substantial improvement in liquidity. The brokerage has reduced to as low as 0.15%. The transaction costs on Indian exchanges are one of the lowest among the major markets.
- (o) The stock exchanges have the most advanced and scientific risk management system which levies VaR based margin on the portfolios at client level on a real time basis.
- (p) Indian securities market has 6.9% weightage in S&P/IFCG Composite Index of emerging stock markets.
- (q) The GSCS settlement benchmark improved from -16.8 in 1995 to 93.1 in 2004. The securities settlement system substantially complies with the G30, BIS-IOSCO and ISSA Recommendations.
- (r) A study by Prof. Marti Subrahmanyam involving 500 ADRs has revealed that ADRs of Indian stocks are paid the highest premium in relation to the domestic prices of equity shares of the respective companies.
- (s) According to the World Bank, with net inward portfolio equity flows of US\$ 7 billion in 2003, India accounted for 48.95% of the net inward portfolio equity flows to all developing countries.

- (t) In terms of the FDI Confidence Index (AT Kearney), India rose to the third most likely FDI location in 2004, just behind China and United States. CALPERS gives a score of 3 (the maximum that could be awarded) via Permissible Equity Market Analysis while voting for India as an investment destination. FDI inflow has been consistently over US \$ 5 billion every year over the last 4-5 years.
- (u) Domestic issuers / investors have the choice to raise resources / invest within / across the borders. Overseas issuers and investors have access to the Indian market also.
- (v) In a study: "What works in Securities Laws?" Professors Rafael La Porta, Florencio Lopez – de-Silanes, and Andrei Shleifer, have observed: "India scores 100% as far as disclosure standards are concerned".
- (w) CLSA-CG Watch, in its September 2004 report, describes: "In terms of consolidation, segmental reporting, deferred tax accounting and related party transactions, the gap between Indian and US GAAP is minimal."
- (x) The Economic Intelligence Unit 2003 Study: The Asian Experience states: "Top of the country class, as might be expected is Singapore followed by Hong Kong and, somewhat surprisingly, India where overall disclosure standards have improved dramatically, accounting differences between local and US standards have been minimized and the number of companies with a majority of independent directors has risen significantly."
- (y) CLSA-Emerging Markets Study on Corporate Governance gives India a score of 6.2 which is next only to 7.5 of Singapore and 6.7 of Hong Kong. It observes: "India's stock market regulatory authority, the Securities and Exchange Board of India continues to raise the bar for good corporate governance".
- (z) In the context of innovations of recent times in raising the risk capital, the Financial Times, London, dated 31st July 2004, observed: "World's Biggest Democracy can show Google how to conduct an online IPO....in India you cannot apply on the web but investors can access one of the world's largest financial networks with 7000 terminals scattered around 350 cities. And every step of the book building process is public. ...The Indian system is a refreshing example of a transparent IPO market but it is also a rare one, especially in the insider-friendly Asian markets."

## SECURITIES LAWS

The securities laws, comprising of four main legislations, namely the SEBI Act, 1992, the Companies Act, 1956, the Securities Contracts (Regulation) Act, 1956 (SCRA) and the Depositories Act, 1996, govern the securities market. The SEBI Act, 1992 establishes SEBI with statutory powers for (a) protecting the interests of investors in securities, (b) promoting the development of the securities market, and (c) regulating the securities market. The SCRA provides for direct and indirect control of virtually all aspects of securities trading and the running of stock exchanges and aims to prevent undesirable transactions in securities. It gives central government/SEBI regulatory jurisdiction over (a) stock exchanges through a process of recognition and continued supervision, (b) contracts in securities, and (c) listing of securities on stock exchanges. The Depositories Act, 1996 provides for the establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security by (a) making securities of public limited companies freely transferable subject to certain exceptions; (b) dematerialising the securities in the depository mode; and (c) providing for maintenance of ownership records in a book entry form. The Companies Act, 1956 deals with issue, allotment and transfer of securities and various aspects relating to company management. It prescribes the standards of disclosure in public issues of capital, particularly in the fields of company management and projects, information about other listed companies under the same management, management perception of risk factors, etc.

Though there is no fixed set of global benchmarks in securities laws, the benchmarks can be derived from the standards / practices in vogue in the best jurisdictions. They generally provide a sound legal basis for (i) enacting, enforcing and upholding laws relating to securities market and the authorities responsible for establishing the rule of law, (ii) establishing autonomous regulator(s) and self regulatory organizations and empowering them to regulate and supervise the markets and the participants effectively, (iii) setting up of institutions such as exchanges, depositories, clearing corporations, etc. and their efficient operations, (iv) regulation and supervision of market intermediaries such as collective investment schemes (CIS), merchant bankers, brokers, etc. and their efficient operations, (v) various activities and operations in the market such as issue, listing, delisting, trading, clearing, settlement, transfer and dematerialisation of securities, (vi) prohibition of malpractices such as insider trading,

fraudulent and unfair trade practices, etc. (vii) expeditious and effective enforcement actions in case of misdemeanour, and quick resolution of disputes, (viii) supporting developmental initiatives, (ix) protecting the interests of investors in securities and (x) ensuring that the laws are transparent and publicly accessible. Indian securities laws provide a sound legal basis for all these purposes.

A few examples are presented here to illustrate the global standards in vogue in the Indian securities laws. The Constitution of India unambiguously authorizes the Central Government to make laws relating to the securities market. The laws made by the central government have empowered various authorities namely, Department of Economic Affairs (DEA), Department of Company Affairs (DCA), Reserve Bank of India (RBI) and SEBI to supervise and regulate different areas in the securities market and make subordinate legislations for this purpose. The laws as well as subordinate legislations and the enforcement actions of the authorities are subject to judicial scrutiny. The SEBI Act provides the legal basis for the establishment of SEBI, its powers and functions, and its operational standards. Similarly, the SCRA and the Depositories Act provide for establishment of the stock exchanges and the depositories respectively as well as their responsibilities and operational standards. The law confers on SEBI, exchanges and depositories adequate powers to frame rules, regulations, and byelaws to govern their operations and regulate the conduct of their constituents.

The best regulators are autonomous and act without fear of, or favour to, any quarter. The regulator can have autonomy if it does not depend on the government for its sustenance, and it has freedom to frame regulations and implement them without fear or intervention of the government. The SEBI Act ensures an independent stream of income for the regulator. The regulator has substantial powers of subordinate legislation. The power of the Government is limited to giving directions on questions of policy and superceding the regulator for a period not exceeding six months in case of grave emergencies. In order to avoid conflict of interests, the regulator does not appropriate the penalties levied by it on the miscreants. However, to ensure its accountability, the law requires that all the regulations made by the regulator are laid before each House of the Parliament for scrutiny and enforcement orders can be appealed before a specialized tribunal.

The best regulators have all the relevant powers to achieve their assigned objectives, with an appropriate mechanism to ensure that the power is not misused or exercised beyond what is warranted. The law empowers the regulator in India to register, regulate and supervise all the market participants including exchanges, depositories, intermediaries and persons associated with the securities market like foreign institutional investors, credit rating agencies, venture capital funds, etc. and their operations. It has blanket authority to regulate other intermediaries or persons, not named specifically in the statute, by specifying them through a notification. Its regulatory jurisdiction extends over corporates in the issuance of capital, transfer of securities and other related matters. It can conduct enquiries, audits, inspections and investigations, including search and seizure, of all concerned in discharge of its duties.

The law provides a penal framework and empowers the regulator to penalise all participants, including intermediaries and companies, in case of violations of the provisions of the Act, Rules and Regulations made thereunder to ensure good conduct in the interests of investors and orderly growth of the securities market. It has a wide choice of penalties, which include prosecution, suspension or cancellation of registration, monetary penalty, directions, cease and desist orders, etc. In order to ensure that the enforcement action is fair and objective, any person aggrieved by an order of the regulator under the securities laws can prefer an appeal before the Securities Appellate Tribunal (SAT).

The law prohibits trades in securities outside the recognized stock exchanges. The exchanges frame and enforce rules to regulate and supervise the trading on exchanges, admission and conduct of the trading members and listing and delisting of securities. The Rules may not always further the public interest (interests of investors and society) and the private interest (interests of trading members) simultaneously. In a mutual structure, private interest may get precedence over public interest. In order to avoid such possibility, the law mandates all exchanges to be corporatised and demutualised by a specified time. All exchanges are now corporatised and demutualised. The law also provides a framework for clearing corporations and the regulatory framework for the same is being developed. As soon as clearing corporations are recognized, the clearing and settlement functions would be transferred from exchanges to clearing corporations.

The Depositories Act provides a legal basis for the establishment of multiple depositories and entrusts them with the responsibility of maintaining ownership records of securities and effecting transfer of securities through book entry only. The depositories render, through participants, any service connected with the recording of allotment of securities and transfer of ownership of securities. The Depositories Act read with the Companies Act have made the securities of all public companies freely transferable. That is, once the agreed consideration is paid and the purchase transaction is settled, the buyer is automatically entitled to all the rights associated with the security. Only if the transfer is in violation of any law, the depository, depository participant, company, SEBI or investor can apply to the Company Law Board within 2 months for rectification of records.

The law provides statutory backing to listing and delisting of securities in the interests of investors. It empowers the authorities to prescribe conditions for listing and delisting. The listed companies are obliged to comply with a set of conditions in the interests of investors. The law also allows delisting of securities under specified circumstances. Similarly, the law provides legal backing for different products. For example, the law supports trades in derivatives explicitly, even though these, being cash settled, could be construed as wagers which are null and void under the general law.

The securities laws in India has evolved over time to meet the emerging deficiencies, improve the safety and efficiency of operations, accommodate new products and market designs, adopt the best practices from the best jurisdictions and to implement international standards. For example, a statutory regulator was created in 1992 to regulate the market participants in the interests of investors in securities and orderly development of the securities market. Its powers and jurisdiction were enhanced by legislations in 1995, 1999 and 2002. The Capital Issues (Control) Act, 1947 was repealed in 1992 to pave the way for market determined allocation of resources. The Depositories Act was enacted in 1996 to provide for the establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security. The law was enacted in 1999 to provide a legal framework for trading of derivatives of securities and units of collective investment scheme. It was further amended in 2004 to mandate corporatisation and demutualisation of stock exchanges and to enable transfer of clearing and settlement function to clearing corporations. This also provided a legal basis for delisting of securities.

## **SECURITIES REGULATIONS**

In order to meet the exigencies of the market and to provide flexibility to the regulators, they have been delegated substantial powers of subordinate legislation. Government has framed rules under the SCRA, the SEBI Act and the Depositories Act. SEBI has framed 27 regulations, 6 guidelines, 2 schemes and one initiative under the SEBI Act and the Depositories Act for registration and regulation of all market intermediaries, and for prevention of unfair trade practices, insider trading, etc. Under these Acts, Government and SEBI issue notifications, guidelines, and circulars which need to be complied with by the market participants. The institutions like exchanges and depositories have framed rules, byelaws, regulations to govern their operations and the operations of their constituents. The regulator and the exchanges have developed listing agreements to be complied with by the listed companies. Various regulations prescribe model agreements to be entered among the participants such as broker, sub-broker and client, depository and depository participant to govern their relations and their respective rights and obligations.

All the intermediaries in the securities market are now registered and regulated by SEBI. Before authorizing a person to act as an intermediary, the regulator determines if he is a fit and proper person to participate in the market. In order to do so, it takes account of financial integrity, convictions or civil liabilities, competence, reputation and character, efficiency and honesty, etc. A code of conduct has been prescribed for each intermediary as well as for their employees in the regulations; capital adequacy and other norms have been specified; a system of monitoring and inspecting their operations has been instituted to enforce compliance; and disciplinary actions are being taken against them for violating any regulation. All the intermediaries in the market are mandated to have a compliance officer who reports independently to SEBI about any non-compliance observed by him. The regulations also stipulate the human resource requirement for various activities to ensure quality intermediation services. These are the standard features of regulations relating to intermediaries all over the world.

The regulations have certain objectives. For example, registration requirements of participants ensure that

only the authorized and capable persons transact in the market. Disclosure of data relevant to firms' financial prospects and standardized accounting practices ensure that information is available to participants to enable them to take informed decisions. Prohibition of insider trading and fraudulent/ manipulative / unfair trade practices prevents insiders / manipulators from profiting at the expense of non-insiders / ordinary investors. Takeover regulations protect minority shareholders. Investment management rules reduce scope for abuse by investment managers. The Indian securities market has effective regulations to achieve all these objectives.

Unlike securities laws, there is a set of benchmarks for securities regulations. The 30 Principles of Securities Regulation, released in February 2002 by IOSCO, is a standard yardstick against which progress towards effective regulation can be measured. IOSCO members, including SEBI, through their endorsement to these principles, intend to use their best endeavours to ensure adherence to these principles within their jurisdictions. The extent of compliance of the Indian securities market regulations with these principles is presented in the Table 1, a perusal of which indicates that India has substantially complied with all the 30 principles.

Table 1  
**Compliance with the IOSCO Principles of Securities Regulation**

#### **A. Principles relating to the Regulator**

P1-5: The responsibilities of the regulator should be clear and objectively stated. It should be operationally independent and accountable in the exercise of its functions and powers. It should have adequate powers, proper resources and the capacity to perform its function and exercise its powers. It should adopt clear and consistent regulatory processes. Its staff should observe the highest professional standards, including appropriate standards of confidentiality.

S : The SEBI Act, 1992 has established SEBI and clothed it with responsibilities to protect the interests of investors and to promote the development of, and to regulate, the securities market. SEBI administers the Depositories Act, 1996. It also exercises powers relating to securities market under SCRA and the Companies Act, 1956 concurrently with central government. The division of responsibility among SEBI, RBI, DEA and DCA has been clearly spelt out in the Acts. SEBI has been vested with the authority to discipline the market participants and develop the market without any recourse to the government. The Government can issue directions to SEBI only in the matters of policy and can supersede it only in cases of grave emergencies or in public interest. The regulations framed by SEBI and its annual report providing an account of its activities, policies and programmes are laid before the Parliament. Its jurisdiction extends over corporates in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with the securities market. It has powers of licensing, supervision, inspection, investigation and enforcement and to issue directions, impose monetary penalty, suspend/cancel certificates of registration, launch prosecution etc. It has instituted a consultative process before framing regulations. It has framed regulations to regulate the conduct of all kinds of intermediaries and for the orderly development of the market. The rules, regulations, guidelines, circulars etc. are put on the SEBI website for easy public access. The regulations framed by SEBI are published in the Gazette of India and also laid before each House of the Parliament. The Parliamentary Committee on Subordinate Legislation reviews them. All orders passed by SEBI are passed following principles of natural justice and are subject to review by the SAT. The Right to Information Act applies to SEBI. A code of conduct has been specified in the service regulations of SEBI. The staff are prohibited from investing in equity and equity related instruments and speculating in securities / commodities. They are also required to undertake and declare fidelity and secrecy.

#### **B. Principles of Self-Regulation**

P6-7: The regulatory regime should make appropriate use of self-regulatory organisations (SROs). They should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality.

S : SEBI is mandated to promote and regulate SROs. It has framed SRO Regulations for this purpose. However, these have not developed appreciably. The only SROs - exchanges - are under the direct oversight of SEBI. They make byelaws, rules and regulations for regulating the conduct of their members and contracts in securities. SEBI approves and amends the rules of exchanges and inspects them to ensure that the rules are adhered to.

**C. Principles for the Enforcement of Securities Regulation**

P8-10 : The regulator should have comprehensive inspection, investigation and surveillance powers. It should have comprehensive enforcement powers, including regulatory and investigative powers. The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers.

S : SEBI has powers to require the provision of information, or to carry out inspections to ensure compliance with the prescribed standards. It can call for information and record from any authority, including statutory authorities, in respect of transactions in securities under investigation, and conduct inspection of any intermediary, person associated with securities market and listed company. While calling for information, it has the powers of a civil court in respect of discovery and production of records, summoning and enforcing attendance of persons and inspection of books / documents. It has powers of inspection, investigation and enforcement and to issue directions, impose monetary penalty, suspend/cancel certificates of registration, launch prosecution, etc. It can appoint an investigating authority to investigate the affairs of an intermediary or persons associated with the securities market. The investigating authority has vast powers, including power to call for information, power of search and seizure etc. It has established an effective and credible system of investigation, surveillance and enforcement.

**D. Principles for Co-operation in Regulation**

P11-13 : The regulator should have authority to share both public and non-public information with domestic and foreign counterparts. It should establish information sharing mechanisms with their domestic and foreign counterparts. The regulatory system should allow assistance to foreign regulators who need to make inquiries in the discharge of their functions.

S : There is no specific provision in law which enables SEBI to share public and non-public information. Nor is there any provision prohibiting it from entering into MOU with other regulatory authorities. However, SEBI has informal arrangements with DEA, DCA and RBI for sharing information. It has also arrangement to share information with securities market regulators of other countries.

**E. Principles for Issuers**

P14-16 : There should be full, timely and accurate disclosure of financial results and other information which is material to investors' decisions. Holders of securities in a company should be treated in a fair and equitable manner. Accounting and auditing standards should be of a high and internationally acceptable quality.

S : The Companies Act, SEBI DIP Guidelines and the listing agreement of the exchanges require the issuers to make full, timely and accurate disclosure of material facts to enable investors to make informed decisions. Disclosure extends to any material information having a bearing on the price of the security, people who have significant interests in or who seek control of the company, etc. The listing agreement requires all listed companies to publish on an annual basis financial statements audited by an external auditor and unaudited quarterly results. They also make disclosures in the annual reports in compliance with the Accounting Standard on "Related Party Disclosures". SEBI has set up an Electronic Data Information Filing and Retrieval System to facilitate an electronic filing of certain information by listed companies and their public dissemination. Financial statements are prepared and audited in accordance with the provisions of the Companies Act, 1956. SEBI Takeover Code, the Companies Act, the buyback and delisting regulations contain provisions for protection of minority shareholders.

**F. Principles for Collective Investment Schemes**

P17-20 : The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a CIS. It should provide for rules governing the legal form and structure of CIS and the segregation and protection of client assets. It should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a CIS for a particular investor. It should ensure that there is a proper and disclosed basis for assets valuation and the pricing and the redemption of units in a CIS.

S : Eligibility criteria in terms of net worth, track record, internal management procedure have been specified in Regulations for Mutual Funds, CIS and Venture Capital Funds. The regulations provide for registration and authorisation of scheme, inspection to ensure compliance, investigations and remedial action. Structure of

CIS has been specified in respective regulations. Disclosure standards, including format of offer document, have been specified in the respective regulations to provide investors with sufficient information to know if the scheme is an appropriate investment vehicle for him. Specific provisions have been made in the respective regulations for asset valuation and pricing of units. For example, applicable load as a percentage of NAV is added to NAV to calculate sale price and is subtracted from NAV to calculate repurchase price.

#### **G. Principles for Market Intermediaries**

P21-24 : The licensing process should require a comprehensive assessment of the applicant and the licensing authority should have power to withdraw or suspend the license. There should be initial and on going capital and prudential requirements for intermediaries that reflect the risks that the intermediaries undertake. Intermediaries should be required to comply with standards for internal organisations and operational conduct that aim to protect the interest of clients, ensure proper management risk, etc. There should be a procedure for dealing with the failure of a market intermediary.

S : An entity intending to act as an intermediary is required to have a registration / license to do so. The registration process checks the credentials and capability of the entities and persons associated with them and grants registration, only if found eligible and suitable. There is an established procedure provided in the regulations for granting the license to the intermediaries as well as its revocation. The entry norms for the intermediaries contain the capital adequacy clause as well as the maintenance of the same on a continuing basis. The intermediaries are required to frame a code on internal procedure and conduct. They also abide by the Code for Corporate Disclosure Practices specified in the regulations. Regulations for intermediaries specify a code of conduct, which contains provisions to protect the interests of the clients and ensure proper management of risk. There are arrangements like Settlement/Trade Guarantee Funds and the Investor Protection Funds for dealing with the failure of market intermediaries.

#### **H. Principles for Secondary Market**

P25-30 : The establishment of trading systems including securities exchanges should be subject to regulatory authorisation and oversight. There should be ongoing regulatory supervision of exchanges. Regulation should promote transparency of trading and detect and deter manipulation and other unfair trading practices. It should aim to ensure the proper management of large exposures, default risk and market disruption. Systems for clearing and settlement of securities transactions should be subject to regulatory oversight.

S : The trading systems (stock exchanges) are regulated by a process of recognition and continued supervision under the SCRA. Fair and equitable rules have been framed by stock exchanges, SEBI and Government under the SCRA and SEBI Act for supervision of trading system and stock exchanges. Approval of the trading system may be withdrawn by the regulator when it is determined that the system is unable to comply with the conditions of approval or with laws/regulations. All trades are executed only through on-line automated price and order matching mechanism of stock exchanges. It enables the market participants to see the full market on a real time basis, making the market transparent. The information relating to trading is available to the public on a real time basis. Regulations have been framed to prevent insider trading, and fraudulent and unfair trade practices. These have been expressly prohibited under the SEBI Act and penalties for such offences extend up to Rs. 25 crore or three times the illegal profits made whichever is higher. Limits have been specified on turnover and exposure in relation to the base minimum capital which a member keeps with exchange. The exposure of members is monitored on a real time basis. Members breaching the limits are automatically and instantaneously disabled by the trading system. The SSS, under the oversight of regulator, guarantees settlement of net obligations of the members.

P : Principle, S: Status of Compliance

### **MARKET DESIGN**

In order to improve the quality of the market, that is, to improve market efficiency, enhance transparency, prevent unfair trade practices and raise the Indian market to international standards, the market is being redesigned continuously. The practice of allocation of resources among different competing entities as well as its terms by a central authority was discontinued. The issuers complying with the eligibility criteria were allowed the freedom to issue the securities at market-determined rates. The market shifted formally and completely from merit based

regulation to disclosure-based regulation. The secondary market overcame the geographical barriers by moving to screen based trading. The trading system is now accessed through 10,000 trading terminals spread across more than 400 cities / towns in the Indian sub-continent and also through the Internet and hand held mobile devices from all over the world. All kinds of securities – debt and equity, government and corporate – are traded on the exchanges side by side. As a result of these redesigns, the market design has changed drastically, and is now at par with, or even better in some respects than, the best jurisdictions, as may be seen from Table 2.

Table 2

**Elements of Market Design in Indian Securities Market, 1992 and 2005**

Features	1992	2005
<b>Corporate Securities Market</b>		
Regulator	No specific regulator, but Central Government oversight	A specialized regulator for securities market (SEBI) vested with the powers to protect investors' interest and to develop and regulate securities market. SROs strengthened
Securities	Limited number of traditional instruments	Expanded to cover government securities, units of CISS and MFs, derivatives of securities, security receipts, etc.
Form of Securities	Physical	Dematerialised
Regulatory Approach	Merit based regulation	Disclosure based regulation
Intermediaries	Some of the intermediaries(stock brokers, authorized clerks and remisiers) regulated by the SROs	A variety of specialized intermediaries emerged. They are registered and regulated by SEBI (also by SROs in some instances). They as well as their employees are required to follow a code of conduct and are subject to a number of compliances. All participants are identified by a unique identification number
Access to Market	Granted by the Central Government	Eligible issuers access the market after complying with the issue requirements
Disclosure	Voluntary, vague, scanty and non-standardised	Standardised, systematic and at par with the international standards. A dedicated web site for corporate disclosures, EDIFAR, operationalised
Pricing of Securities	Determined by the Central Government	Determined by market, either by the issuer through fixed price or by the investors through book building
Access to International Market	No access	Corporates allowed to issue ADRs/ GDRs and raise ECBs. ADRs/GDRs have two way fungibility. FIIs allowed to trade in Indian market. MFs also allowed to invest overseas
Corporate Compliance	Very little emphasis	Emphasis on disclosures, accounting standards and corporate governance
Mutual Funds	Restricted to public sector	Open to private sector and emergence of a variety of funds and schemes
Exchange Structure	Mutual not-for-profit exchanges	For profit corporate, demutualised exchanges

Trading Mechanism	Open outcry, available at the trading rings of the exchanges; opaque, auction/negotiated deals	Screen based trading system; orders are matched on price-time priority; transparent, trading platform accessible from all over the country
Aggregation of Order Flow	Market fragmented by geographical distance.	Order flow unobserved. Order flow observed. The exchanges have open electronic consolidated limit order book (OECLOB)
Anonymity in Trading	Absent	Complete
Settlement Cycle	14-days account period settlement, not adhered to always	Rolling settlement on T + 2 basis
Counter-party Risk	Present	Absent
Form of Settlement	Physical	Mostly electronic
Basis of Settlement	Bilateral netting	Multilateral netting
Transfer of Securities	Cumbersome. Transfer by endorsement on security and registration by issuer	Securities are freely transferable. Transfers are recorded electronically in book entry form by depositories.
Risk Management	No focus on risk management	Comprehensive risk management system encompassing capital adequacy, limits on exposure and turnover, VaR based margining, client level gross margining, on-line position monitoring, business continuity plans, etc.
Derivatives Trading	Absent	A wide array of exchange traded derivatives such as Futures and Options on indices and select securities and Futures on interest rate available
Research	Very little	Many market participants have full fledged research departments. Some of them have schemes / initiatives to promote research

### Government Securities Market

Securities	Plain vanilla securities	Expanded to include zero coupon bonds, floating rate bonds, capital indexed bonds, bonds with embedded derivatives, interest rate futures, etc.
Form of Securities	Physical	Demat holding by RBI regulated entities
Pricing of Securities	Administered interest rates	Issue at market related rates (auction)
Participation	Captive investors (mostly banks)	Expanded to allow primary dealers, FIIs, retail investors
Trading Mechanism	Through telephone	Negotiated Dealing System which provides negotiation and screen based trading
Counterparty Risk	Present	Clearing Corporation provides novation and guarantees settlement
Mode of Settlement		Delivery-versus-payment (DVP-III)

There are three sets of global benchmarks in the area of SSS. There are: ISSA Recommendations 2000, BIS-IOSCO Recommendations 2001, and G30 Recommendations 2003. ISSA Recommendations 2000 recommend standards for governance of SSS, technology, technical standards, market practices, settlement risk, market linkages, investor protection and legal infrastructure. BIS – IOSCO Recommendation 2001 prescribe standards for legal risk, pre-settlement risk, settlement risk, operational risk and other issues relating to SSS. G30 Recommendations 2003 require comparison of trade between direct market participants by T + 0, an effective and fully developed central securities depository, a trade netting system, a DvP system, "same day" funds convention for payments, T + 3 rolling settlement, securities lending and borrowing mechanism, adoption of ISO standard for securities messages and the ISIN numbering system for securities transactions.

In Indian securities market, the trades accumulate over the trading cycle of one day and at the end of the day, these are clubbed together, and positions are netted and payment of cash and delivery of securities settle the balance two working days after the trading day. Trades are executed on screen and matched trade details are linked to settlement system electronically, and hence matching and confirmation of trades for direct participants are instantaneous. All communications relating to securities settlement are fully electronic and automated. For instance, the clearing agency uploads the obligations and pay-in advices of funds / securities to members electronically through secured networks. It also sends electronic advice to clearing banks and depositories to debit the members' accounts to the extent of their obligations. The banks and the depositories debit accounts of members and credit the account of the clearing agency electronically. The reverse happens when the funds / securities are paid out to members. The exchange is connected electronically to the clearing and settlement agency, which in turn is connected electronically to clearing banks, depositories, custodians and members. The depositories have electronic communication with depository participants, clearing agency, custodians, clients and exchanges. Most of these electronic communications are interactive. To pre-empt market failures and protect investors, the regulator/exchanges have developed a comprehensive risk management system, which is constantly monitored and upgraded. It encompasses capital adequacy requirements for members, adequate margin requirements, limits on exposure and turnover, indemnity insurance, on-line position monitoring and automatic disablement, etc. They also operate an efficient market surveillance system to detect excessive volatility and prevent price manipulations. Exchanges have set up trade/settlement guarantee funds for meeting shortages in a settlement arising out of non-fulfillment/partial fulfillment of funds obligations by the members. A clearing corporation assumes the counterparty risk of each member and guarantees financial settlement.

The Indian SSS architecture encompasses the use of the state-of-the-art information technology in the SSS, T + 2 rolling settlement, securities lending and borrowing, professionalisation of trading members, fine-tuned risk management system, clearing corporation to assume counterparty risk, real time gross settlement / electronic fund transfer facility, straight through processing, 100% electronic trading which obviates the need for trade confirmation, finality of settlement from the moment the trade is executed, delivery versus payment, dematerialisation and electronic transfer of securities, 100% settlement in demat form, etc. and complies with the international standards such as ISSA Recommendations 2000, CPSS-IOSCO Recommendations 2001, and G30 Recommendations 2003 in letter and spirit. In many respects, Indian SSS is ahead of many developed markets.

One yardstick used internationally to measure the extent of improvement in the SSS is the GSCS Benchmarks. These Benchmarks assess the settlement efficiency in the form of a single number expressed as a score out of 100 and provide an indication of the aggregate level of post-trade operational efficiency in the securities market and track the evolution of the settlement performance over time. The higher the score, the higher is the efficiency. These Benchmarks comprise of Settlement Benchmark, Safekeeping Benchmark and Operational Risk Benchmark. Over the last 10 years, the settlement benchmark improved from -16.8 in 1995 to 93.1 in 2004, as presented in the Table No. 3.

Table 3  
**GSCS Benchmarks on Settlement Efficiency**

Benchmark	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Settlement	-16.8	-0.7	-1.2	10.0	41.9	59.6	75.8	87.7	93.6	93.1
Safekeeping	75.0	76.6	76.8	69.7	78.1	81.9	86.7	88.6	88.1	91.8
Operational Risk	0.0	16.8	23.5	47.3	43.6	51.4	59.1	64.1	66.0	67.2

Source : Various Issues of Review of Emerging Markets, GSCS Benchmarks.

## MARKET OUTCOME

The proof of the pudding lies in eating. The impact of laws, regulations and market design is ultimately reflected in the market outcomes such as amount of capital raised, the depth of the market, liquidity and volatility, cost of transactions, etc. However, comparative data in respect of different parameters of the outcome are not easily available. The comparable data are available only in respect of transactions in the secondary market, albeit with severe limitations. For example, the number of listed companies in India is 4730, as presented in Table 5, while the actual number is about 10,000. This is so because the data compilation agency has collected data only from one exchange in India. The data presented in Table 4, 5 and 6, therefore, underestimate the different parameters in respect of the Indian securities market. Despite this limitation, India ranks second in terms of the number of listed companies. The number of companies listed in many markets is much less than the number of companies traded daily on the Indian exchanges.

Table 4  
International Comparison of Secondary Cash Market (End December 2004)

Particulars	India	USA	UK	Japan	Malaysia	Thailand	Singapore	China
Number of Listed Companies	4730	5231	2486	3220	962	465	489	1384
Ranking in terms of Listed Companies	2	1	7	6	12	20	19	10
Ranking in terms of Company Size	70	4	16	15	51	47	37	32
MC (US \$ Billion)	387. 85	16323. 73	2815. 93	3678. 26	190. 01	115.40	171.56	639.77
Ranking in terms of MC	18	1	3	2	23	31	26	13
MC Ratio (%)	56.06	139.91	131.53	79.56	161.33	70.58	160.60	38.79
Share in World MC (%)	1.00	41.96	7.24	9.45	0.57	0.30	0.44	1.64
Market Weight in the World Index (%)	6.90	52.80	10.50	9.60	3.10	2.70	0.40	9.80
World Index Stocks' Share of MC (%)	73.70	95.60	95.90	86.40	75.10	84.10	94.60	66.60
10 Largest Index Stocks' Share in MC (%)	33.40	14.70	40.90	18.20	34.20	44.90	34.20	28.90
Turnover (US \$ Billion)	379. 09	19354. 90	3707. 19	3430. 42	59.88	109.95	81.31	748.27
Ranking in terms of Turnover	18	1	2	3	30	24	27	8
Turnover Ratio (%)	115.50	126.50	142.20	105.10	33.40	95.80	52.20	113.30
Ranking in terms of Turnover Ratio	15	9	8	18	41	19	32	16
Share in World Turnover (%)	0.96	49.24	9.43	8.73	0.15	0.28	0.21	1.90
World Index Stocks' Share of Turnover (%)	75.10	NA	NA	NA	49.30	70.50	NA	47.40
10 Most Active Index Stocks' Share in Turnover (%)	42.60	NA	NA	NA	23.90	32.30	NA	13.70
Trading Cost, including Impact Cost (BP)	66.91	32.41	51.60	19.80	55.86	54.05	37.98	NA
Index Return (%)	23.7	9.0	15.3	15.2	14.3	-11.8	21.8	-15.4
Ranking in terms of Return	64	91	82	84	85	99	67	100
Price - Earning Ratio	18.08	22.35	23.80	29.17	22.35	12.78	16.83	19.12
Blue Chips Index Volatility (%)	1.6	NA	9.8	48.4	NA	27.8	NA	1.2

MC : Market Capitalisation

Source : World Development Indicators 2005, Global Stock Markets Fact Book 2005, and World Federation of Exchanges.

It may be noted that Table 4 and 5 present data in respect of India vis-à-vis the developed securities markets and India's position in the comity of markets. The market capitalization, which has been growing at an annual compound growth rate of 13% over 1996-2005, is comparable in absolute as well as relative terms to any other emerging market and many a developed market. As a ratio of GDP, it worked out to 46.5% in 2003. This ratio surpassed that of middle-income markets. Indian securities market was the 18th largest market in terms of market capitalisation as at end December 2004, accounting for 8.2% of the market capitalization of emerging markets and 1% of the world market capitalization as against 6.38% and 0.41% respectively in 1990. The constituent shares from the Indian securities market, which has a weightage of 6.9% (up from 5.3% in 1995) in the S&P/IFCG Index of Emerging Stock Markets, accounted for 73.7% of the market capitalization. The ten largest index stocks accounted for only 33.4% of the market capitalization.

Table 5

**Market Capitalisation and Turnover for Major Markets**

(In US \$ million)

Country/Region	Market Capitalisation (End of Period)			Turnover (12 Months Cumulative)		
	1990	1995	2004	1990	1995	2004
<b>All Developed Markets</b>	<b>8795239</b>	<b>15880109</b>	<b>34173600</b>	<b>4616473</b>	<b>9180132</b>	<b>35341782</b>
Australia	108879	245218	776403	40113	98654	514249
Japan	2917679	3667292	3678262	1602388	1231552	3430420
United Kingdom	848866	1407737	2815928	278740	510131	3707191
United States of America	3059434	6857622	16323726	1751252	5108591	19354899
<b>All Emerging Markets</b>	<b>604420</b>	<b>1893234</b>	<b>4730418</b>	<b>898233</b>	<b>1040192</b>	<b>3967806</b>
China	2030	42055	639765	-	49774	748274
<b>India</b>	<b>38567</b>	<b>127199</b>	<b>387851</b>	<b>21918</b>	<b>21962</b>	<b>379085</b>
Indonesia	8081	66585	73251	3992	14403	27561
Korea	110594	181955	428649	75949	185197	638891
Malaysia	48611	190011	222729	10871	76822	59878
Philippines	5927	58930	28948	1216	14727	3664
Taiwan	100710	187206	441436	715005	383099	718619
<b>World Total</b>	<b>9399659</b>	<b>17773343</b>	<b>38904018</b>	<b>5514706</b>	<b>10220324</b>	<b>39309589</b>
Developed Markets as a % of World	93.57	89.35	87.84	83.71	89.82	89.91
Emerging Markets as a % of World	6.43	10.65	12.16	16.29	10.18	10.09
USA as a % of World	32.55	38.58	41.96	31.76	49.98	49.24
<b>India as a % of Emerging Markets</b>	<b>6.38</b>	<b>6.72</b>	<b>8.20</b>	<b>2.44</b>	<b>2.11</b>	<b>9.55</b>
<b>India as a % of World</b>	<b>0.41</b>	<b>0.72</b>	<b>1.00</b>	<b>0.40</b>	<b>0.21</b>	<b>0.96</b>

Source : Global Stock Markets Fact Book 2005.

The turnover in the cash segment of the Indian securities market has been increasing at an annual compound growth rate of 22% over 1996-2005. It ranked 18th among the securities markets in terms of turnover and 15th in terms of turnover ratio during 2004 with a turnover ratio of 115.5% as against 65.9% in 1990. The turnover

ratio is not only higher than the world average, but also higher than that of the high-income markets. It accounted for 0.96% of world turnover and 9.6% of emerging markets turnover in 2004 as against 0.21% and 2.11% in 1995. The ten largest index stocks accounted for only 42.6% of total turnover. In terms of number of transactions, NSE and BSE are the 3rd and 5th largest exchange respectively in the world.

Table 6

### Breadth and Depth of Secondary Securities Markets

Markets	Market Capitalisation (% of GDP)		Turnover Ratio (% of MC)		Listed Domestic Companies	
	1990	2003	1990	2004	1990	2004
<b>High Income</b>	<b>51.6</b>	<b>100.1</b>	<b>59.4</b>	<b>110.1</b>	<b>17,733</b>	<b>27,594</b>
<b>Middle Income</b>	<b>19.4</b>	<b>44.5</b>	....	<b>60.9</b>	<b>4,370</b>	<b>14,456</b>
<b>Low &amp; Middle Income</b>	<b>18.8</b>	<b>43.5</b>	....	<b>72.4</b>	<b>7,691</b>	<b>22,444</b>
East Asia & Pacific	16.4	53.5	118.1	103.5	774	3,582
Europe and Central Asia	2.2	29.7	....	37.9	110	7,776
Latin America & Caribbean	7.7	33.2	29.8	22.0	1,748	1,468
Middle East & N. Africa	27.4	47.3	....	64.4	817	1,803
South Asia	10.8	39.8	54.0	131.2	3,231	6,909
Sub-Saharan Africa	52.3	105.9	....	39.3	1,011	906
<b>Low Income</b>	<b>10.5</b>	<b>37.3</b>	<b>48.2</b>	<b>130.5</b>	<b>3,321</b>	<b>7,988</b>
<b>India</b>	<b>12.2</b>	<b>46.5</b>	<b>65.9</b>	<b>115.5</b>	<b>2,435</b>	<b>4,730</b>
<b>World</b>	<b>48.0</b>	<b>89.7</b>	<b>57.2</b>	<b>72.4</b>	<b>25,424</b>	<b>50,038</b>

Source : World Development Indicators 2005

The Indian securities market is quite attractive in terms of cost of transactions, returns and volatility. The trading costs for institutions were 66.91 basis points during 2004. The index return was not only the highest among all the markets considered; it was one of the least volatile. It is not surprising that India accounts for almost half of the net inward portfolio equity flows to all developing economies. The last two years have witnessed FII inflows of US\$ 10 billion each. Their holding constitutes about 15% of market capitalization.

### REMAINING AREAS

There is no substantive area, where Indian securities laws and markets do not have global standards. This section, however, makes a few suggestions in the peripheral areas to bring Indian securities laws and markets to the global standards.

#### A. Securities Laws

- (i) There are several statutes regulating different aspects of the securities market. The four main legislations are: the SEBI Act, 1992, the Companies Act, 1956, the SCRA, 1956, and the Depositories Act, 1996. The larger the number of laws, the higher is the scope for inconsistency among them and the possibility of regulatory overlaps and gaps. There are also as many regulators as the number of laws. The larger the number of regulators, the higher is the scope for confusion among the regulators and the regulated and duplicacy and inconsistency in regulations. Besides, there is no statutory provision to provide for regulatory cooperation / sharing information among the domestic regulators and between overseas and domestic regulators. Powers of the regulator to assist / seek assistance from overseas regulators or to enter into

MOUs or other co-operation arrangements with them to deal with cross border misconduct are not explicitly provided in any legislation, though these are also not forbidden. The protection of the interests of investors requires consolidation of all laws relating to securities market into a single piece of legislation, preferably called the Securities Act which should prevail over the general laws. The administration of the Act may be assigned to one agency with clearly defined regulatory jurisdiction and accountability. And the agency must work in close coordination with other regulators, domestic or foreign.

- (ii) Most of the enforcement actions of Securities Exchange Commission (SEC), US are resolved by settlement with defendants (accused), who generally consent to the entry of judicial or administrative orders without admitting or denying the allegations against them. These orders usually require the defendants to agree to be censured, to a cease and desist order, to be barred from appearing/practising/dealing in a certain manner / before an authority, to a permanent injunction, to pay a civil monetary penalty, to the disgorgement of illegal gains or illegally avoided losses, or to comply with numerous other undertakings. The SEC lets off the accused who simply pay up without admitting to an offence. This prevents every case being locked up in a court. Given the number of cases pending in the Indian courts and intangible nature of securities market offences, SEBI requires similar facilities if the offenders are to be punished on priority. This would help to bring all the co-accused to book or solve difficult cases if one accused provides lead by agreeing to plea bargain in exchange of a lenient sentence.
- (iii) The SEBI Act provides for two alternative types of punishment. They are: (a) suspension or cancellation of certificates of registration to be imposed by SEBI on the recommendation of an enquiry officer, or (b) monetary penalty to be imposed by an adjudicating officer. These two types of punishments are mutually exclusive. If a contravention is assigned to an adjudicating officer for adjudication, it cannot be referred to enquiry officer and vice-versa. A corollary of this is that mind is made up about the type of punishment (not quantity of punishment) to be imposed on the erring party when the alleged contravention is referred to an adjudicating officer for adjudication or to an enquiry officer for imposition of suspension or cancellation of registration, that is, at a stage when the nature and gravity of the contravention has not been fully ascertained. If a contravention is assigned to an enquiry officer, monetary penalty cannot be imposed even if the enquiry findings justify monetary penalty. Similarly if a contravention is assigned to an adjudication officer, the registration cannot be cancelled even if the adjudicating officer comes to the conclusion that the contravention warrants cancellation of registration. It would, therefore, be desirable to allow adjudicating officers to try all contraventions under the SEBI Act, rather all securities laws, and award all types of penalties so that SEBI can concentrate on developmental and regulatory work.
- (iv) The regulator must not be an interested party. It must not have any interest other than the protection of interests of investors and orderly development of the market. This principle is not followed in case of government securities. RBI, which is the manager of the monetary policy, acts as the regulator for government securities market, and also participates in the market simultaneously as the manager of government debt, issuer of securities, merchant banker to issue, registrar and transfer agent, clearing and settlement agent, depository for securities, provider of trading platform, and subscriber to securities. In such cases, it may not always be possible to avoid conflict of interests. The decisions relating to debt management, interest rate and regulation of market should be taken independently to avoid perceived conflict of interests.
- (v) The intermediaries hold in their custody, and handle, the money and the securities on behalf of clients. However, there is an apprehension that the assets of the clients can be attached in case of insolvency of the intermediaries or can be misused by them. In order to dispel this apprehension, it is necessary to provide in law that an investor can entrust the money or securities to any intermediary who shall hold such assets in trust and shall not have any right, title or interest of any nature therein. He shall deal with such assets as directed by the investor and shall be accountable for the same. Such assets shall not form part of assets of the intermediary and no authority can attach or seize such assets.
- (vi) It is not enough that the culprit is punished. The culprit needs to be punished in an exemplary manner, while investor should have means to recover his loss caused by the culprit. The law should empower the authorities not only to levy penalties, but also award compensation to investor and enforce disgorgement

of illegal gains made by the accused. A group insurance policy may be considered under which an investor, losing any money for whatever reason except for market loss or his own negligence and not compensated by the negligent or defrauding party, is compensated upto a specified amount. In the US, an organisation called Securities Investor Protection Corporation under the Securities Investor Protection Act, 1970, operates a similar insurance mechanism to compensate up to US \$ 5,00,000 per investor in securities.

## B. Securities Regulations

- (i) Many investors, particularly small ones, do not have expertise on their own to make investment decisions. They depend on the advice from others who may not be competent to render such advice and be accountable for the same. All kinds of people, irrespective of their competence, sell financial products to, and advise, the investors on various products. This is as dangerous as a quack providing medical treatment. SEBI Act empowers SEBI to register and regulate investment advisors in securities. While SEBI may frame regulations for investment advisers in securities, it may be desirable to lay down a set of comprehensive regulations to groom and govern the profession of Financial Planners / Investment Advisers across the financial market. This is akin to the provisions in the Investment Advisers Act, 1940 in the US.
- (ii) The SROs are expected to share the responsibility with the regulator in framing as well as administering regulations. However, the SROs have not developed appreciably in India, even though SEBI has framed regulations for regulation of SROs. Most of the associations of intermediaries like, AMFI, AMBI do not exactly regulate, though they promote the activities of their members. It may be desirable to mandate SROs for all kinds of market participants.
- (iii) While formulating regulations, no conscious effort is made to estimate the cost of regulation and to verify if the benefits from regulation outweigh the costs of regulation. In order to prevent overregulation, it is necessary that the regulators explicitly take into account the costs of regulation. Further, there is no provision in the law requiring the regulator to consult the regulated while formulating regulations. SEBI has, however, instituted a consultative process before framing regulations. A statutory obligation may be cast on the regulator to consult the regulated, as this improves quality of regulation and ensures its smooth implementation.
- (iv) In developed markets and in some of the developing markets, quality of intermediation services is ensured through a system of testing and certification of persons working with market intermediaries in the securities market. In the US, for example, any securities professional associated with a member firm, including partners, officers, directors, branch managers, department supervisors, and salespersons, is required to register with the NASD. As part of the registration process, securities professionals must pass an examination administered by the NASD Regulation to demonstrate their competence in the areas in which they will work. This sort of arrangement ensures that a person dealing with financial products has a minimum standard of knowledge about them, market and regulations so as to assist the customers in their dealings, and bars ill-equipped personnel from providing intermediation services in the securities market. The SEBI regulations require such certification in case of mutual fund distributors and derivative dealers. Regulations of exchanges and depositories require such certification for their constituents. This needs to be extended to all persons working with or as market intermediaries.
- (v) A significant challenge to the regulators across the globe is the convergences of the opportunity zones. Traditionally, businesses were clearly differentiated; banks offered banking, insurance companies offered risk covers and securities companies offered services related to investments. This resulted in separation of supervisory structures along business lines. The economies of scale and economies of scope are, however, driving the emergence of financial power houses which are one stop shops for all financial products / services. This has the danger of risk of one activity / segment spilling over to the other activities / segments of the markets. If there are different regulators for different activities, there is a potential problem of shifting responsibilities among the regulators, particularly at times of crisis. The regulators, domestic and overseas, need to co-operate more frequently than ever before, and that too at multiple levels. This can be accomplished either through effective co-ordination among the regulators or

by the creation of a single regulatory body. Some economies are choosing the first option and some the second. India has to choose a course and move forward fast.

- (vii) There should be a procedure for dealing with failure, closure, or cancellation of registration of an intermediary in order to minimize loss to investors and to contain systemic risk. In respect many intermediaries, there is an arrangement to deal with failures. However, the consequences of voluntary surrender or penal cancellation of registration on the investors are not very clear. The order accepting surrender of registration or cancellation of registration may provide for certain consequential matters. For example, the intermediary may be allowed a period of moratorium to enable it to wind up the business and the investors to make alternative arrangements. In respect of depository participants, brokers and sub-brokers, the responsibility to oversee winding up of business and shifting of customers to another intermediary may be assigned to depositories or exchanges concerned, as the case may be. In other cases, the regulations may provide for an administrator to do so. In all such cases, the claim of the clients of the intermediary should have priority over other claims or debts. The regulator may be empowered to file a winding up petition against an intermediary in case such intermediary goes bankrupt or the continuance of such intermediary is considered detrimental to the interests of investors or market.
- (vii) In order to enable the investor to choose the right intermediary through whom he may transact business, it may be useful to make details of the intermediaries available to him. The details may include the form of organization, management, capital adequacy, liabilities, defaults and penal actions taken by the regulator and self-regulatory organizations against the intermediary in the past and other relevant information. The intermediary may be mandated to make continuous disclosures about its performance and financial positions through a web site such as the EDIFAR. The intermediaries may not be allowed to outsource their activities unless they comply with the IOSCO standards of outsourcing. The Regulations may prescribe the governance standards for the intermediaries.

### C. Market Design

- (i) The trades executed on exchanges are settled through clearing corporation. The law has been amended recently to provide that an exchange may, with the approval of SEBI, transfer the duties and functions of a clearing house to a recognized clearing corporation. The rules relating to governance of clearing corporations need to be framed and the clearing corporations need to be recognized. All exchanges need to be mandated to settle trades through a clearing corporation. STP needs to be extended to cover all the market participants. All participants need to be identified by global identification methodology. They need to follow internationally compatible messaging standards.
- (ii) The optimum utilization of resources dictates that a member / client is allowed to take an aggregate position across products / market segments / exchanges as long as he does not exceed the permitted aggregate exposure. The clearing agency should compute and levy a single net margin amount after netting the positions of a member / client in different products / segments / exchanges.
- (iii) The market for securities lending and borrowing allows the participants to sell the securities that they do not own and to obtain finance through the lending of securities against cash. This enhances liquidity, which leads to reduced cost of trading, thereby facilitating more efficient settlement, tighter dealer spreads and a reduction in the cost of capital. With an active securities lending and borrowing market in place, the market can even do away with auctions and the derivatives can be settled by actual delivery of securities. This market needs to be promoted and all obstacles in the way need to be removed.
- (iv) The Securities Exchange Act, 1934 provides specific power to SEC to regulate short sales of exchange listed securities. The regulations allow relatively unrestricted short selling in an advancing market while preventing short sellers from accelerating a declining market. The regulation uses tick-test, a formula for defining price for permissible as well as non-permissible short selling. Every short-sale transaction is disclosed upfront to the dealing broker who is held responsible for ensuring that the transaction does not violate the tick-test. It means that short selling cannot take place surreptitiously in the US market. All market participants may be allowed to sell short subject to regulations that may be framed by SEBI.

(v) The margin trading enables clients to trade more than their own resources would permit and hence increases supply of and demand for securities / funds in the market. It thus contributes to liquidity by making higher trading volumes possible than it would have been otherwise possible. It helps in better price discovery by supporting larger supply of and demand for funds / securities. Margin trading and trading of derivatives generally complement rolling settlement, where time for round about transaction is limited to a day. This is why markets having rolling settlement generally provide the facility of margin trading. Despite the enabling provisions, margin trading has not taken off. This calls for a review of the existing mechanism.

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