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Securities and Exchange Board of India and the Indian Capital Markets - A Survey of the Regulatory Provisions

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ABSTRACT

The Securities and Exchange Board of India (SEBI) has been a visible entity in the Indian capital market, thanks to the tremendous growth in the capital market and its numerous legislative and institutional responses in attempting to ensure the orderly functioning of the market, protecting public investors and development of new products and institutions. While a general awareness of the role that SEBI is expected to and has played exists among investors, academics and lay people, the exact legal levers that SEBI operates are not widely understood, from an economic perspective. Such an understanding would be an important first step for a more systematic evaluation of the contribution of SEBI to the working of the Indian securities market. The paper traces the evolution of the regulation of two of the more important aspects of the securities market, namely the primary and the secondary market. The paper does not empirically evaluate the economic or financial impact of SEBI's regulatory activity or the exercise of its regulatory provisions or analyse the same from a public policy perspective. Instead the paper would be a useful precursor to either of such analyses. This paper is part of a larger research endeavour to critically examine the field of securities regulation in India under the supervision of SEBI.

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Keywords : Securities and Exchange Board of India, SEBI, Securities Contract Regulation Act, Securities Contract Regulation Rules, Controller of Capital Issues, Indian Securities Market, Primary Market, Secondary Market.

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Financial markets play an important role in the development of the economy. Broadly, financial markets may be considered to comprise the securities markets and financial institutions such as banks and non banking finance companies. In the former, economic agents with investible surplus provide capital directly to firms to meet their investment requirements. Securities markets may in turn be considered to consist of capital markets and money markets. Capital markets are concerned with instruments of investment which have maturities of one year or more, such as equity shares, preference shares, bonds and debentures. Instruments trading in the money market are typically of a shorter tenor, of less than a year such as treasury bills, commercial paper and overnight call money market. This distinction is somewhat arbitrary and useful mainly for practical discourse on the financial markets. In the case of financial institutions, economic agents with investible surplus deposit their capital into an intermediary institution, commonly known as a bank and in some countries referred to more generically as a deposit taking institution. These intermediaries pool savings from a large number of depositors and invest them in firms, which have investment requirements.

In the first part we discuss the connection between finance and economic development, the relative importance of bank centric financial systems versus capital market centric financial systems for economic development, the need for regulating the financial sector, alternate approaches to regulation and their important features. In the second part we briefly discuss Indian capital market and the regulation of the same prior to the establishment of SEBI. In the

third part the statutory provisions governing SEBI and the importance of the Securities Contract Regulation Act, 1956 and Securities Contract Regulation Rules, 1956 in the regulation of the capital market are examined. In the fourth part we trace the development of two of the key aspects of SEBI's regulatory activity since its inception, namely the regulation of public issues and some key elements of the regulation of the secondary market. The fifth part concludes.[1]

[1] This paper essentially focuses on the economic aspects of securities regulation. The approach to research as well as certain constructs in the language follow the general usage in economic literature. For eg., the idea of an agent or agency is as used in economics, which is somewhat different from the legal usage of the term [Cheffin : 1999]. However, as far as possible care has been taken to use constructs which may have a legal connotation with the accuracy that goes with usage in legal discussion. For eg., the paper uses the term company all though and not "body corporate" or firm as is used interchangeably in economic literature since each of these terms mean different entities in legal parlance. with Citation of court cases follow legal convention in citation of case law; however, the legal research approach to providing a list of cases cited at the beginning of the paper has not been followed. References to provisions of relevant laws usually are to the main section unless the context of the discussion requires specific reference to a sub-section, clause or proviso thereto.

I. FINANCE, DEVELOPMENT AND REGULATION

I-A Finance and Development

The earlier view in this regard was propounded by Robinson [1952] which is often cited in a large part of the literature in this area. This view believed that "where enterprise leads finance follows" and accorded a supportive role for the financial sector in driving real growth. More recent work starting with Goldsmith [1962] and continued by contemporary work by Levine [1998], King and Levine [1993], Rajan and Zingales [1998] have tried to establish that there exists a definite relationship between finance and development and that the causality flows from finance to development. Although the tentativeness in their conclusions cannot be dismissed, the evidence establishes the importance of the financial sector in the economy.

I-B Bank Versus Market

Yet another debate has been about the role of the financial sector in economic development and within the financial sector the relative importance of banks versus financial markets in the role of economic development, now more popularly referred to as the "bank versus market" debate. The conclusion on this debate appears to be less ambivalent and has been neatly summed up in Demriguc Kunt and Levine: "Overall, financial development matters for economic success but financial structure per se does not seem to matter much. Thus, policy makers may achieve greater return by focusing less on the extent to which their country is bank based or market based and more on legal, regulatory and policy reforms that boost the functioning of markets and banks" (Emphasis in original)

I-C Regulation of Financial Markets

The role of regulation in financial systems has been studied both in the context of markets as well as that of banks. The Coasian view has been that in perfect markets economic agents can negotiate bargains that obviate the need for an exogenous regulatory influence. [Coase :]. In the sixties the view among academics was led by Stigler [1956] where it was argued that the disclosure norms of the Securities and Exchange Commission (SEC), the securities regulator of the USA did not make any difference to enhancing investor welfare in terms of the rate of return

on new equity offerings, which was then supported by Benston [1964]. More recently legal scholars such as Romano [1998] and Easterbrook and Fischel [1991] have questioned the need for company law codes and argued that private contracting could serve the purpose more efficiently than an one-size-fits-all company law. Jarrell [1981] studied the effect of SEC regulations using data on bonds, preference share issues in addition to equity issuances. Based on the decline in the default frequencies of the bonds and the lower levels of risk in common stock issuances than in the pre SEC period Jarrell suggests that the "documented reduction in risk of securities sold publicly is a general effect of the SEC regulation". Simon [1989] pointed out various methodological issues with the Stigler paper and using a larger sample found that the evidence supports the view that the SEC regulations had a favourable impact on the risk adjusted rate of return of issues from regional stock exchanges which did not have a regulatory regime prior to the SEC, unlike the New York Stock Exchange which had its own regulatory regime.

More recently adherents to the Coase view point have drawn attention to the conditions assumed by Coase in arriving at his view. For eg., Shleifer and Johnson [1999] argue that the Polish stock market experienced a healthier development than the Czechoslovakian market due to the stringent security regulations that were equally stringently enforced in Poland as opposed to a more laissez faire approach adopted by the Czech Republic. Beck, Demirguc-Kunt, Levine and Maksimovic [2001] propose the Law and Finance view as one of the four views of the bank versus market debate, suggesting that the legal system is the primary determinant of the effectiveness of the financial system in facilitating innovation and growth, by effectively protecting outside investors, both equity and debt-holders. They find evidence that firms are more likely to grow at rates requiring external finance in economies in which the legal system is conducive the development of large, active and efficient banks and stock markets. Wurgler [2000] finds evidence that strong minority rights help limit investments in declining industries. The recent advances in the study of corporate governance have also argues for a role for regulation. Black [2001] finds a positive relationship between the poor corporate governance practices in post glasnost Russia and estimates the valuation of publicly listed oil producing firms at $ 30 bn against their intrinsic worth of $ 3 trillion based on the valuation of comparable firms listed on American securities markets. Other country case studies of the securities markets in Peru, [Glen and Madhavan: 1998] and the Neuer Market in Germany, have corroborated the impact of regulation on activity and valuation levels in the securities markets. The picture that emerges is one of increasing evidence is that law and regulation matter for the financial markets.

I-D Approach to Regulation

Policy scholars have debated the ideal form of regulation. The principal strands of these debates have been as follows:

(1) *Unified versus a separate regulatory regime for each constituent of the financial markets* (such as banks and financial institutions, insurance companies and the securities markets) : The proponents of the former argue that it leads to several benefits such as economies of scale and more effective co-ordination and interchange of information whereas the advocates of the latter argue that the unified regulatory regime exemplified by the Financial Services Authority of the UK (FSA) could become monolithic and bureaucratic institutions unable to respond to the rapid developments of the world of finance. [Abrams and Taylor:2000 and Ferran: 2001.] Also see [Briault: 2001]. Evidence from Mwenda and Fleming [2001]suggests that even where regulators are moving towards a unified regime some countries have not chosen to go all the way along the lines of the FSA.

(2) *Self regulation vs regulation by a regulatory agency belonging to the state*: There is a strong view that when stock exchanges and other trade associations in the form of a self regulatory organization (SRO) regulate themselves they might lead to a more effective and efficient regulation because of the gains for firms from good governance, the proximity of the SRO to the trade and market information and expertise. [Pritchard: 2002]. Others like Cheffin [2001] have argued that firms listed on the London Stock Exchange have had a long ethos of good governance that antedates the FSA and has been based on the social pressures. Coffee [2002] suggests that norms, which he defines as "informal rules of conduct that constrain self-interested behaviour but are not enforced by any authoritative body that can impose a sanction", play an important role in societies where legal regimes are weak. Concerns about the efficacy of stock exchanges as SROs have centred around (a) their lack of enforcement authority and therefore the need for a regulator who can at least enforce (unless they can be bestowed with enforcement authority as Pritchard [2000] suggests) and (b) the apprehension that they may be subject to pressures from the constituency that they are expected to regulate.

(3) *Reform of law on the books versus the implementation of law on the ground*: The debate on these issues is more recent and it may be traced back to the developments in the Soviet Union.

Black [2000] points to how the best drafted legal codes may not produce the desired results in the absence of a rule of law. Pistor, Raiser and Gelfer [2000]argue that in emerging markets, where the small shareholder may not have the same ability to exercise his rights, the problems of governance could be different from that of countries with a well developed set of legal institutions. Formal laws introduced into a legal system unfamiliar with and unreceptive to new laws have been less effective than in countries where the legal transfer was smoothed by cultural proximity, legal adaptation and the availability of lawyers trained in the application of new laws. [Berkowitz, Pistor and Richard: 1999]. As an example, although Russia scores better than France and Germany in terms of investor protection on the books, its record in corporate governance on the ground has been less than satisfactory as pointed out by Black [2000]. Levine [1998] suggests a broad definition of legal reforms which allows for procedural changes and not just changes of statute, which are more difficult to pull off, can have a significant impact in stimulating economic development by improving the financial system.

(4) *Regulation by the government directly versus regulation by specialized agencies*: Through legislation that is subordinate to the parliament. This debate essentially involves the question of delegated or subordinate legislation. The benefit of subordinate legislation is that specialized agencies may be entrusted with the responsibility of achieving defined certain policy objectives. The agency may also be conceived and structured as an autonomous agency, free from bureaucratic or political control or influence. They may also be able to respond to the regulatory needs more expeditiously. The downside may be that such agencies may be more susceptible to regulatory capture.

(5) *Merit Regulation Vs Disclosure Regulation* : This is more a matter of the philosophy or approach to regulation. Merit regulation implies that the regulator assumes the role of deciding what is good for the market. In extreme instances it can involve the regulator deciding on the quantum, price and non-price terms and even timing of an offer of securities, apart from deciding on what kind of companies may access the market. The regime under the Controller of Capital Issues that regulated the Indian capital market prior to the advent of SEBI may be considered an example of merit regulation. Many other countries where public policy vigorously pursued distributive goals adopted merit regulation. Disclosure based approach in comparison adopts a *caveat emptor* approach, with the responsibility of the regulator being limited to ensuring timely availability of quality information from the issuer and intermediaries, that could be considered sufficient for a reasonable person to make an informed investment or trading decision. The

essence of this was captured in Louis Brandeis' now famous statement, "Sunlight is the best disinfectant and electric light the best policeman" quoted in Lowenstein [1996].

(5) *Common law versus civil law debate:* The debate on common law versus civil law and its impact on regulatory systems is again more recent. Brierley and David [1989] trace the key differences between the major legal systems in the world. Mahoney [2001] argues that between 1960 and 1992 common law countries experienced a little more than 0.50% higher real per capita GDP growth than their civil law counterparts. The UK and the USA are the most significant examples of common law countries whereas Germany, France, Japan and the Netherlands are cited as examples of civil law. Mahoney attributes these systems to different political histories of the countries although they evolved from the common origin of Roman Law; but they resulted in different institutional arrangements with common law consisting primarily of judge made law while civil law consists of codified law. Common law also allows for greater judicial autonomy, freedom to interpret the jurisprudential aspect of the statute and immunity from administrative influence unlike civil law where the judges tend to act more as administrators of the law on the books. LLSV [2000] have tended to support this view with some empirical assessments of the level and quality of protection available to investors in common law countries. However, Cheffin [2001] suggests caution against drawing too much upon the common law tradition and points out that despite their common law traditions of the legal systems of the USA and UK, there might be important differences between the two systems (such as the willingness of the judge to interpret the law more broadly in the USA and the system of litigation which incentivises more aggressive litigation in the USA). Further, the issue of implementation of law that was pointed out earlier may be more important than the tradition itself in many instances.

These debates assume relevance in establishing the case for examining the need for regulation of securities markets from a policy perspective.

II INDIAN SECURITIES MARKET

II-A Participants in the Indian Securities Market

The Indian securities market comprises a wide range of institutions as may be seen from Table I below:

Institution Type (as on March 31, 2002)	**Nos**
Securities Appellate Tribunal	1
Regulators	4
Depositories	2
Stock Exchanges	23
Listed Securities	9644
Brokers	9687
Corporate Brokers	3862
Sub-brokers	12208
Foreign Institutional Investors (FIIs)	490
Portfolio Managers	47
Custodians	12
Share Transfer Agents	161
Primary Dealers	18
Merchant Bankers	145
Bankers to an Issue	68
Debenture Trustees	40
Underwriters	54
Venture Capital Funds	34
Foreign Venture Capital Investors	2
Mutual Funds	37
Collective Investment Schemes	6

Source : NSE: 2002 (adapted)

While the Bombay Stock Exchange has been in operation since 1878 [BSE :2003] the securities markets have expanded since the reform process in 1991 in terms of daily turnover on the stock exchanges, the number of listed companies, market capitalisation and the number of domestic and foreign institutional investors and retail investors. The large number of retail investors who participate in the securities market directly (19 million investors) or indirectly (through mutual funds – 23 million investors)[2] - makes the securities market important from a public policy perspective.

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[2] NSE [2002]

II-B Regulatory Structure

Five agencies have a significant regulatory influence, directly or indirectly, over the securities markets in India currently. These are

- The Board of Company Law Administration (Company Law Board or CLB) which is responsible for the administration of the Companies Act, 1956[3]
- The Reserve Bank of India (RBI) which is primarily responsible, *inter alia*, for the supervision of banks and money markets
- Securities and Exchange Board of India (SEBI) which is responsible for the regulation of capital markets and the various participants and activities therein; and
- Department of Economic Affairs (DEA) which is responsible for the economic management of the country and is the arm of the government that is concerned with the orderly functioning of the financial markets as a whole
- Department of Company Affairs (DCA) which is the arm of the government responsible for the administration of incorporated entities.

Of these, the agency that is directly charged with the supervision of the capital markets in India is SEBI. The working of SEBI is the primary focus of this paper.

II-C Securities Market Regulation prior to SEBI

Prior to the establishment of SEBI stock exchanges were under the administrative control of the under the Stock Exchange Division of DEA. The stock exchange division was responsible for the administration of the Securities Contract Regulation Act, 1956 (SCR Act, 1956 hereafter) which governed the business of buying, selling and dealing in securities. The mobilization or issuance of capital through the public securities market or otherwise was controlled by the Controller of Capital Issues (CCI). The CCI had to fulfill several social and economic objectives in the discharge of its functions such as (i) public investor protection; (ii) alignment of corporate investments with plan priorities; (iii) ensuring that the capital structure of companies was sound and in public interest (iv) ensuring that undue congestion of public issues did not occur in any part of the year; and (v) regulation of foreign investment. CCI's means of realizing these

[3] Constituted under Section 10E of the Companies Act, 1956

objectives included (i) micro-management of the securities issuance process (ii) centralised administration and cumbersome procedures and (iii) Tight controls on quantum of issue, terms (price and non -price) and even timing of issue. The CCI regime thus represented an extreme instance of "merit regulation". The net result of the CCI regime was that it (i) impeded resource mobilization (ii) led to unhealthy administrative practices (iii) resulted in the inability of the system to cope with the increasing resource mobilisation load (iv) led to the development of a grey market and consequent unhealthy developments in the capital market and (v) paid little or no attention to / progress in development of market institutions.

While the CCI appears to have suffered from many drawbacks with the benefit of hindsight the role of CCI would have to be seen in the context of the political economy that prevailed at that time, with the government assuming a large role in the allocation of resources, an overarching concern with distributive goals and the relatively inadequate level of development of institutions that could have supported a market economy.

Role of Regulation : A Framework

There are multiple perspectives from which the rationale for regulation may be examined. The framework within which we propose to examine the role and activity of SEBI so far is presented below. The framework builds upon the primary role and functioning of the financial markets as discussed in most standard text books on the subject. [See Harris: 2002 and Fabozzi et al: 2001}. We analyse the various elements of the regulatory regime put in place by SEBI in the light of this framework.

One of the key roles of a market is to facilitate the pricing of assets. This requires the flow of quality information quickly and in a cost and efficient manner. In the context of the financial market we denote quality by the accuracy and timeliness of information. Information has public good characteristics and hence it is important to ensure that it is produced in adequate quantity to ensure proper pricing of assets.

The second key role of the financial markets is to provide liquidity to asset-owners. Liquidity arises from trade. Trade may be motivated by several considerations such as hedging risk, speculative motives and value exchange. Our interest in this paper is mainly in asset owners who see the prospect for exchanging something that they own for some other asset that has more

immediate value or attraction to them. Traders have two principal concerns when they contemplate participation in the market : Transaction Cost and Counterparty Risk.

First, traders want to be sure that the value that they exchange is less than the cost of engaging in the trade. We refer to this cost broadly as transaction cost. Transaction cost may comprise the commissions payable to trade facilitators such as brokers, cost of funds blocked in the trade due to the time taken to consummate the trade and thereafter for the assets to change hands, due to delays in trade and settlement procedures on that market and other costs, if any, such as stamp duty. Transaction cost could also be on account of the search and information cost of buyer finding seller. A third element of transaction cost may be on account of impact costs. Impact costs arise due to adverse movement in price of assets due to low liquidity levels in the market. Minimising transaction cost is not entirely the responsibility of the regulator. Competitive forces in the market (as between marketplaces or exchanges) could also be expected to bring about reduction in transaction costs. However in situations where the markets are still developing and are controlled by a group of entrenched interests and transaction costs are maintained at higher levels, (resulting in lower levels of equilibria), policy intervention in terms of regulatory mandating of institutional changes that will help reduce transaction costs would be necessary.

Second, traders want to be sure that the transaction can be completed without any risk of default. We refer to this risk broadly as counterparty risk. Counterparty risk may arise due to the lack of incentives for one of the parties in the transaction not to fulfill his trade obligation. It may also arise due to factors beyond the control of the trading parties due to emergencies in the market such as temporary or permanent closing down of the market, or a market-wide payment crisis and so on. Counterparty risks may be mitigated through private contracting. However that would be a costly process and would add to the transaction costs. Regulation is an alternative to private contracting that provides a set of rules of engagement and a cost of non compliance and thus can mitigate counterparty risks.

Thirdly, financial markets have several agency relationships: Between investors and management of the issuer company, between broker and client, between broker and sub-broker and between stock exchange ownership, its management and the brokers and dealers trading on the exchange. Resolving the conflicts in these agency relationships through private bargaining may not be just inefficient but also infeasible practically due to the complex nature of many of these relationships. A regulatory framework can also help mitigate some of these agency conflicts.

Common regulatory means of resolving the agency conflict, for eg., are ensuring meaningful disclosure as well as processes which will ensure that the issuer or the exchange may not set up costly impediments to allotments and transfer of securities.

For the purpose of understanding the institutional and regulatory aspects capital markets may be divided into primary and secondary markets. Primary markets comprise public offerings of the company securities or the first time, also known as initial public offerings or IPO. An IPO consists of securities issued by the company to raise capital to meet the investment needs of the company or sale of securities by existing investors for achieving liquidity on their investment. IPOs may also involve selling of securities by shareholders of the company looking for liquidity. The distinguishing feature of an IPO compared to a subsequent offering that the securities are sold to the public for the first time. Which is why they are referred to as unseasoned offerings. IPOs pose interesting information problems to the economist. Primary markets also include subsequent offerings after the IPO in the form of rights issues or further public issue of securities by the company, also known as seasoned offerings. Secondary markets, on the contrary, involve buying, selling or dealing in securities that have been issued by the company and allotted to some subscribers. Secondary markets are essentially a mechanism of liquidity for investors in securities. They play an equally important role in discovering the price of the security, in valuing the firm and in risk management through mechanisms of futures and derivatives. The economic, institutional and operational issues relating to the two segments of the capital market are quite distinct from each other. Overlaps exist between the two segments in terms of the characteristics just discussed.

III THE LEGAL LEVERS THAT SEBI OPERATES

In this section we look at the two pieces of statute that SEBI draws upon to discharge its statutory roles. These are the Securities and Exchange Board of India Act, 1992 (SEBI Act hereafter) and the Securities Contract Regulation Act, 1956 and the rules made thereunder. We briefly survey how these provisions enable SEBI to regulate the capital market.

III-A Securities and Exchange Board of India Act, 1992

SEBI was brought into existence by the Securities and Exchange Board of India Act, 1992 (the SEBI Act, hereafter), which came into effect on January 30, 1992. The preamble to the act describes the purpose of the Act in broad terms as "an act to provide for the establishment of a Board to protect the interests of investors in securities and to promote the development of, and to regulate, the securities market and for matters connected therewith or incidental thereto". The provisions of the SEBI Act define its role in more specific terms.[4] These broadly relate to (i) Regulating the business in stock exchanges and any other securities markets (ii) Registration and regulation of a range of financial intermediaries and trade participants (iii) Prohibiting practices that are considered to be unhealthy for development of the securities market such as insider trading and fraudulent and unfair trade practices for promoting and regulating self regulatory organisations (iv) Promoting investors education and training of intermediaries of securities markets (v) Inspection and calling for information from various regulated entities referred to in (ii) above (vi) Conducting research (viii) Collecting fees or other charges for carrying out the purposes of this section and (ix) Performing such other functions as may be prescribed. However, the provision states at the outset, while delineating these areas that the spelling out of specifics areas of concern are without prejudice to the generality of the earlier part of the section. Thus should SEBI find that development of a particular facet of the market is important for its development SEBI would be at liberty to concern itself with that facet *suo motu*, even though that has not been spelt out in the areas above that are of concern to SEBI.

Scope and source of SEBI's authority

The wide coverage of these powers may be observed from three other aspects. First, SEBI is empowered to perform such functions and exercising such powers under the provisions of the SCR Act as may be delegated to it by the central government.[5] Secondly, the SEBI Act leaves open the room for SEBI to perform such other functions as may be prescribed.[6]

The other principal source from which SEBI draws authority is from the Companies Act[7] which empowers SEBI to administer a number of provisions of the Companies Act[8] insofar as they

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[4] S 11(2) of SEBI Act
[5] S 11(2)(j) of the SEBI Act
[6] S 11(m) of the SEBI Act
[7] S 55A of the Companies Act

relate to issue and transfer of securities and nonpayment of dividend in the case of listed companies, as well as those public companies which intend to get their securities listed on any stock exchange. Further, unlisted companies are now allowed to list their debt securities without listing their equity securities.[9] Thus the provisions of the Companies Act to be administered by SEBI will now extend to those companies whose debt securities are listed even if their equity shares may be closely held, should these companies be considered as listed companies as indeed they ought to be. Companies which propose to expand their equity shareholder base to more than fifty members will be deemed to have made a public offer.[10] As such companies which have more than fifty members should fall under the regulatory purview of SEBI since all companies that intend to make a public offer are required to get their shares listed on a recognized stock exchange.[11]

The sections of the Companies Act above relate to procedure for issue of prospectus, and the contents mandated by the company law, authorization and responsibility of those authorizing the issue of the prospectus, procedure for allotment of shares and debentures, payment of brokerage and commission, buyback of shares, issue of shares at a premium or discount, further issue of capital (rights or otherwise), issue and redemption of preference share capital, administration of share capital (such as numbering, certificates and so on) transfer of shares and certification of shares, provisions relating to issue of debentures and protection of debentureholders such as creation of trust and redemption reserve and payment of dividend. These sections pretty much govern the capital mobilization process (issuance of capital), liquidity creation process (transfer) and the realization of return (dividend), the three important aspects of the issuer's relationship with investors. It is worth pointing out that these fundamental aspects are governed by the Companies Act and SEBI is merely playing the role of an administrator of these provisions insofar as they relate to listed companies.

SEBI's regulatory strategy

The principal approaches resorted to by SEBI for achieving its objectives as a regulator are (i) Registration and licensing of market participants (other than investors) (ii) Mandating disclosure

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[8] The sections identified are Sections 55 to 58, 59 to 84, 108, 109, 110, 112, 113, 116, 117, 118, 119, 120, 121, 122, 206, 206A and 207 of the Companies Act.
[9] Regulation 8.2 of SEBI's (Disclosure and Investor Protection) Guidelines, 2000 as amended
[10] S 67(3) of Companies Act
[11] of Companies Act

of information by issuers, various intermediaries and participants (iii) Making rules governing the conduct of market participants (iv)Enforcement of compliance with the rules through (a) Collection of information (b) Inspection of intermediaries' business and records (c) Penal action against errant participants, where appropriate or necessary (v) Market development initiatives (vi) Investor protection and education initiatives.[12] We discuss all but the last two aspects in this section.

Registration and Certification

The SEBI Act provides that no stockbroker, sub-broker and such other intermediary who may be associated with the securities market shall buy, sell or deal in securities except under and in accordance with the terms of the certificate of registration. Intermediaries subject to the licensing process of SEBI include depositories, depository participants, custodians, credit rating agencies, mutual funds, venture capital funds, foreign institutional investors and collective investment schemes and the buying, selling and dealing of securities. SEBI has evolved rules and regulations governing each one of these intermediaries or participants under which the firm gets registered. Typically these regulations also specify conditions relating to the size, capital adequacy, business conduct, record keeping and so on.

Mandating disclosure of information

SEBI drives disclosure through the stock exchanges mainly. Three reasons may be advanced in favour of SEBI driving the disclosure in this regard through stock exchanges. For a long time prior to the advent of SEBI issuers had been providing some amount of periodic financial information to stock exchanges as part of their listing obligations. It made practical sense to continue with that approach. Second, by definition, by and large these items of information are price sensitive. Speedy dissemination of such information is important. Stock exchanges are likely to be better equipped than SEBI to disseminate this information. Thirdly, it is a step towards preparing the stock exchanges to evolve into being SROs, or at least allowing more regulatory activity to devolve in the favour of stock exchanges.

Information to be produced at the time of a primary issue is governed by the Companies Act which is being now administered by SEBI. The disclosure requirements in the prospectus and

[12] These are based on the provisions of S 11 of SEBI Act

offer documents relating to rights issues generally further build on the requirements of the Companies Act. SEBI further requires intermediaries associated with the capital markets to provide information related to the transactions that they are associated with, compliance with which is mandatory. Much of the information that is produced in compliance with the regulations is such as to enable the regulator and the other participants in the trade to develop a complete picture of market preferences for various alternative investments. In the absence of regulatory compulsion on participants in the market there would be under-production of information as has been witnessed in the case of market for privately placed debt.

Making rules and Issuing Directions

This is one of the most significant aspects of SEBI's functioning so far. The SCR Act and Rules and the SEBI Act are enabling statutes that empower SEBI to make rules and regulations maximizing welfare either proactively or in response to developments in the market that potentially challenge the functioning of the market mechanism. The SEBI Act provides for SEBI "to make regulations consistent with this Act and and the rules made there under to carry out the purposes of this Act." [13] A wide range of powers has also been delegated by the Central Government to SEBI under the SCR Act.[14] All the rules and regulations made by SEBI governing the activities of the various capital market participants have all been under the rule making powers under this Act except in the case of the Depositories Act, 1996, which we shall discuss later.[15] Apart from these powers to make rules SEBI may also issue directions from time to time SEBI may issue directions to intermediaries in the market as well as issuers so as to protect investors or to ensure proper management of the intermediary's affairs.[16] SEBI has used the power to issue directions quite extensively across a number of instances. We look at a few such instances in the fourth part of this paper.

Compliance Enforcement

In addition to being armed with powers to enforce compliance with the rules and regulations that it makes we have seen how SEBI has been provided powers to administer the relevant parts of the Companies Act and SCR Act. For eg., SEBI is empowered to carry out inspection of listed

[13] S 30 of SEBI Act
[14] S 29A of SCR Act
[15] S 11, 11A and S 30 of the SEBI Act.
[16] S 11B of SEBI Act

companies to the extent that it is necessary for enforcement of the provisions that it is responsible for[17]. SEBI is also empowered to lodge a complaint to initiate legal proceedings in a court against listed companies in respect of the provisions of the Companies Act that it is responsible for.[18] We have already noted the powers of enforcement that SEBI has against the stock exchanges.

Under the SEBI Act, the Board has the power to call for periodic information and undertake routine or one-off inspections of the books of intermediaries, records, facilities, and premises, audits and inquiries.[19,20] These powers are also exercisable under the provisions of individual rules and regulations. In case the books and records required are not made available by the issuer by the intermediaries or issuer concerned SEBI may seek permission from a first class magistrate to enter the premises of the business concerned and seize such records as necessary.[21] During the course of an investigation SEBI is empowered to call for information and record statements from any bank or any other institution established under a state, central or provincial statute insofar as it relates to a transaction in securities, which is under investigation.[22] SEBI's information gathering activities go beyond these formal and official channels as in the case of public issues for eg., where it gathers information from a variety of other non official sources.[23]

In case the information gathering, inquiry or inspection exercises reveal non-compliance with the provisions of the SEBI Act, rules or regulations, SEBI has powers under the SEBI Act as well as individual rules and regulations to enforce compliance, deter continued or further non-compliance or cure any breaches in the compliance through a series of measures ranging from passing strictures and issuing warnings to the non-compliant participant, to enforcing reversal of non-compliance to imposition of fines, suspension of intermediary from the market, cancellation of licenses or in instances of grave violation to prosecute the violator and award punishments including imprisonment.[24] In case an inquiry reveals violations of SEBI's regulations by an

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[17] S 209 A of Companies Act
[18] S 621 of Companies Act
[19] S 11(2)(i) of SEBI Act
[20] Powers to inspect the books of a company under grounds of suspected insider trading or unfair trade practices is exercisable under section 11(2A) of SEBI Act
[21] S 11C(8) of SEBI Act
[22] S 11(2)(ia) of SEBI Act
[23] SEBI's Annual Report 1993-94, p 14
[24] The procedure for carrying out these inquiries and warding penalties under the SEBI Act and the related rules, regulations and guidelines are provided for under the Securities and Exchange Board of India (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002. These

intermediary or SEBI has reasonable grounds to believe that an issuer who is about to get its securities listed on a stock exchange has indulged in market manipulation or insider trading, which need to be immediately checked, SEBI may issue "cease and desist orders".[25] As an emergency measure, pending the investigation or completion of inquiry SEBI may order the suspension of trading of a security on a stock exchange, restrain persons from accessing the securities market, buy sell or deal in securities or suspend office bearer(s) of stock exchanges or SROs, impound or retain securities underlying the transaction being investigated or attach bank accounts with magisterial permission.[26] The summary nature of these powers might appear extra ordinary and considerable in terms of scope and effect; but considering the speed with which financial markets react to information and and events and the criticality of maintaining confidence in the market in terms of pre-empting or stopping continued injury to investors and other market participants, speed ad effectiveness of deterrent action are important and these provisions enable speedy deterrence. Finally, the SEBI Act provides for a set of monetary penalties for most of the major violations of the regulations.[27] It is interesting to note that the SEBI Act may be one of the few laws, if not the only one, that provides for disgorgement of profits made out of practices that violate the law.[28] In an interesting contrast, the maximum monetary penalty under the Companies Act is Rs 50,000 after the penalties were recently increased hundred fold. One possible justification for the difference in the monetary penalties is that in the case of listed companies the loss of welfare consequent to a violation can be of larger financial magnitude and if left undeterred can lead to a downward spiral in the financial markets. The objective in disgorging profits acquired through illegitimate means is not to restore the affected investors to their earlier levels of welfare; for the proceeds of these penalties are credited to the Consolidated Fund of India.[29] These penalties would therefore appear to be meant to take away the economic incentives from these violations. To enforce the powers vested under the SEBI Act and many of the related regulations, including the Depositories Act, 1996, SEBI has the powers of a Civil Court under the SEBI Act.[30]

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regulations specify a uniform set of procedures to be followed across the entire set of SEBI related or SEBI made rules and regulations.

[25] S 11D of SEBI Act.

[26] S 11(4) of SEBI Act

[27] S 15A to S 15HB of the SEBI Act

[28] S 15HA which levies penalty for fraudulent and unfair trade practices.

[29] S 15 JA of SEBI Act

[30] The powers of a Civil Court under the Code of Civil Procedure, 1908, while trying a suit, relate to (i) Discovery and production of books of account and other documents, at such place and such time as may be specified by the Board (ii) Summoning and enforcement of attendance of persons and examining them on oath (iii) Inspection of books, registers and other documents of any person referred to in S 12 of SEBI Act

Review and Appeal Mechanism

A person aggrieved by an order of SEBI or by an adjudicating officer under this Act may appeal to the Securities Appellate Tribunal.[31] The SAT may confirm, modify or set aside SEBI's order. An appeal aginats an order of the SAT would lie at the Supreme Court (SC). But the SC's review of the SAT order would be limited to the a question of law relating to the above order and not to one of facts.[32] The provisions relating to the appointment of the Presiding Officer and the members of SAT and restrictions on movement of personnel from SEBI to SAT are meant to ensure an arm's length relationship between the regulator and the appellate body and that the SAT plays the role of an independent agency.[33] That said, the role of the Central Government in the appointment of the Presiding Officer and the limited nature of the review of the SC have caused some concern about the effectiveness of SAT in providing effective redressal of grievance against a SEBI order.

III-B The Securities Contract Regulation Act and Rules

Trade in securities in India has been regulated primarily through the Securities Contract Regulation Act, 1956 (14 of 1956) (SCR Act, hereafter) and the rules made thereunder, the Securities Contract Regulation Rules, 1956 (SCR Rules, hereafter). The object of the SCR Act is to provide for the regulation of stock exchanges and of securities dealt in on them with a view to preventing undesirable speculation in them. It also seeks to regulate the buying and selling of securities outside stock exchanges through its various provisions that we shall discuss later. The post war boom in the stock exchanges between 1945 and 1946 and its aftermath emphasized the urgency of stock exchange reform on an all-India basis. Two amendments in 1995 and 1999[34] brought about several important changes to the scope and the administration of the SCR Act, resulting in the current form of the law. Together with the SCR Act, the SCR Rules provide the

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(iv) inspection of any book, or register, or other document or record of the company referred to in Section 12(2A) of SEBI Act and (v) Issuing commissions for the examination of witnesses or documents.

[31] S 15T of SEBI Act

[32] S 15Z of SEBI Act

[33] In the SEBI Act, S 15L SEBI deals with the appointment of the members and the presiding officer of SAT, 15M provides restrictions on appointment of serving and former officers of SEBI to SAT.

[34] Securities Laws (Amendment) Act 1995 and Securities Laws (Amendment) Act 1999 respectively

basic legal framework for the regulation of the securities market in India, while the Companies Act provides the legal framework for the administration of body corporates in India.

The law has an inclusive and broad definition of "securities" as "shares, scrips, bonds, debentures, debenture stock or other marketable securities of a like nature" and covers derivatives, units of collective investment schemes (such as mutual funds) and government securities.[35] Courts have interpreted the term "marketable" to include shares that are freely transferable even if they are not listed on a stock exchange. Further, the SCR Act deals with contracts in securities and hence those companies that list only their debt securities without listing their equity instruments [36]would fall under the regulatory purview of the SCR Act.

The principal elements of the regulatory role of SCR Act are : (i) Limiting and prohibiting contracts in securities to defined constituencies, geographical areas or trading fora (ii) Licensing of stock exchanges (iii) Controlling of stock exchanges (iv) Regulating Issuer Conduct and (v) Control over the Listing Agreement. We will discuss each of these elements in some detail and analyse the purpose they serve on the basis of the framework outlined earlier.

Licensing of Stock Exchanges

Contracts in securities may be entered into and performed only on recognized stock exchanges.[37] The power to grant recognition stock exchanges has been vested in SEBI[38] and may be accorded in response to an application in the form prescribed for that purpose along with necessary enclosures, if SEBI feels that the granting of the license is the in the interests of the trade as well as the public.[39] The process of licensing has important economic, legal and policy implications. Once a stock exchange is recognized under the SCR Act, (referred to as recognized stock exchanges or just stock exchanges in the rest of this paper) in a particular area, it gets the exclusive right to function as a stock exchange in that area. An injunction may be obtained against any other firm which attempts to set up and advertise something similar even if it does not

[35] S 2(h) of SCR Act
[36] Under Regulation 8.2 of the Disclosure and Investor Protection Guidelines 2000, as amended
[37] S19 of the SCR Act
[38] Many of the powers exercisable by SEBI are actually concurrent with the central government. A list of such powers is provided at the end of this note in Annex I. In these discussions all powers exercisable by SEBI are concurrent with the central government unless stated otherwise. Many of such powers have been delegated by the Central Government to SEBI under S 29A of the SCR Act.
[39] S 3 of the SCR Act.

call itself a stock exchange. Thus licensing provides the stock exchange a monopolistic position.[40] At the same time the fact that the stock exchange is also deemed to be a statutory body with a public duty ameliorates the risk of arbitrary behaviour by the exchange as a monopolist in the conduct of its business.[41] The monopolist status of stock exchanges and the consequent lack of competitive pressure can lead to some of the inefficiencies that we alluded to earlier, warranting the need for regulatory or policy intervention. However through the process of licensing, by imposing such conditions as SEBI may consider necessary, SEBI can ensure that the affairs of the exchange will promote economic efficiency or other welfare goals that the regulator may deem appropriate.

Limiting and prohibiting contracts: In addition to the licensing of stock exchanges the SEBI may notify that in a particular state or area every contract which is entered into after the date of the notification has to be between, through or with members of a recognised stock exchange.[42] SEBI may also prohibit contracts in certain notified securities in notified areas (other than those notified under S 13 as above) to be carried out by persons who have been licensed by the central government. SEBI (and in this case the Reserve Bank Of India or RBI) also may also prohibit contracts in securities "to prevent undesirable speculation in specified securities in any State or area" or limit them to a specified level.[43] The legal nuances of these provisions aside, as the courts have observed, the SCR Act confers an effective controlling power on the Central Government over the stock exchanges".[44] The provisions limiting or prohibiting contracts have been invoked by the Central Government in the past on many occasions against what was felt to be build up of unhealthy speculative activities or positions, with the prospect of leading to loss of investor welfare and eventually loss of investor confidence in the securities market system.

Controlling Exchanges

At the heart of the conduct of the business of the exchange and its administration are the bye-laws and the governing body of the exchange. The application for grant of recognition of stock exchanges has to be accompanied by documents relating to these. SEBI has the power to direct

40 Radhakrishnan vs Cochin Stock Exchange Ltd. (1994) 80 Com Cases (Ker).
41 AIR 1996 Andh Pra 413 (1996)
42 S 13 of the SCR Act
43 S 16 of SCR Act
44 Madhubhai Amatlal Gandhi Vs Union Of India AIR 1961, SC 21, 23-24: (1960) Com Cases 667 (SC)

stock exchanges to make rules or to draft rules *suo motu* wherever it deems necessary.[45] The bye-laws of a stock exchange requires the prior approval of SEBI before it comes into effect.[46] Where SEBI feels the need for the same it may direct changes to be made to all or any of the provisions of the bye-laws.[47] Further, where SEBI perceives a problem with the governance and the administration of the stock exchange, it may supercede the governing body of the stock exchange, by serving a notice in that regard, and the governance of the exchange then passes over to the nominees of SEBI.[48] Finally, in the event of an "emergency" if SEBI "considers it expedient so to do" it may direct that the business of the stock exchange be suspended for a period of seven days to begin with and for subsequent periods of seven days at a time if it feels that it will be in the interests of the trade and public interests to do so.[49] Thus SEBI has a range of tools at its disposal to control the affairs of stock exchanges, from controlling the key levers of the management and administration of the business to bringing the conduct of business to a halt for such lengths of time as it finds necessary.

Bye-Laws of Stock Exchanges

The bye-laws of the exchange typically deal with trading hours, establishing of clearing and settlement mechanisms, terms and conditions of contracts between members inter se, members and non-members, consequences of default or insolvency, criteria for and conditions of listing of securities, brokerage terms, separation of functions of jobbers and brokers, dealings of brokers on their own accounts and providing of information by brokers to the governing body of the exchange as required. The bye-laws are the basic contract that governs the conduct of the members of an exchange inter se as well as the conduct between the members and the management of the exchange and between issuers and the exchange. As noted above, the bye-laws allow the exchange management to lay down the business rules on the exchange. By requiring that the bye-laws require SEBI's approval and allowing SEBI to amend the bye-laws through the management of the exchange or through fiat, SEBI wields control over nearly every facet of the functioning of the exchange.

[45] S 8 of SCR Act
[46] S 9(1) of SCR Act
[47] S 10 of SCR Act
[48] S 11 of SCR Act
[49] S 12 of SCR Act

Listing of Securities

The conditions for listing of securities are a matter that falls under the powers of the stock exchange. It is one of the matters on which the stock exchange may establish rules as part of the bye-laws.[50] As such, companies or collective investment schemes which wish to get their securities or units respectively listed on a stock exchange have to apply to the stock exchange on which they wish to get registered and comply with the necessary conditions in that regard. In case the stock exchange does not list the shares or does not communicate the decision not to list with reasons within ten weeks from the closure of the subscription list[51], the company or the collective investment scheme may appeal to the Securities Appellate Tribunal[52]. The stock exchange's decision may be set aside or varied by SAT after hearing the stock exchange's views.

The SCR Rules define the documents and information that a company needs to provide to the stock exchange while seeking listing of its securities[53] and a collective investment scheme needs to furnish for listing its units.[54] The information sought for typically includes copy of the memorandum and articles of association, prospectus, copies of key contracts with vendors, promoters, underwriters and top management, brief terms of key commercial agreements entered into by the company, historical financial statements of the company, copies of all documents and reports referred to in the prospectus, copies of acknowledgement card from SEBI, list of ten largest holders of each class of securities and so on. The exchange may stipulate additional conditions apart from a few basic requirements regarding the articles of association specified in the SCR Rules.[55] Companies may offer a minimum of 10% of each of the securities sought to be listed if they satisfy the following conditions : Minimum 20 lakh securities to be offered(excluding reservations, firm allotments and promoters' contribution), minimum offer size to public of Rs 100 crores and book built issue with 60% to be offered to Qualified Institutional Buyers (QIBs). A company that does not satisfy these criteria would need to offer a minimum of 25% of the securities instead of the 10%.[56] Stock exchanges have the right to relax the minimum

[50] S 9(1)(m) of the SCR Act
[51] S 73(1) of the Companies Act
[52] S 22A of SCR Act
[53] Rule 19 of the SCR Act
[54] Rule 20 of the SCR Act
[55] Rule 19 (2)(a) of the SCR Act
[56] Rule 19(2)(b) SCR Rules

issue rule with the prior approval of SEBI.[57] A recognized stock exchange may suspend or withdraw the admissions to dealing in the securities of a company in case of non-compliance with the conditions of the listing agreement, which can be contested by the company with the Securities Appellate Tribunal.[58] In addition to the above, the SCR Rules specify a detailed set of rules that companies seeking to list need to comply. These rules govern the processes of allotment, splitting of share certificates and so on, commit the company to provide periodic information and updates on exceptional material events to the exchange, and intimate the exchange of "any other information necessary to enable shareholders to appraise the company and to avoid the establishment of a false market in the shares of the company".[59] The extremely specific and administrative nature of some of these requirement raise the question of whether they should form part of the listing rules or be left to administrative circulars from the Department of Company Affairs. The Rules leave an overarching authority in the hands of SEBI to waive or relax the enforcement of the listing requirements of SCR Rules.[60]

As mentioned earlier, the relationship between the stock exchange and the issuer company is governed by the listing agreement.[61] The primary purpose of the agreement is to ensure that the issuer complies with certain requirements relating to the disclosure of information, allotment, investor servicing, transfer of shares and so on such that the interests of the traders, investors and brokers who avail of the services of the exchange are protected. One of the means by which SEBI tries to ensure a minimum level of investor protection is proposing a draft listing agreement, which has the minimum provisions that SEBI deems necessary. Exchanges are at liberty to provide for additional requirements in their agreements. Some of the key issues [62]that the standard agreement deals with are format and issue of letters of allotment and certificates, procedure and standards of servicing of investor application for transfer and issue of duplicate certificates, closure of books, disclosure of information relating to dividends, bonus shares, due process for new or further issue of shares, furnishing of periodic and annual financial and other reports, quarterly information on shareholding patterns, committing not to create a lien on shares, not to forfeit dividend earlier than required by law, agreeing to communicate material

[57] Rule 19(6A) if SCR Rules.
[58] Rule 19(5) of SCR Rules
[59] Rule 19(3) of SCR Rules
[60] Rule 19(7) of SCR Rules
[61] Rule 21 of SCR Act
[62] These observations are based on the draft listing agreement of The Stock Exchange, Mumbai.

developments, [63] furnishing unaudited quarterly results and half yearly results with a limited review. The listed company is required to maintain the non promoter holding at the minimum that is required as part of the conditions of listing.[64] The company will not make preferential allotment of share in case the post issue holding will drop below the minimum. In case the percentage of non-promoter holding falls below the minimum and the company does not manage to raise the non promoter holding to at least 10% it will be required to buy the shares of the company back as provided for in the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997. In case there is a takeover offer or change of control of the company, the new management as well as the company will continue to comply with the requirements of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997.

Information, Investigation, Offences and Penalties

Information and Reporting Requirements : In order to ensure compliance with these provisions SEBI needs to have access to information on the activities of the exchange. SEBI has the right to call for periodical returns[65] as well as annual reports.[66] Where the need arises in the interests of the public or the trade, SEBI has the right to initiate an inquiry into the affairs of individual members of the stock exchange or the stock exchange as a whole.[67] If in the interests of the trade or public interests, the Central Government feels the need, it may ask for an inquiry into the affairs of a stock exchange by SEBI or an inquiry into the affairs of an individual member by the governing body. The officers of the stock exchange in question, its members and every other person or company who has had dealings with the exchange, its officers or members, directly or indirectly will be bound to produce the investigating authority all books, documents, records and information that may be called for.[68] The report of this investigation is to be provided to SEBI. Clearly, this is a sweeping power meant to enable the central government to develop a clear understanding of the affairs and working of an exchange whenever the circumstances so warrant.

[63] such as change in nature of business, disruption of operations due to natural calamity, commencement of commercial production / operations, regulatory changes in pricing / realization, litigation / dispute with a material impact, revision in ratings any other information having a bearing on the operation or performance of the company as well as price sensitive information, examples of which are given in Clause 36 (7)
[64] Clause 40A of the Listing Agreement
[65] S 6 of the SCR Act
[66] S 7 of the SCR Act
[67] S 6(3) of the SCR Act
[68] S 6 of the SCR Act

Finally, SEBI may withdraw recognition to the stock exchange, if it is convinced that it is necessary to do so in the interests of the trade or in public interest.[69]

The SCR Act specifically recognizes a few offences, which are deemed to be a cognizable offence under the Code of Criminal Procedure.[70] The offences are unwillingness to co-operate in an investigation by the central government of the affairs of a stock exchange,[71] contracting in contravention of the restrictions in certain areas[72] or restrictions on certain types of contracts discussed earlier[73], owning or managing a place for the purpose of carrying on trading in securities other than a recognized stock exchange or gathering at a place other than the place of business specified in the bye-laws of the stock exchange, and inducing people that they can invest through oneself or advertising for securities business when one is not a member of a recognized stock exchange or a dealer licensed under S 17 of the SCR Act.[74] These offences can be punished with imprisonment of up to one year or fine or both.

Analysis of the provisions of the SCR Act

In the process of granting the license SEBI is expected to ensure that the applicant has the infrastructure and that its charter documents such as the bye-laws have provisions to conduct the business of securities trading in an orderly manner. The bye-laws provide the mandate to the stock exchange to frame appropriate rules, the type of order system that the exchange may adopt, rules for qualifications for brokers, the kind of trading systems that the exchange may adopt, clearing and settlement procedures, criteria for listing and so on. The bye-laws empower the stock exchange to deal with the issue of counter-party risks in a variety of ways. By providing a framework of rules that deal with the issue of defaults and procedure for dealing with defaults (such as auctioning of defaulting parties position) the bye-laws can mitigate counter party risk at individual traders' level. By providing for appropriate documentation of trades executed by brokers on behalf of clients, the exchange can improve the confidence level of investors trading on that exchange. Exchange level crises may be avoided by providing for margining systems, monitoring the position of brokers and dealers so as not to let them build positions that can increase the risk of an exchange level default and providing for a settlement and trade guarantee

[69] S 5 of SCR Act
[70] S 25 of the SCR Act
[71] S 6(4) of the SCR Act
[72] S 13 of the SCR Act
[73] S 16 of the SCR Act
[74] S 23 of the SCR Act

fund that will minimize the risk of loss due to an exchange wide crisis. Notionally, the bye-laws as provided for on the books allow for a great deal of differentiation among the exchanges. However, as we shall see later, in the case of trading and settlement systems, by exercising its powers to modify the bye-laws SEBI has been setting minimum standards for the exchanges on many of these issues so far.

Similarly, in the area of information disclosure SEBI has driven the content and the frequency of the continuous disclosure regime as may be noticed from the discussion on the listing agreement above. Instantaneous dissemination of related information is now possible now thanks to information technology. Disclosure by issuers at the time of listing largely comprises the disclosure in the prospectus since the listing agreement requires more of supportive documentation such as copies of contracts and records and does not require much additional substantive content by itself that is not already included in the prospectus or offer document. At the trading level the exchange can minimize instances of trading on the "kerb" or off market transactions which may result in incomplete information flowing through to the rest of the market. The exchange may on its own or under a SEBI directive prohibit certain specific types of trades or trading practices in case they hinder the flow of information and consequently or otherwise affect the microstructure of the market. For eg., SEBI directed that block trades which were getting executed outside the market trading mechanism be routed through the electronic trading systems of the stock exchange so that the information may be absorbed immediately by the market. [75] The exchange may also invest in market surveillance systems which could help detect insider trading or market manipulation transactions. We will discuss the specific role that SEBI has played in the enhancement of the flow of information relating to issuance of securities and trading in our discussion on the role of SEBI in primary markets and in the trading and settlement systems.

Transaction costs, as we noted earlier, consist of direct costs such as brokerage and indirect costs such as illegitimate gains of the broker in not passing on the benefits of the best price or in simply misreporting the purchase or sale price of the order, the cost of funds blocked due to the settlement cycles or delays at the issuer's end in delaying or mishandling the transfer of securities. The bye-laws provide enough leverage to fix brokerage rates, form operational

[75] It is worth noting that since these block trades are spot transactions it would be perfectly legal under the SCR Act to execute them outside a stock exchange. However, the restriction on block trades is an instance of how the SCR Act provides SEBI with the authority to bring every transaction in securities under its supervision.

procedures and rules that will force brokers to be transparent with the client in terms of the break up of the purchase price and the brokerage in the contract note and installing an electronic trading system which will help the client ensure that the price of his trade has not been misreported to him by the broker. The minimum offer to the public and conditions for continued listing essentially are aimed at ensuring a minimum floating stock of the company's securities in the market. A minimum non-promoter holding does not obviously ensure the level of liquidity that is required to bring down impact costs. However, it is a first step in that direction. Stock exchanges could also look at other liquidity enhancement measures such as market making that will reduce impact costs. These are within the purview of the exchange's business policies. The Over The Counter Exchange of India (OTCEI), for eg., has always required issuers to provide for at least market makers, with some minimum performance conditions thrown in.

The provisions of the SCR Rules relating to allotment and transfer of shares, book closure dates, forfeiting of dividends, procedures for dealing with defective applications for transfer, issue of duplicate certificates and so on are steps to ensure that the management of the company does not misuse the trade and transfer or allotment process to their benefit and the detriment of the investor. Market manipulation, creation of a false market and price rigging by promoters and owner managers of companies followed by dumping of share, causing losses to the outsider investor can be mitigated by the tracking of trading patterns with the help of surveillance systems mentioned earlier and a set of deterrent punishments. Termination of membership of the brokers and withdrawal of listing for the securities of the delinquent issuer are two extreme options that are well within the ambit of the bye-laws of stock exchanges. The agency problems between brokers and their clients have been discussed as part of the transaction cost. There could be conflicts between sub-brokers and the main brokers. The bye-laws allow exchange to frame rules that will make it costly for sub-brokers to act against the interest of the main broker and thus mitigate some of the agency problems.

In short, the discussion above shows that the SCR Act does, directly as well as indirectly, address the various issues or problems that we stated could potentially come in the way of the stock exchange playing its role as a market for securities. The regulation leaves enough flexibility with the exchanges to make rules which will mitigate the problems at the level of individual exchanges. It does however empower SEBI to monitor if exchanges play that role and where they do not it empowers SEBI to influence them to do so, or should the circumstances demand

even direct them to do so with the threat that failure to comply with the directive could invite punitive action from a range of deterrent measures that SEBI has at its command.

To what extent have stock exchanges used the powers vested in them by the bye-laws in addressing the problems that we have discussed, in case such problems are indeed prevalent on those stock exchanges? That is a matter for considerable research in itself and beyond the scope of this paper. Elsewhere in this paper we will examine the role that SEBI has played in driving some of the developments on Indian stock exchanges in an attempt to resolve some of these problems.

IV SEBI'S REGULATORY PERFORMANCE – TWO INSTANCES

Since its inception in 1992 SEBI has been actively engaged in developing the regulatory framework as well as developing new institutions or overhauling the existing institutions to improve the functioning of the capital markets. In the previous section we referred to the series of rules and regulations making initiatives of SEBI.

The rule making activity of SEBI so far is summarised in the table below. The table lists the intermediary or capital market activity sought to be regulated by each of these separate rules and / or regulations.

Primary	**Secondary**	**Investment Institutions**	**Trading Ops**	**Others**
Bankers	Brokers / Sub-brokers	Mutual Funds	Depositories, Depository Participants	FUTP Regulations
Underwriters	Takeover Code	Venture Capital Funds	Custodians	Insider Trading
Merchant Bankers	BuyBack of Shares	Foreign VC Institution		
Registrars / Share Transfer Agents		Collective Investment Schemes		
Disclosure and Investment Protection Guideline				
Debenture Trustee		Foreign Institutional Investor		
Credit Rating Agencies				

Tracing the evolution of these rules and regulations over the years can offer insights into the approach underlying the same, adopted by SEBI. In this part we trace the evolution of two of the more important among these developments: The development of the rules governing the public issues by companies, more particularly, the public issue of equity shares and the some of the key

developments in the secondary market. The emphasis here is on the major developments and trends in the evolution rather than minutiae.

We primarily rely on the regulations per se and the annual reports of SEBI from 1992-93 to 2002-2003 to carry out the exercise. The SEBI annual reports provide an overview of the policy making activities of SEBI during the year under review. In some instances the analyses point out questions of an empirical nature that would need investigation in order to establish the purposes achieved by the regulation in question.

We examine the developments in the public issue of equity shares along the following lines:

Regulation of Disclosures: We trace the evolution of the key disclosure requirements for companies planning to make a public issue.

Access Criteria: These are criteria applied by the regulator to screen issuers that can make a public issue. Unlike in the case of disclosures, access criteria may be said to distort the market mechanism in that the investor's opportunity set is artificially constrained or limited by the regulator. We analyse the access criteria to see if they can actually serve the purpose they might be intended to.

Issue Mechanism: This deals with institutional mechanisms put in place by the regulator to ensure that (i) The issue process allows better discovery of price and demand for the shares and (ii) The allotment mechanism meets the desired economic or social objectives.

Pricing: Although an outcome of the issue mechanism, pricing is being discussed separately here because traditionally pricing of securities has been regulated in the past in India to achieve social objectives. We examine pricing related regulations here, if any, to understand the economic or social purpose that they are intended to serve.

Bonding: We analyse the provisions which might ensure that the managements of firms or the owner-managers as the case may be bond themselves to fulfill the contract implicit between the investor in a company and the management. One would expect that the typical mechanism would involve some means to align the interests of the management to that of the investor or the interests of the owner manager or insider shareholder to that of the external investor.

Certification: Ensuring compliance with the regulations through a process of monitoring and penalizing non-compliance can be a costly process for the regulator and eventually will adversely impact the welfare of the society that is intended to benefit from the regulation. A regime of certification by intermediaries who participate in the market, backed by an appropriate set of

incentives such as renewal of the intermediary's license to engage in business, in return for compliant behaviour, can be a delegated and more cost effective means of ensuring compliance. We analyse the regulation to see if there are such mechanisms in place.

Our discussion of the developments in the secondary market is along the lines of the following framework.

Trading and Settlement Systems: We trace the regulatory initiatives of SEBI to improve the trading and settlement systems in the various stock exchanges and their impact on the transparency of the system, efficiency in terms of minimizing transaction cost and reducing counterparty risk.

Dematerialisation : The impact of dematerialsation cuts across stock exchanges and also impacts the securities market in a broader sense. We trace the steps taken by SEBI to implement dematerialisation and the rationale for the same.

Continuing Disclosure: The area of continuing disclosure by listed companies has witnessed enormous change under SEBI's regulatory regime. This paper analyses the expanding coverage of continuous disclosure requirements and the rationale for the same.

Governance of Stock Exchanges: We survey the steps taken by SEBI to improve the governance of the stock exchanges and their possible impact on the functioning of the exchanges.

Risk Management and New Products: While there has been considerable progress in these two areas we do not survey them in this paper.

Regulation of Disclosures

During the first five years leading upto 1995-96, SEBI appears to have focussed to a large extent on the primary markets, especially on disclosures and regulation of intermediaries associated with the market and on the governance of stock exchanges. The first Disclosure and Investor Protection Guidelines were announced in December 1992. The main changes in the disclosure regime during the year related to mention of premium as per the erstwhile CCI pricing formula as a benchmark, disclosure to bring out the promises held out by the promoters in the past against the actual performance, manner of investment and deployment of issue proceeds historical stock prices to bring out the genuineness of market price and possibility of price rigging. In 1993-94, SEBI announced a code of advertisement and required that issue related advertisements had to emphasise highlights as well as risks in equal manner.

The first major initiative to bring about a substantial improvement in disclosure levels compared to the past was in 1995-96. SEBI's annual report for 1995-96 stated "the principal focus of the activities were on improving the disclosure standards"[SEBI : 1996]. The trigger appears to have been "the quantitative growth of the market and the freedom to price issues had also raised questions about the quality of issues entering the market." [SEBI : 1996]. The new disclosure regime implemented nearly entirely the recommendations of the Committee headed by Shri YH Malegam, popularly known as the "Malegam Committee." Broadly, the recommendations required disclosure of pre-issue expenses and means of financing for the same, bridge loans if any to be rapid from the issue, break-up of turnover product / businesswise, adjustments for revaluation reserves on the assets as well as the reserves in the issuer's balance sheet, shareholding of promoters and directors of promoter company, details of technical and financial collaboration, details of unusual or infrequent events or transactions which are likely to affect income from continuing operations, quantification of effect of auditors' qualifications and management's discussion of financial conditions and operations as reflected in financial statements. Financial projections were allowed only in the case of new companies or projects and substantial expansions. The advertisement code was further strengthened to prevent advertisements from the time of receipt of the acknowledgement card till receipt of the minimum subscription was confirmed by the merchant banker. As a measure of further enhancing the transparency levels the draft prospectus was required to be made available to the public at large. These disclosures not only expanded the coverage but also provide a finer resolution picture of the issuer's business and financial performance, including financial projections where there is no historical performance to fall back upon.

The next round of disclosure related amendments was announced in 2000-01 [SEBI 2001]. These requirements included details of utilization of funds raised from promoters and other reservations and firm allotments, investments of the same where it has not been fully utilized. The new requirements prohibited financial projections in all cases, in contrast to the Malegam Committee recommendations. Issuer companies were required to justify the price based on financial ratios; if the price was not justified the issue would not be allowed to proceed. In the case of book-built issues the issue could be floated at the price based on demand from Qualified Institutional Brokers (QIBs), thus providing an added advantage for book-built issues. The emphasis in this round of additional disclosure requirements has been on justifying the price on the basis of historical financial ratios or on the basis of price estimated by the QIBs, instead of financial projections. In order to ensure a level playing field amongst institutional investors and retail

investors SEBI limited the information in research reports to information that was available in the offer document, once observations from SEBI were received on the offer document. [SEBI : 2002]. The requirement of equal emphasis on risks as well as highlights would apply to research reports as much as they did to advertisements. The offer document was to contain only a floor price and not a maximum or a range so that the investor would not be influenced by the price indicated in the offer document. [SEBI : 2002]

What were the developments in the capital market that triggered these changes? Were these regulatory responses appropriate or adequate? Did the performance of subsequent IPOs reflect the intended effect? These are questions waiting to be answered.

Access Criteria

The early set of access criteria announced by SEBI as part of the DIPG 1992 allowed every company to make a public issue as long as it satisfied the criteria of the stock exchanges. The difference between a company with a profitable track record (or companies where more than 50% of the paid up equity capital was held by companies which had a profitable track record) and that without a track record was merely that the former category of companies could charge a premium for the shares. However, as the SEBI Annual Report for 1995-96 noted, this resulted in a large flood of public issues. [SEBI: 1996]. In response to this, SEBI made the access criteria more stringent by requiring a three year dividend record during the most recent five years for a company to make a public issue and a minimum networth of Rs 1 crore to have been maintained during the most recent three years, failing which the company would need some kind of certification by having its project evaluated by a bank or a financial institution and obtaining financial assistance to the extent of 5% of the project cost from the appraising bank. These criteria would apply to even those companies which were already listed but proposed to make a public issue large enough to increase its post issue equity to more than five times the pre-equity capital. [SEBI: 1996]. The dividend payment record was soon amended to ability to pay dividend, in response to investor representations that the dividend payment record was too harsh. [SEBI : 1999]. The dividend payment ability was also eventually replaced with the current requirement of a profitability[76] record in 2000-01. The SEBI Annual report for that year also

[76] Distributable profits in three out of the most recent five years as computed under S 205 of Companies Act

recognized that the alternate criterion of ensuring issues of a minimum quality entered the market, namely, requiring investment of 5% by a financial institution or bank that appraises the project was done away with. Instead, issues that did not satisfy the new profitability record criterion or companies whose post issue equity exceeded the pre issue equity by five times or more were required to book build their issues with at least 60% of the offer to the public being subscribed to by QIBs. The rationale for this requirement, according to the annual report, was that through this route retail investors got to participate in issues which had been evaluated by and at the same price as institutional investors who are, on average, arguably better informed and skilled than retail investors. It must be noted that in addition to these access criteria of SEBI individual stock exchanges have their won criteria. For eg., the Stock Exchange Mumbai quickly increased the minimum paid up capital to qualify for listing from Rs 3 crores to Rs 5 crores and to the current minimum of Rs 10 crores. The regional stock exchanges increased their minimum requirement from a paid up capital of Rs 3 crores to Rs 5 crores.

The dividend or profitability requirement, apart from providing evidence of the financial viability of the issuer, also ensures that the investor has historical data base don which he can assess the prospects for the investment. The utility for the networth requirement or the paid up capital requirement of the stock exchange is not readily apparent. One explanation might be that SEBI as well as the stock exchanges consider size (for which paid up capital and networth may be proxies) as an indicator of the likely financial robustness of the issuer. However there appears to be no compelling evidence from industrial organization to that effect, much less to suggest what might be a "safe" minimum size and what if any might be an appropriate measure for size. In any case there appears to be no known empirical evidence from the Indian context that assesses the impact of these access criteria on the quality of the issuers who raise capital from the public securities market.[77] The other possible explanation might be that apart from greater financial robustness, listed companies also need to be of a minimum size so that they may be able to invest in the organization and systems necessary to meet the mandatory disclosure and other investor servicing requirements expected of listed companies.[78]

SEBI'a access criteria raise several questions. As noted earlier, access criteria represent a form of merit judgement by SEBI which appears to believe that companies which meet those criteria are

[77] This should be one of several interesting problems for research, with considerable practical relevance.
[78] The effort involved in meeting these requirements has a fixed cost element and hence companies can enjoy benefits of scale economies on these costs.

more likely to be better investment candidates. It will be interesting to see if the empirical evidence supports this belief. Secondly, did SEBI have to go through so many iterations to arrive at the current profitability criterion in place of the dividend record criterion? Both practitioners as well as theory have recognized that dividends are not necessary indicators of the value or earnings potential of a company, especially given that growth firms may not pay any dividends. Similarly, the rationale behind assigning a 'gatekeeper's' role to banks and financial institutions with an insignificant stake of 5% in the form of either debt or equity is not apparent. Banks and financial institutions have been lending institutions with credit appraisal skills. The credit appraisal paradigm is quite different from that of valuation of equity investment. Further, the level of bad assets in the loan or equity portfolios of some of these institutions would seem to question their appraisal skills and / or incentive structure to provide sound professional assessment of the financial prospects for the companies to which they provide funds. Given the manner in which SEBI's requirement of participation by a bank or financial institution ahs been specified it could have been apparent at the time of drafting those guidelines it would be quite easy for many issuers to take this alternate route to qualifying for making a public issue.[79] Speculative as it might be, it is even possible to argue that by suggesting a certification role for banks and financial institutions SEBI may even have wittingly or otherwise signalled a quality that did not exist in those public issues that took this route. Finally, and more fundamentally, arises the question of assigning gatekeeping roles to investment institutions. This assumes that the investment objectives of all investors in the market would be the same as or similar to that of QIBs. Accounts in the financial press indicate that QIBs prefer investments in companies that meet certain firm size criteria (in terms of market capitalization), given the economics of portfolio management activity. In the light of such preferences should SEBI think of alternate means of protecting the interests of non-institutional investors without limiting their investment opportunity set?[80]

Issue Mechanism

[79] For eg., the original guidelines did not specify whether the funds would have to be brought in before the issue; nor did it specify the period for which the funds would have to be provided to the issuer. Thus technically, it would have been possible for an issuer to park a part of the proceeds as fixed deposits and raise the 5% financing as a loan against the same. This was subsequently modified to state that the funds would have to be brought in a day before the issue opens for subscription at least but the tenor of the funds was still left open, allowing a great deal of flexibility to the issuer to meet this requirement too.

[80] One such possibility may be a market making requirement for issues that do not meet the more general market access criteria stipulated by SEBI.

We survey the issue related processes and procedures that SEBI has sought to regulate as well as the regulatory requirements relating to the allotment process. SEBI has tried to address various aspects of the issue process (pre and post issue). Anecdotal accounts indicate that as the controlled price regime of the CCI days provided windfall opportunities for investors, the allotment and post-issue processes provided a fertile ground for unscrupulous promoters and their issue management agencies to engage in practices that harmed investor interest. Similarly, the huge levels of oversubscription provided opportunities for bankers to the issue as well as promoters to enjoy the subscription monies, including those from applications which did not get share allotments. SEBI attempted to plug this through the use of Stockinvest, a payment mechanism by which the investor's applications monies would earn interest for the investor till such time as the Stockinvest was encashed by the investor or the registrar to the issue against successful allotment. Over the years SEBI devoted considerable regulatory effort and attention to ensure that investors who used the Stockinvest did not receive a less than equal treatment from issuers and their agents compared to those investors who used alternate payment mechanisms that allowed issuers to enjoy investors' application funds. The verdict on the effectiveness of the Stockinvest scheme is not clear yet.

In 1993-94 SEBI introduced the proportionate allotment process in response to the problem of multiple, often benami, applications [SEBI :1994]. Investors resorted to these methods to maximize the chances of allotment especially in highly oversubscribed issues. Issuers responded to the proportionate allotment requirement by limiting the maximum number of shares allotted to each applicant so as to preempt large numbers of shares getting concentrated in the hands of a small group of investors. Intuitively one can see that the proportionate allotment and the issuers' response thereto were a source of market imperfection.

SEBI mandated the association of a public representative in the allotment process in all public issue allotments to ensure that the allotments were made in a fair manner and in accordance with the guidelines. This was presumably triggered by the numerous instances of inadequacies and irregularities in the allotment process that was revealed by SEBI's inspection of the Registrars to the Issue and Share Transfer Agents during 1992-93. [SEBI 1993]. SEBI replaced the requirement of a public nominee with the requirement of associating SEBI's resource personnel and that the requirement of associating stock exchange personnel in 1999-2000. [SEBI : 2000].

The other major area of focus for SEBI over the years has been the issue mechanism per se. In 1995-96, SEBI introduced the first major initiative by announcing guidelines for book building public issues for issues larger than Rs 100 crores, upto 75% of the net offer to the public.[SEBI : 1996]. In 1997-98, SEBI extended book building to 100% of the issue to allow the entire issue to enjoy the benefit of price and demand discovery [SEBI : 1998]. In 1998-99 SEBI further extended the 100% book building to issue sizes of Rs 25 crores or more. But the first book built issue did not enter the market till 1999-2000. Why did issuers take so long to make use of a mechanism that would have helped them assess demand and price in a more market oriented fashion (and which would hence have been advantageous to the issuer most often, if not all the time) is not clear. Book built issues started picking up sizably from 2000-01, the year in which SEBI withdrew the minimum issue requirement of Rs 25 crores and further strengthened and streamlined the book building processes.

Pricing

One of the early areas of focus was the pricing of public issues. Accordingly in the Disclosure and Investment Protection Guidelines, 1992, SEBI removed the pricing restrictions on equity share issues from companies which satisfied certain profitability criteria; all other companies had to make par issues. This was part of the merit regulation approach that SEBI retained in its initial years. As mentioned earlier, in 1995-96 the DIPG was amended, shifting the emphasis from pricing regulation to access regulation. Thus all issuers were free to price their equity issuances in line with the market, as long as they qualified to make a public issue. Pricing regulations however continued to be an important tool in SEBI's regulatory activity to remedy what SEBI considered to be market abuses. In 1994-95 SEBI announced guidelines for the pricing of preferential issues. The guidelines fixed the price for such preferential allotments at the higher of the average of the monthly high lows over a six month period commencing one month prior to the date of announcement of the issue (termed as the reference date in the guidelines) and average weekly high lows over a two week period commencing from the reference date. The guidelines were a response to the feeling in the market that the preferential allotment route[81] was being misused by promoters, foreign owners and collaborators [SEBI : 1995]. SEBI sought to protect the interests of existing shareholders by linking the issue price to the market price.

[81] Under Section 81(1A) of Companies Act public limited companies may issue shares to shareholders other than existing shareholders and other than on existing proportion by passing a special resolution with approval from 75% of the shareholders.

Bonding

Coming from a planned economy background, one of the key concerns of the erstwhile CCI as part of its social justice priorities was to ensure that the small shareholder was protected from being taken advantage of by the promoters of companies who as owner managers wielded considerable power over the retail shareholder in administering the affairs pf the company. In continued acknowledgement of these concerns SEBI introduced measures as part of the DIPG to ensure that the promoter had adequate financial stake in the company. SEBI stipulated a minimum promoters' contribution of 20% of the paid up equity towards this, which would be locked in for a minimum of five years from the date of allotment. The rationale appears to be that by tying up a part of the owner manager's wealth the economic interests of the owner manager could be aligned with maximizing the long term value of the company. The level of mandatory minimum promoters' contribution, the lock-in period and the method of reckoning which shares of the promoter ought to be locked-in for how long have been through so many amendments that keeping track of these changes is quite challenging. The administration of these provisions must have been even more challenging. The most recent form of this provision as amended in requires a minimum contribution of 20% to locked in for a period of three years. Similarly all preferential allotments were required to be locked in for a five year period. This was then limited to preferential allotments to promoters by an amendment in August 1994.

The figure of 20% is similar to the promoters' contribution that Indian development financial institutions (DFIs) used to stipulate as part of their terms of financing as is the lock-in which is similar to the requirement of non-disposal of promoters' shareholding. The DFIs' rationale for these requirements was pretty much the same as our conjecture above in the case of SEBI: Tying in the economic interests of the promoters to the long term value of the company. The distinction that has to be noted is that that DFIs used to stipulate 20% of the project cost which would have been considerably higher, given that most projects would have an equity base of 35% to 50% of the total cost, the rest being debt financing. In the case of companies with on going operations the promoters' contribution stipulated by DFIs was usually higher at around 33%. If the DFIs' stipulation was the reference point for SEBI it is not clear why SEBI thought 20% of a much lower base, i.e. the equity capital of the company, would signal sufficient commitment on the part of the promoter. The other possible explanation may be the regulatory objective of ensuring that promoters of companies did not manage to control large business corporations by holding a small

percentage of the equity and taking advantage of the rest of the shareholding dispersed among a large number of shareholders. More fundamentally, however, if SEBI's interest was to align promoters' interests it was equally important to ensure that owner managers did not extract private benefits of control such as appropriating disproportionate shares of the company's cashflows to themselves. [See La Porta et al : 2000]. In fact the private benefits of control would ensure that promoters hold shares in the company that are considerably higher than the minimum levels mandated by SEBI, thus questioning the plausibility of the latter explanation above. The minimum promoters' contribution must be difficult and costly to monitor as well, given that the definition of who might constitute a promoter shareholder would be difficult to validate. In short, the stipulation regarding minimum promoters' contribution appears to be a costly provision with little practical use. The growing realization of its limited utility must be evident from the progressive dilution of the provision to its current form of applicability.

Certification

SEBI has also relied on certification as a means to ensure compliance with the regulations. The provisions cast the responsibility for the accuracy of the certificate on the intermediary, with incorrect certification carrying the risk of loss of license to carry on the business. Thus merchant bankers were required to provide a due diligence certificate from the early versions of DIPG. In 1994-95 the due diligence certificate of the merchant banker was made part of the offer document. The due diligence certificate would thus attract the provisions of liability of the Companies Act.[82] Certification requirements were further enhanced in 1995-96 by requiring the merchant banker to provide due diligence certificates at five different stages from the time of filing the draft offer document upto issue closure. [SEBI 1996] The merchant banker's certification role included ensuring that the other financial intermediaries involved in the management of the issue had the necessary license to provide their respective service. It was further extended to ensure that the financial capacity the underwriter did not exceed his exposure in 1994-95 [SEBI : 1995].

IV-B SECONDARY MARKETt

Trading and Trading Mechanism

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The first screen based trading system was set up by OTCEI in 1992. However, screen based trading made an impact on the mainstream stock market with the setting up of the NSE in 1994. Around the same time, SEBI started encouraging other stock exchanges to up screen based trading systems. Mumbai, Pune and Delhi stock exchanges set up screen based trading systems, presumably at SEBI's instance in 1995-96. [SEBI : 1996]. The moot point is as to whether SEBI did indeed have to direct stock exchanges - at least the major ones – to resort to screen based trading? Or would competitive pressure from new generation exchanges like NSE have achieved the same result? While it is true that SEBI had to exert pressure on some exchanges that hesitated to switch to screen based trading such as Jaipur, Magadh and Inter-Connected Stock Exchanges India Ltd., in 1998-99 the fact remains that these exchanges accounted for small trading volumes and hence the impact of the method of trading on these exchanges would not have had any practical consequences. But whatever the role of or the need for regulation in bringing about the transition the benefits of screen based trading at the major exchanges are significant. As SEBI noted in its annual report, "With the automation of trading and post trading systems on the major stock exchanges it has become more difficult to manipulate prices and to conceal audit trails of such manipulation". But automation of trading also fundamentally altered the economics of the business of stock exchanges as the operations of NSE and The Stock Exchange, Mumbai were allowed to be extended electronically to other cities from 1996-97. Note this : SEBI allowed the two exchanges to set up trading terminals in other cities in after an enabling amendment to the SCR Act was passed.[83] The share of the other stock exchanges in the total national trade on stock exchanges dropped steadily from 57% in 1994-95 [SEBI : 1995] to 4% in 2002-03 [SEBI :2003]. Eventually, in 1999-2000 these other stock exchanges were allowed by SEBI to from subsidiaries through which their members could trade on BSE or NSE so as to provide an alternate trading source for their members. [SEBI : 2000]

Settlement

The other major area of focus for SEBI in the secondary markets in the early years was that of settlement. The importance of settlement from the point of view of investors has already been pointed out elsewhere in this paper. As a first step in this direction SEBI directed all stock exchanges in 1992-93 to adopt a weekly settlement for all non-specified shares.[84] [SEBI : 1993]

[83] Section 13A of SCR Act, inserted by Securities Laws (Amendment) Act, 1995 w.e.f. 25-1-1995.
[84] Non specified shares are those in which the trade cannot be carried forward beyond the settlement period and has to be settled through delivery and payment. [BSE :] [CHECK]

As a further measure SEBI suspended the carry forward system, which was popularly known as badla, in December 1993 and directed the stock exchanges at Bombay, Delhi, Calcutta and Ahmedabad, the four major exchanges at that time in terms of trading volume, to gradually reduce their outstanding position. The SEBI annual report noted that "transparency had to be re-established before the reintroduction of carry forward trading could be considered", pointing out to a fundamental problem with the stock exchanges at that time. [SEBI : 1994]. The badla system was reintroduced in 1995-96 in The Stock Exchange, Mumbai in the form of the Revised Carry Forward System proposed by the GS Patel Committee that looked into the matter of badla facility and later extended to other exchanges. The weekly settlement requirement was extended on the BSE to B group shares (non specified shares) in 1994-95. With the introduction of dematerialisation of securities SEBI introduced, on an optional basis, in January 1998 rolling T+5 settlement system, to bring down the waiting time for investors to complete their trade. [SEBI : 1999]. Rolling settlement was introduced on a compulsory basis for ten scrips from January 2000. This was then increased to an additional 34 scrips from March 2000 and to 119 from March 2000 and to 414 scrips and to all the scrips in 2001-02. This was accompanied by discontinuation of all deferral products such as Carry Forward Systems, making it impossible to delay or defer settlement of trade. Rolling settlement was further shortened to T+3 from April 2002. In 2001-02 SEBI also banned all deferral products. With effect from April 1, 2003 SEBI introduced T+2 rolling settlement for all the scrips, which was as far as the existing infrastructure could accommodate.

Although not without criticism, SEBI's handling of the settlement requirement must have resulted in a tremendous benefit for investors. The long settlement cycles combined with badla and its subsequent variants led to speculation albeit in a disguised form, build up of leveraged positions by brokers, funded by badla arrangements. This resulted frequently in defaults, payment crises and temporary closure of the stock exchanges. The reduction of settlement cycles and the introduction of rolling settlement substantially eliminated these risks. The introduction of screen based trading systems helped bring about transparency as investors could be sure that their orders received time based priority. It was also possible for investors to verify the prices at which their trades were executed.

Alongwith the settlement SEBI also directed the stock exchanges to set up trade and settlement guarantee funds to assure investors that they would not face the risk of loss on account of a default by the counterparty. NSE was the first to introduce the National Securities Clearing

Corporation Ltd. (NSCCL). In 1997-98 SEBI approved the trade guarantee funds of Mumbai, Ludhiana, Bangalore and Calcutta Stock Exchanges. By 1999-2000 sixteen out of the 23 exchanges that had any turnover had all set up trade guarantee funds.[SEBI : 2000].

Dematerialisation

By far the development that made the most impact on the Indian stock markets was that of the setting up of depositories and the dematerialisation of shares. While the need for setting up a depository had been recognized as far back as 1993-94 [SEBI : 1994] the implementation of the idea was possible only with the passing of the Depositories Act, 1996. Given the benefits of the dematerialisation to the investor, SEBI had to resort to an "element of compulsion" as it acknowledged. [SEBI : 1999].

In order to understand the impact of dematerialisation it would be important to appreciate the constraints imposed by the paper based system that existed until the setting up of depositories. Starting 1992, with the entry of FIIs and with the setting up of mutual funds in the private sector from 1992, the institutionalization of stock trading had increased considerably. Trading volumes had also increased across the stock exchanges from Rs 164057 crores in 1994-95 to Rs 968908 crores in 2002-03. Several alternatives had been tried to mitigate the difficulties faced by the traders in putting through trades in paper-based securities. These included the setting up of specialised custodial companies, which handled the processing of the trade such as the stamping and signing of the transfer deeds, the handling of large volumes of paper and finally bulk payment of stamp duty and the introduction of jumbo certificates in 1993-94 [SEBI :1994]. These improvements addressed the needs of large volume investors by compressing the number of scrips into a single certificate. Yet these did not meet the growing needs of a rapidly burgeoning trade. The SEBI appointed Chandrasekaran Committee which looked into possibilities of simplification of share transfer and allotment procedures also confirmed the need for an early introduction of dematerialisation. [SEBI: 1998]

Several other problems had also been documented with paper based trading. These included delays in transfer due to genuine reasons of defect with the transfer instruments such as signature mismatch as also (alleged) due to not so genuine motives such as withholding transfers to create a shortage of scrips in the market. There were other associated problems such as mutilation or loss of scrips, long periods of closure of books for processing corporate actions such as dividends

payments, rights or bonus issues and so on. The concept of market lots and the consequent vexatious problem of odd lots was also because the paper based system found it necessary to have some minimum lot size. The frequent closure of books and the problem of market lots also reduced liquidity in the market.

SEBI first insisted that the trading in dematerialisation mode would be made compulsory for institutional trades, given the large volumes accounted for these traders and the expected readiness from their side in view of the enormous difficulties faced by them with the extant paper based trading system. Thus eight scrips were identified for dematerialisation effective January 1998 which went up to 319 in March 1999 and 360 by May 1999, accounting for 80% of the market capitalization and 90% of the trading volumes. Dematerialisation for the retail trade was introduced in January 1999 for twelve companies, increasing up to 109 in May 1999. Consequent to dematerialisation the idea of market lots lost its relevance and the same was abolished and the "no-delivery" period was reduced for dematerialised shares, resulting in greater liquidity. Through 2000-01 SEBI pursued the idea of dematerialisation with companies and in 2001-02 SEBI directed that all issuers had to compulsorily dematerialize their securities by September 30, 2001. SEBI had also amended the DIPG to provide that all allotments in IPOs would have to be compulsorily in dematerialized mode, with an option to the investor in the IPO to be provided paper based certificates.

Given the benefits of dematerialisation to the investor, in particular the savings in costs, it would be reasonable to expect that the drive for dematerialisation would have come from stock exchanges. The role for the regulator may accordingly be limited to putting the regulatory framework in place, considering the implications of the same to various other extant statutes as discussed earlier. However, the resistance to dematerialization from issuers raises reasonable doubts about whether the stock exchanges by themselves may have succe3eded in this endeavour. Given the scope for market manipulation that paper based trading offered, it is possible that the broker-issuer nexus, which stood to gain most from the paper based trading, would have been difficult to persuade into accepting the dematerialized trading system. It required the enforcement authority of the regulator to bring about the acceptance of the system.

Disclosure

The importance of continuing disclosure has been discussed earlier in this paper. Indian companies are governed by the continuing disclosure requirements of the Companies Act. However, these are annual requirements, which is not frequent enough to meet the needs of investors in a dynamic market who wish to constantly reassess the prospects for the investments in the portfolio. The rapid rate of change in the environment also makes it necessary to get updates more frequently than once a year. Most developed countries have made it mandatory for listed companies to provide quarterly updates. As Indian companies compete for international capital it is necessary for them to provide information to investors with comparable frequency. Further, the enforcement requirements under the Companies Act do not have adequate deterrents to force companies not to default on these disclosure requirements. Finally, the requirements under the Companies Act addresses, as in the case of many other matters, the needs of a wide variety of types of companies, with different ownership structures and therefore differing disclosure needs.[85] Stock exchanges in India have stipulated reporting requirements traditionally as part of their listing agreement. These have included the reporting of results of the listed company's business operations as well as reporting of corporate actions such as dividends, bonus shares and so on. In addition, companies have also been required to report exceptional events that could impact the outlook for investors in the company.

SEBI has tried to systematize and improve the reporting requirements of listed companies. It has driven the disclosure requirement mainly through the listing agreement. "Given that it is mainly in terms of the listing agreement that price sensitive information about the firm is required to be disclosed to the stock exchange and hence to investors, SEBI has been emphasizing the need to strengthen the provisions of the Listing Agreement, as well as its strict enforcement by the exchanges". [SEBI : 1995]. During the year SEBI required companies to include a yearly statement on actual utilization of funds and a statement comparing actual profitability against projections. Similar disclosures were required in newspapers and with audited or unaudited results as the case may be. Further, during the year violations against the listing agreement were declared as an offence under the SCR Act, thus increasing the enforceability of the disclosure requirements among others.[86] The first systematic examination of continuous disclosure requirements was carried out by the Bhave Committee. In a way, the Bhave Committee was to continuous disclosures what the Malegam Committee was to public issues. The Bahve

[85] For eg., a company whose share capital is entirely held by the owner-manager and members of his family and / or his friends need not necessarily have a formal periodic reporting system unlike a company which has a large group of outside shareholders.
[86] It has been pointed out earlier that S 24 of the SCR Act provides for offences committed by companies.

Committee's requirements of continuous disclosure requirements were introduced by directing stock exchanges to implement the recommendations of the Bhave Committee that had been appointed to look into this aspect. The requirements of the committee included quarterly disclosure of financial results[87], publishing details of deployment of proceeds of public and rights issues half yearly,[88] that the quarterly and half yearly disclosures have to be on the same basis as the accounting principles of the previous year (failing which the previous year's figures have to be restated for comparability) and all other material events having a bearing on the operations or performance of the company as well as price sensitive information.[89] Continuing disclosure requirements were further enhanced in 1999-2000 with the introduction of the corporate governance requirements. In 2000-01 SEBI introduced another round of disclosure requirements which included materially significant related party transactions with promoters, directors, management, subsidiaries, relatives and so on. The recommendations of the Accounting Standards Committee marked a step towards institutionalization of the process of fine tuning and evolving accounting standards on an on-going basis. The first set of the recommendations from the ASC related to Segmental Reporting, Related Party Transactions, Consolidation of Accounts, Deferred Taxes and Earnings Per Share. Further, SEBI specified quarterly disclosure of shareholding pattern by the issuer to the stock exchange within fifteen days of the end of the quarter. Segmental reporting got further extended to include segmental details of capital employed, accounting for tax and earnings per share calculation with effect from September 30, 2001. During the year consolidation on quarterly basis was also mandated. The amendments in 2001-02 required a minimum non promoter holding to the extent required as part of the listing conditions,[90,91] mandatory compliance with ICAI's accounting standards,[92] quarterly audited statement for trading as well as manufacturing companies, audit qualification and addressing of previous quarter's audit qualifications.[93]

Over the years, thus the drift of the changes in disclosure requirements has been to move from a more frequent extension of the annual reporting requirement to a much more fine-grained presentation of the performance of the company, such that each of the segments of the company's

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[87] Amendment to Clause 41 of the Listing Agreement
[88] Amendment to Clause 43 of the Listing Agreement
[89] Amendment to Clause 36 of the Listing Agreement
[90] Rule 19(2)(b) of the SCR Rules requires a minimum public offer of 10% or 25% of the post issue capital as the case may be in order to qualify for listing.
[91] Amendment introduced vide Clause 40A of the Listing Agreement
[92] Clause 50 of the Listing Agreement
[93] Amendment of Clause 41 of listing agreement

business may be evaluated separately, to provide information to the investor on matters of self-dealing by the company's management and to extend more rigorous accounting treatment such as treatment of deferred taxes and consolidation to the company's disclosure on a quarterly basis. As part of the process of institutionalization of the evolution of the continuing disclosure process, SEBI entered into a collaborative initiative with the Institute of Chartered Accountants of India (ICAI) and formed the ASC. SEBI claims in its annual report that mandating disclosures through the listing agreement has taken "India to the select list of countries with similar continuing disclosure requirement." How do SEBI's continuing disclosure requirements compare with that in other securities markets in developed countries and emerging markets? What has been the impact of these requirements on the investor assessment of the value of the companies? These are important questions for researchers to address in the years to come. For now, it is very apparent that SEBI has been expanding the continuing disclosure obligations of listed companies and appears to be looking at fine tuning, if not enhancing these, in the days to come.

Governance of Stock Exchanges

SEBI's approach towards governance of stock exchanges seems to have been influenced by the findings in the inspection completed in 1992-93. The principal finding of this inspection was that the exchanges were not functioning as effective SROs, not regulating their members through the enforcement of bye-laws, rules and regulations and paid minimal attention to redressal of investor grievances with long pending arbitration cases. [SEBI: 1993]. In 1993-94 SEBI directed stock exchanges to amend the rules and articles of association to (i) provide for equal non-elected public representatives (ii) to provide for SEBI's approval for nomination of the public representatives and the executive director and a (iii) two year break before elected members / office bearers are re-elected. So also statutory committees such as arbitration committee, defaulters' committee and disciplinary committee were required to have 60% of public representatives, up from no representation from public representatives at all. SEBI's annual report observed: "It is expected that with this restructuring stock exchanges would move away from their "closed club character" and re-orient themselves to function as public institutions. [BRING IN DISCIPLINARY INSTANCE] In 2002-03 SEBI required the exchanges to accept a uniform model of corporatisation and demutualization and required the exchanges to submit a proposal along these lines in six months.

V CONCLUSION

The analysis in this paper brings out a few salient aspects of SEBI's working so far. First, as an institution SEBI appears to have started off with a regulatory legacy that it inherited from a planned political economic paradigm. Having been asked to regulate and develop at the same time a securities market that would be consistent with the new market driven political economy, the creators of SEBI do not seem to have neither bestowed it with the authority, nor holistically thought through the legal framework, taking into account the existing company or securities law, that would be required for SEBI to discharge its role meaningfully. When SEBI opened a market driven securities regime, the Indian capital market responded with an enthusiasm that SEBI or its creators had not anticipated, much less prepared for; which is surprising considering the exuberance displayed by market participants in the controlled era, albeit in unpredictable and short bursts. SEBI seems to have responded to the needs of the market both in terms of its own activities as well as in terms of working with the government in evolving regulatory changes that would empower to play its in part in the emerging securities market scenario. The SEBI and the securities regime it runs in 2004 have come a long way from the powerless extension that it seemed to be of the Government of India in 1992.

That said, viewed in the light of our current understanding of the regulation of securities markets and the role that one expects of SEBI the analysis of the features of SEBI's regulatory regime and the approach that may be seen from the evolution of the regulation of some key aspects of the primary and secondary markets, several questions remain to be answered. The need for SEBI as opposed to the alternatives of allowing the exchanges to regulate themselves on the one hand or controlling them through a department of the Ministry is an issue that needs consideration. The current regulatory framework puts SEBI in charge of the capital market whereas the regulation of the money markets comes under the ambit of the Reserve Bank of India (RBI). As noted earlier this distinction between the capital and the money markets is somewhat arbitrary and can get blurred often. For eg., money market mutual funds invest in securities that are regulated by the RBI but the AMC is itself regulated by SEBI[94]. Financial and investment institution such as Life Insurance Corporation of India also have acted as underwriters in the past, a business that is regulated by SEBI; but their core business of insurance or banking are regulated by designated regulators. These and other instances raise the question of whether it makes sense to one single regulator along the lines of the FSA. What should SEBI's approach to regulation be? Merit regulation or disclosure based? So far SEBI has moved more towards a disclosure-based

[94] SEBI Mutual Fund Regulations

regulation. For eg., SEBI started off by vetting prospectus and finally gave up the vetting of prospectuses by 1996 in stages and instead focused on ensuring better disclosure and compliance. There are however elements of the regulatory regime that have a strong merit slant to them such as the market access criteria for unlisted and listed companies, the issue of a minimum promoters' contribution and lock-in, the extinguishing of warrants and options prior to listing and so on. While it is possible that these stipulations have been conceived in response to abuses in the marketplace, the question that arises is whether investors cannot be expected to factor this information, if disclosed, in their investment decision making process. Fewer and simpler regulations make it easier to understand for the regulated and easier to enforce compliance. This follows from the view and the empirical evidence stated earlier that implementation and streamlining procedures for the same are as important as the comprehensiveness and the sophistication of the law on the books themselves. Are the current regulations of SEBI easy to comprehend and comply with? How successful has SEBI in enforcing compliance with the same? And then there is the cost of regulation. There is practically no published research on the cost of SEBI's regulatory regime and the benefits from the same.

At a popular level it need not be a surprise if there is a belief that SEBI does not do enough to police the market especially when there is a scam or there are wild swings in the market leading to loss of investors' wealth. Here again, there appears to be very little research based analysis of the utility of the role that SEBI has played so far.

In short, the role of SEBI in the regulation of the securities market provides a fertile ground for research from a variety of different perspectives.

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