Institutionalisation of India's Primary Market

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The primary function of Capital Markets is to optimally allocate capital and efficiently price risk. This premise can only be fulfilled via agencies that have both, the talent to interpret and analyse vast amount of data available and the resources to use analysis for making profit. Historically, all financial nerve centres of the global economy, from New York to Hong Kong, have developed on the back of extensive participatory support from such agencies, also known as Institutional Investors. The Indian Capital Market, which was dominated by state-owned agencies and unregulated pools of private capital till liberalisation, has also undergone rapid institutionalisation with increased participation from professional Institutional Investors over the past few years. Given the spate of Initial Public Offerings (IPOs) in the past couple of years, increased Institutional participation has better-equipped the Indian market to price capital efficiently.

Therefore, any regulatory framework that seeks to increase the scope and scale of primary markets must begin with an appreciation of the beneficial role of such Institutional Investors and attempt to harness their full potential. Regulations allowing Qualified Institutional Investors (QIIs) to lead the market in pricing IPOs and, thereby, acting as beacons of Issue Quality are an example of a well thought-out regulatory mechanism weeding out inefficiency from the financial system.

So far, the regulatory policy for primary markets has focused on issues such as eligibility criteria, routes for listing and stringent preconditions for unlisted firms going public. However, the need to ensure that promising organisations, poised to grow exponentially, are not hamstrung for capital must be balanced with the responsibility to protect the weaker elements of the market from falling prey to poor-quality offerings that would inevitably intersperse good issues, albeit sparsely. One way to balance these seemingly contradictory objectives could be to set up an alternative market, on the lines of the AIM in London, for smaller and lightly regulated issues that would be accessible only to qualified institutions, which understand the risks involved and possess financial depth to deal with adverse ramifications of investing in riskier assets.

Evolution of the Indian Primary Capital Market

The Industrial sector in India at end-nineteenth and early-twentieth centuries comprised of traditional sectors such as textile and steel that are highly capital intensive, especially in the first few years post independence, when there was urgent need to create mammoth Industrial complexes producing basic goods that had, till then, been imported from Britain. Despite the challenges posed by Government overspending and the resulting crowding out of private investment, the Indian Capital Market admirably funded such industries by mobilising resources disproportionate to their own size.

The Mahalonobis Model – Import substitution

The Indian economic structure post independence focused on evolving a self-sufficient model of growth, driven by socialist ideas that had, at that time, gained prominence among many noted intellectuals and seemingly been implemented with great success in countries such as Russia. The basic premise of such a structure was that the state was best positioned to allocate resources most efficiently. This belief ensured that the 'commanding heights of the economy' were put in the hands of the public sector.

Predictably, the state took control of allocation of resources in the economy as banks and insurance companies were nationalised and development financial institutions grew in importance. The planned economic model not only placed curbs on the free pricing and production of goods & services, but also on the quantum and nature of funding available to private enterprise, thereby severely constricting stock market growth.

Reform-driven growth

Reform initiatives, which began in the mid 1980s and took concrete shape in 1991, jumpstarted the Indian stock market. Driven by easier regulatory norms and participation of retail investors through non-UTI public & private sector mutual funds that had, till then, been prohibited, total trading volume on the BSE and NSE combined reached Rs0.4lakh crore at end-FY91, and further increased to Rs4.1lakh crore at end-FY97.

Significant global events such as steep fall in commodity prices, collapse of the Soviet Union and the East Asian meltdown halted growth of the Indian stock market.

Reform slowdown

The resulting activity in the markets without a commensurate regulatory framework converged to the securities scam in the early 1990s, where over Rs3,500crore worth of funds were misappropriated over two years. The scam exploited deep-rooted deficiencies in the internal control systems of Indian as well as foreign banks operating in India and was made possible by certain settlement practices in the Government bond market.

The valuation structures that had been in place were shaken and share prices became choppy. The more enduring legacy of the scam was a slowdown in the reform process due to uncertainty and malpractices redolent in the stock market. Also, the free pricing mechanism introduced by the SEBI in 1992 led to a major boom in public offers in the mid 1990s. However, some companies that raised funds via public issues vanished with the investors' money. This boom period ended 1995-1996, with a fall in the stock market and downturn in the economy that was plagued by deteriorating fiscal health and Industrial overcapacity.

Close on the heels of the dotcom mania in the US in 1999-'00, Indian markets saw a period of irrational exuberance in technology stocks. The subsequent meltdown of technology stocks in '01 significantly impaired activity in the primary markets for the next two years.

Economic rethink and a fresh start

The forces of globalisation necessitated a fresh start of the economic reforms, which focused on stringent disclosure norms along with free market pricing, thereby laying the groundwork for increased institutional participation in the markets in recent years.

The primary equity market witnessed historic changes, including the abolition of the Capital Issues (Control) Act 1947 in 1991 and the subsequent advent of the SEBI as the capital market regulator, with the passing of the SEBI Act in 1992. By the first decade of its regulation, SEBI brought in a paradigm shift in the Indian Capital Market, including:

Free pricing of equity This meant that the Issuers could price their shares based on market forces and their fundamentals without recourse to administrative clearance. This new framework sought to protect the investor via ensuring disclosure and transparency vis-à-vis direct control of Issue prices. The resultant concept of the book building mechanism facilitated price discovery in the new era and encouraged corporations to increasingly rely on the securities market, as illustrated by increase in number of issuers as well as amount of capital raised from the market, leading to the aforementioned mid 1990s boom .

Disclosure requirements. Disclosure requirements were improved to enable investors to take more informed decisions. Introduction of the DIP guidelines and their constant improvement over the past decade has also led to greater transparency. Prior to these guidelines, the only disclosure requirements were those of Section 56 read with Schedule II of the Companies Act. Besides these disclosures, the guidelines have ushered in investor-friendly measures such as eligibility norms for Issuers, lock-in of shares, minimum contribution from promoters, compulsory rating for debt instruments (and IPOs), reservation in allotment for small investors etc.

Also, the SEBI has introduced statutory recognition to merchant bankers by making them accountable for Issue management. Now, the Issue manager brings in his professional expertise to the entire process of a public offer.

Further, the SEBI has brought the activities of all Issue intermediaries under its purview via suitable regulation to improve the quality of primary market services.

SEBI, by making dematerialisation mandatory for all new IPOs, has used technology to create a transparent and water-tight delivery mechanism that has increased Institutional confidence in the system. SEBI has also considerably reduced the time between closure of an Issue and listing of shares.

On the corporate governance front, SEBI has taken the following actions:

- Regulations were framed for insider trading
- Regulatory framework for takeovers was revamped
- A comprehensive code of corporate governance was formulated and implementation initiated

Systemic reforms in the stock market have sanitised it, thereby increasing investor confidence and participation.

Current status of Institutional Investors

Foreign institutions

Foreign Institutional Investors (FIIs) registered with SEBI enjoy a high degree of capital-account convertibility in an otherwise closed capital account system. FIIs are allowed to buy and sell shares on the stock exchange and repatriate the proceeds freely to their home countries.

FIIs, as the name suggests, are institutions such as mutual funds, pension funds, banks and insurance companies. However, there is provision for a corporate or high networth individual (HNI) to avail the same benefits by registering as a sub account of a registered FII with an appropriate cap on its holding in any company. The rationale for this distinction is to ensure that such benefits are not abused by corporate and individual investors to circumvent norms governing foreign direct investment (FDI).

Mutual funds

The Unit Trust of India (UTI) was set up by a separate statute in 1964. Aided by favourable tax breaks, UTI has, over the decades, built a large investor base.

In the late 1980s, the mutual fund industry was thrown open to the public sector banks and financial institutions, followed by the private sector in the mid 1990s. The first foray of private mutual funds was marked by investor bitterness as the funds raised money at the peak of the stock market and saw their Net Asset Values (NAVs) plunge in a falling market. Over the years, however, private sector players have re-established their credibility and gradually gained market share from other players.

The regulatory structure for mutual funds involves an asset management company working under the control of an independent board of trustees. This creates an additional layer of protection between the fund manager and the regulator. This is particularly useful where the fund manager has not committed fraud or violated the regulations, but has been negligent or incompetent. The board of trustees would be able to exercise business judgment where the regulator's freedom of action would be limited.

SEBI regulations for mutual funds include prudential norms regarding investment, guidelines on advertising, detailed disclosures in the offer document, restrictions on sales & recurring loads and restrictions on related party transactions.

Development financial institutions

In the pre-reform era, development financial institutions provided long-term finance to the industry. Along with extending loans, such institutions subscribed to equity issues and underwrote them. In most cases, loans were at subsidised rates of interest, but provided for conversion into equity on highly favourable terms. As a result, development financial institutions had a significant shareholding in many large Indian companies.

Given the historical background of such holdings, development financial institutions have often behaved as strategic investors rather than as portfolio investors. There have been repeated suggestions for restructuring such holdings, including secondary market sales, auctions to strategic bidders and transfer to mutual funds or other special purpose vehicles (SPVs). There have also been suggestions for the institutions to behave as portfolio investors as against strategic investors.

Venture capital funds

SEBI has recently liberalised regulations for venture capital funds and permitted foreign venture capital funds to operate in India. Such funds have been granted freedom to invest in unlisted companies and repatriate sale proceeds unencumbered.

Private Equity funds

The advent of Private Equity (PE) funds in India has also facilitated institutionalisation of equity markets. PE funds are pools of capital owned by HNIs, Institutions, Trusts or endowment funds that seek to invest in public or private corporations with the intent of providing capital & management guidance to such corporations to enable them to achieve their full potential. These funds seek to liquidate their holdings, once companies have matured reasonably. Although PE funds have largely eschewed acquiring partial stakes in public companies globally, in India, such partial acquisitions via PIPE (Private Equity In Public Enterprises) deals are a major part of the their strategy. Since this involves accessing public markets, both for entry and exit from the investment, increased PE activity has fostered greater professionalism and discipline in Capital Markets.

Contribution of Institutional Investors

Introduction of professionalism and valuation discipline in Capital Markets

Institutional Investors have played a major role in introducing professionalism to Capital Markets in India. The regulations have tended to force such investors to actively participate in driving valuations. To this end, Institutional Investors have responded by bringing in sophisticated valuation models & techniques at their disposal that retail investors lack.

Their demand for high-quality analysis and information has spurred growth of specialised financial services in India.

Only 12 years ago, beta was unheard of, P/E was regarded as an esoteric tool, financial coverage was limited in the media and there was lack of earnings forecasts or other tools of equity analysis. Today, the country boasts of a vibrant financial press, an active community of financial analysts and high professionalism. Most of this has been driven by growth of institutions that value service quality over personal relationships and seeks to trade on the basis of tangible financial analysis as against rumours and seemingly 'insider' information.

Corporate governance

The institutional positive impact of improving corporate governance has been most marked in companies that have raised funds through institutional support. However, although institutional activism has been limited, it is set to grow with increased participation of Hedge Funds and greater maturity in markets.

Measures to encourage Institutionalisation

Mandatory gate-keeping and partial QIB markets. SEBI has introduced partial QIB (Qualified Institutional Buyers) markets as a means of mandatory gate-keeping. Companies without an adequate track record cannot access the public capital market unless at least 60% of the issue is sold to QIBs at the price it is being issued to the public.

Fiscal incentives. The Government has extended several fiscal incentives to mutual funds and venture capital funds. Venture capital funds have been given pass-through status. Mutual funds operate in a different tax regime, where it is completely tax exempt and distributions by the fund are given concessions in the applicable tax rate.

Introduction of the QIP market has further enhanced the role of Institutional Investors in the listed space.

Key concerns

A central concern voiced in India, with institutionalisation of the market and nudging the retail investor away from the primary market, is that liquidity in the secondary market may fall. This is debatable in so far as the extent of damage to liquidity is concerned.

The empirical basis for the aforementioned view is that the retail investor churns his portfolio more frequently than the institutional investor, which is ambiguous. The retail investor was observed to resell issues within days of obtaining them, when the Controller of Capital Issues (CCI) regulated the market; this was due to CCI issues being underpriced. Such deviations in pricing are antithetical to liquidity as good issuers would find the primary market expensive and, therefore, substitute equity with other forms of capital.

In the long term, as QIIs get access to more capital and investment banks are able withstand greater underwriting risks, the bought-out deal mechanism will merit introduction. Although this would push up underwriting costs, ease of placement for the issuing firm and clear market signalling for the investor would be major advantages. However, the ability to signal Issuer quality depends on the emergence of strong investment banks, as also on the availability of legal remedies to the investor.

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