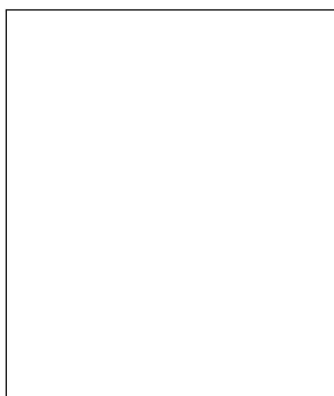
Strengthening the Capital Market



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The primary equity market has turned from a goldmine to a minefiled. Little wonder that, for over three years now, investors have stayed away. Public issues of equity have nose-dived to only 17 in the entire calendar, 1998. Tens of committees, scores of conferences, and countless articles have addressed the issue of resuscitation and of bringing the small investor back. A plethora of regulations have also been created. However, nothing seems to have worked. Solutions continue to elude us because we, in the first place, do not even have a consensus on the problems. Most deliberations also tend to be biased in favour of the issuers' perspective and not that of the investors. The main concern seems to be to 'lure' the small investor back.

Overlooking the hard facts, some experts have identified the economic slowdown as the main cause of the debacle. The reverse could be substantially true. Among other reasons, it is the lack of capital formation due to absence of risk capital that has led to inadequate growth.

PRIMARY ISSUE MARKET

For healthy long-term development of the primary market and to ensure continuing participation by the small investor, here’s a 9-point agenda:

Listing Norms

In the long run, SEBI’s objectives coincide with those of the BSE and other stock exchanges: whereas SEBI wants to confine floatation to companies which would survive, grow and give returns, the stock exchanges are looking for companies which would attract continuing investors' interest.

The compulsion to list on multiple stock exchanges under The Companies Act should be removed. Competition amongst the exchanges and all-India reach of exchanges would ensure the most efficient and cost-effective listing. Further, errant promoters could eliminate the process of delisting of deviant companies, thereby preventing the use of these escape routes. The “Z” Category listing introduced by The Stock Exchange, Mumbai is a highly innovative alternative to delisting.

Removal of Restriction of 25% Public Holding

At present, one of the conditions for listing is that at least 25% of equity should be sold to the public. This condition has lost its relevance particularly in case of bigger companies. World over, listing requirements normally have certain minimum number of shares to be sold to public and minimum market capitalisation of shares. **On similar lines, the listing agreement may be amended to allow companies to go public provided at least 25 lakh shares are made available to the public, and total market capitalisation of shares sold to public, at the time of going public, is Rs.10 crore.**

PSU Divestment

At least 10% of PSU shares should be divested in favour of retail investors to infuse interest in the capital market. This will not only help in widening the capital market but would also help proper price discovery for shares of such PSUs. This will also bring better corporate governance in PSUs as investors’ demands would result in greater transparency and better performance.

Public Shareholding in Multinationals

In many cases, foreign companies listed in their own countries are allowed to hold 100% equity stake in their Indian ventures established by them in India. If the concern is to have absolute control on management, a maximum of 76% of holding could be allowed.

The balance 24% may be sold to public so that the retail investors could participate in the growth and wealth creation by these foreign companies. If it is not possible for these companies to make a public issue at the time of establishing their undertakings here, a maximum period of two years could be allowed to them , to either disinvest 24% of their holdings or to raise new capital so that at least 24% of the new capital is in the hands of Indian public. In fact, we are seeing a trend among listed multinationals, wherein they are going for delisting their companies after they get approval from FIPB to raise their holdings to 100%. This is clearly detrimental to the cause of creating shareholder wealth and of development of a healthy capital market in India.

IPO Criteria

Like the Controller of Capital Issues (CCI’s) regulations in the past, the current SEBI criteria for initial public offerings too displays a historical approach, which does not take in to account the

future potential, promise or performance. Hence, there is a school of thought that advocates replacing SEBI's highly centralised "yes-no" decision on IPO's with either exercise of an investor's own judgement or by specific record of performance. Protection of small investors could be ensured by permitting IPOs on a 'private placement' basis only to investors investing a minimum of say Rs.1 million. The alternative system could be an IPO in the form of a secured debt issue such as debentures to be floated, listed and serviced successfully for at least three years without default or delay. Only then would an equity issue be permitted.

New Issue Pricing

Auctions and book building need to be seriously looked at as means of determining pricing of new issues. These would not only result in market-oriented and realistic prices but would also help bring down the cost of raising funds.

Under book building, the issuer's manager receives bids stating interest at a certain price. The process determines the maximum price at which the issuer will be able to sell the entire issue. If the bids fail to elicit the minimum expected price, the issue is cancelled. The use of technology can convert this process into an auction with on-line bids from all over the country.

Punish Vanished Companies

A staggering 84% out of a total 3911 equity issue floated between April 1992 and March 1996 raising over Rs.25,000 crore from retail investors are not quoted, listed or quoted far below the offer price.

Not just the investors' funds, but their confidence as well, has vanished. Until promoters of such companies are taken to task and made answerable for their misdeeds, no amount of pre-announcements are going to either deter future offenders or assure potential investors.

The Stock Exchange, Mumbai has introduced the concept of 'Z' category scrips. All companies not complying with the listing norms or not responding to investor grievances have been put in the 'Z' category so that the investors are cautioned against investing in such companies.

Monitor Utilisation of Issue Funds

In future, special attention should be given to the utilisation of issue funds. These have been grossly misused in the past, including diversion to activities other than those stated in the prospectus. (Shouldn't the small investor have the option to recall his money if it is not used for the stated purpose?)

The company's lead bank or financial institution could probably do the monitoring. Every company should be required to submit a quarterly status report on fund utilisation to the stock exchange where they are listed and to SEBI, while the annual reports should carry a detailed disclosure for the investors' benefit, duly certified by the statutory authority.

Market Making

It must be mandatory for a company coming out with a public issue for the first time to provide market making in its shares at least until such time they are regularly traded and quoted on the stock exchanges. Companies whose securities are not regularly traded should be obligated to appoint market makers to provide two-way quotes on a continued basis. Care should be taken that spreads are controlled and continuous trades provided as and when needed. The "market makers" may be provided enough incentive to take the risk of giving two-way prices in illiquid stocks. This can be done either by making it compulsory for all trades to be routed through the designated market makers for each scrip or by providing the market makers with a predefined commission for all traders where market making is done even if these trades are done by other brokers.

SECONDARY STOCK MARKET

Despite detailed regulation by the Ministry of Finance, the pre-reform stock market was scandal-prone, speculation-ridden, and only accidentally friendly to the final investor. In the days when a corporate security was a physical certificate, transporting it across the country was a slow and hazardous business. Hence the official model was to have as many stock exchanges as possible so that they could be close to investors, and allow for infrequent transfers. But the larger the number of stock exchanges, the lower the average turnover on each, and the lower the liquidity. To counteract illiquidity, the government bestowed a monopoly of trade in a city to each stock exchange. The business in the city stock exchanges was highly cyclical, going up during booms and dwindling in slumps. In the speculative environment, it was always possible that an investor's cash or securities, entrusted to a stock exchange member for trading, would be sucked in without trace; brokers' failures and malpractice were an ever-present danger. In the changed scenario of screen-based trading and dematerialization, monopoly of stock exchanges in their respective cities is superfluous.

Investments by Banks

Investments by banks in equity market should be accorded a priority status in the same manner as accorded to Agriculture, Exports and Small Scale Industries. It is a well established fact that investment in equities gives higher returns than debt and it would, therefore, be in the interest of the banks to invest in equities, specially in the present

environment of low inflation and low interest rates. **Towards this end, banks can unleash a fresh wave of growth by earmarking at least 1% of deposits for investment in equity as against the current provision of maximum of 5% of incremental deposits.** Alternatively, investment in equity market may at least be regarded as part of 40% priority sector reservation.

Banks, Financial Institution, Foreign Institutional Investors, and Mutual Funds should be allowed to participate in Carry-Forward System as Vyaj Badla Financiers which provides competitive returns.

Investment by LIC

The investible funds of Life Insurance Corporation are around Rs.1,30,000 crore, of which currently only around 5% (Rs.7000 crore) is invested in equities. Worldwide, life insurance companies invest between 10% and 50% in equities.

LIC should earmark at least 15% of its investible funds for the equity market. This will also result in higher bonus to policyholders and lower premium rate, assuming the returns in equity investments are higher than debt. LIC may also be asked to make public information about returns on different categories of investments. Present policy of government-directed investment in certain fields needs review and suitable changes.

Investments by GIC

GIC and its subsidiaries presently have a corpus of about Rs.20,000 crores, of which only about 15% (Rs.3,000 crores) is invested in equities. Worldwide equity investments by General Insurance corporations are anywhere between 30% and 50%. **There is a need, therefore, for reconsideration to the proportion of investment by GIC and its subsidiaries in the equity market and increase it to the level of at least 30-50%.**

All-India Term Lending Institutions

The portfolios of the major financial institutions are highly biased in favour of fixed interest loans. In the light of growing NPAs due to the non-performance of some sectors of the economy, there is now a perceived imbalance that needs to be set off by major investment in equity. All institutions may strive to invest about 2% to 3% of their resources in equity markets.

PF Deployment

At present, provident funds are not allowed to be invested in equities whereas in other countries a substantial portion of these funds is invested in the equity market. **Employees should be given the option of investing at least 20% of their provident fund in the equity market through approved Mutual Funds aided by appropriate tax incentives.** To begin with, investments in an Index Fund based on Sensex can provide good returns with minimum risk.

Investments by Pension Funds

At least 5% of the retirement funds should be routed to the equity market through Mutual Funds. This will ensure sufficient exposure of this repository of funds to the capital market and provide them with an opportunity to earn above-average returns.

Promote Government Securities Business

At present, trading in Government Securities is restricted amongst banks, institutions and selected intermediaries. The stock exchanges can provide greater liquidity, reach and depth and give investors access to this avenue of relatively lower risk investment.

INVESTOR PROTECTION

Changes in Company Law

The following changes are proposed to be brought about in Company Law :

* Registrars are extremely important intermediaries in the capital market. Either owned or funded by companies, the level of their service causes either great investor comfort or discomfert; delays in transfer being a case in point. Professionalisation of registrars is a welcome development but their services need to be streamlined and subjected to time-bound regulation with suitable penalties to discourage delays and defaults. **Transfer of shares should be made compulsory within 21 days. Penalty of Re.1 per share per day (for shares of Rs.100 each) should be imposed on the company in case of delay of transfer.**
* If a company does not pay dividend/interest in time, there should be penal interest at the rate of 2% per month payable by the company.
* Separate benches at High Courts, District Courts and Civil Courts should be established to hear the complaints of the investors and any case filed in these Courts should be disposed off within a maximum period of six months.
* If the company does not attend to investors' complaints consistently over a period of 6 months or more, filing a winding up petition against the company should be permitted.

MACRO-ECONOMIC MEASURES

Foreign Direct Investment

Foreign Direct Investments (FDI) increase the availability of investible funds and tends to reduce their cost. These also stimulate growth and free domestic capital for alternative investment. FDI needs to be encouraged both in the primary (greenfield projects) and secondary (take-over)segments, with

clear and easy guidelines.In the case of take-overs, whether friendly or hostile, the ultimate yardstick should be the beneficial impart on the company, its employees, its shareholders and its future prospects. FDI in BIFR cases should be especially encouraged as it may often mean their only hope of revival.

CORPORATE GOVERNANCE

Independent Directors

Independent directors represent the interests of those shareholders who are not directly represented on the board. They should be chosen not only for professional competence and relevant expertise, but also for their ability to bring an outside point of view into the board. Truly independent directors should have the majority for taking crucial decisions. A more active use of independent directors has also been recommended in almost all industrialised countries.

At least a third of the directors of any company above a certain size should be non-executive, independent directors. One way of ensuring their independence would be for credit rating agencies, industry organisations and chambers to make and circulate lists of prominent personalities - lawyers, accountants, financiers, bankers, economists - who have the competence and the integrity to be independent directors. If independent directors were to contribute conscientiously to the management process, they would have to be well compensated. The limit of Rs.2000 on sitting fees in the present Companies Act should be removed. Further, every large company should have an audit committee, on which independent directors should have a majority. Amongst other things, it should approve the annual report, ensure compliance with all financial disclosure requirements, and certify that funds raised from outside were used for the designated purpose.

Accounting Standards

Accounting Standards in India should reflect international practices.

Accounts should report, amongst other things, profitability by business segment, earnings as they would be diluted by expected increases in equity, foreign exchange losses, monthly volume of production of main products and services, and economic value added (the difference between the return earned and the cost of capital at a market rate of return). They should also report off-balance sheet exposures and their possible impact on the balance sheet.

Stock Exchanges' Powers

The powers of stock exchanges' are limited and hence they are unable to deal effectively with companies, promoters and registries. SEBI should frame stronger rules on disclosure, and levy non-discretionary, deterrent fines for infractions. Disclosures should cover two types of information. One is an event that may have significance for the investors; these must be revealed immediately to the press and the stock exchanges and posted on the company's Internet site. The other is financial information, the most important carrier of which is the annual report with audited accounts. SEBI should ensure that it is prepared and despatched to all investors in time. **Disclosures should be made simultaneously to SEBI, the stock exchanges and the press. Stringent time limits should be set, and SEBI should visit failures to make the disclosures in time with fines that are high enough to act as a deterrent. SEBI and stock exchanges should be given broader powers to punish companies for non-disclosure, delayed disclosure or inaccurate disclosure.**

CONCLUSION

The Indian capital market has come a long way from the pre-reform era. The future beckons in the form of Net-based trading. Step by step, the transition will be made easier. Each participant must play his role. Companies should provide better governance SEBI should contribute sensible regulation, and the stock exchanges should provide greater professionalism. What this will give the investor is a resurgent buoyant capital market where he can put his hard-earned money with confidence and trust.