

# What Reforms are Needed to Improve the Capital Market?



## 1. History

The Bombay Stock Exchange (BSE) was established in 1875, three years before the Tokyo Stock Exchange, which was established in 1878. The capital market in India has undergone many changes since the inception of the Stock Exchange.

## 2. Regulatory History

Over time, about a dozen stock exchanges were established across the country. The regulator for all of them was the Ministry of Finance, through a department called the Controller of Capital Issues (CCI). With barely a dozen staff members, the CCI managed to oversee all stock exchanges in the country. At that time, any public issue of more than ₹25 lakh in a year required permission from the CCI. In the case of existing companies, even the valuation was carried out by them.

The Securities and Exchange Board of India (SEBI) was established in 1988 but derived its statutory powers in 1993. Today, it regulates all stock exchanges, brokers, and intermediaries, and exercises certain quasi-judicial powers. The total strength of the erstwhile CCI was only about a dozen personnel, whereas today SEBI's staff numbers over 1,000.

## 3. Issues with Over-Regulation

There is no doubt about the need for a regulator, given the considerable increase in volumes and activity in the capital market. However, SEBI has unfortunately been dubbed as a "circular-making machine." Some notable examples are discussed below.

### 3.1 Insider Trading Rules

The rules are so stringent that in one case, the husband of an HR manager, who dealt in shares worth just ₹1,000, was hauled up by SEBI for contravention of insider trading rules. This was indeed extremely disproportionate.

### 3.2 Definition of "Promoter"

The definition of "promoter" does not exist in the same manner in any developed country are promoters personally responsible for all acts of omission or commission by the company? SEBI and the stock exchanges have such wide powers that they can freeze the demat accounts not only of the primary promoter but also of family members who are treated as part of the "promoter group."

The fundamental purpose of a limited liability company is that a shareholder's liability is limited to the amount invested. However, merely by virtue of being a promoter or entrepreneur, one runs the risk of punitive action from both SEBI and the stock exchanges.

### 3.3 Trading Restrictions During the Shut Period

SEBI has issued circulars prohibiting promoters and key managerial persons from trading in the shares of their own company from the last day of the quarter until the accounts are adopted and for two days thereafter. The rationale is that promoters and Key Managerial Personnel (KMPs) are likely to possess inside information and should therefore be barred from trading.

However, if the shut period begins on 31 March, the KMPs would still have some indication of the company's profitability on that very date. Yet, they are barred from buying or selling shares from 1st April for the next 45 to 48 days. In my opinion, such a restriction amounts to an infringement of the right to property as enshrined in the Constitution of India and is unreasonable. Effectively the shut period to deal in shares is over 64 days in an year. This makes no sense.

### 3.4 Stockbroker Compliance

The compliance requirements imposed on stockbrokers by SEBI are so complicated and burdensome that many old and established brokers have chosen to exit the stockbroking business entirely. Sadly, a single "no-frills" broker is believed to control approximately 25% of the total market volume. The regulator is creating a monopoly against the old and established brokers.

This results in excessive concentration as well as a severe lack of advisory services, since it is the full-service broker with a dedicated research department who provides meaningful guidance to investor, while the no frills brokers do only execute transacts without providing advice. The 1st time investor are attracted to trade with these type of brokers without any advice.

## 4. Capital Market Instruments

At present, the instruments available to retail investors are largely limited to equity shares. Products such as preference shares, compulsory convertible debentures, and optionally convertible debentures have virtually disappeared from the

market. Debentures are now primarily the preserve of mutual funds and financial institutions, not retail investors.

The investor community needs a far broader range of instruments beyond equity alone. The issuance of bonds by a company currently requires them to be rated and secured by assets. Unsecured debentures, commonly called junk bonds, are not permitted beyond a maturity of 18 months. This law needs to be changed.

Junk bonds are widely prevalent overseas, particularly when a blue-chip company issues unsecured bonds to finance a corporate acquisition. India should also consider permitting such instruments in a regulated but practical manner.

## **5. Impact of the Landmark Budget of 21 July 1991**

The landmark Budget of 21 July 1991, presented by Dr. Manmohan Singh, brought about the dismantling of the License Raj and opened the Indian market to Foreign Institutional Investors (FIIs) for the first time. This inflow, though sometimes characterized as “hot money,” gave the market considerable depth and liquidity.

However, whenever FIIs sold en masse, the market slumped sharply. Earlier, similar disruptions occurred whenever LIC or UTI sold large holdings. The market would slump on their selling and surge on their buying.

With the growth of the mutual fund industry, now having an AUM of approximately ₹81 lakh crore, the market has developed a substantial domestic buffer. Mutual funds now serve as an effective counterbalance, moderating the volatility that once accompanied large institutional sell-offs.

## **6. Ease of Doing Business: Recommendations**

In keeping with the stated objective of the Government of India to promote ease of doing business, the following reforms are recommended.

### **6.1 KYC and Documentation**

The paperwork required to comply with KYC rules should be drastically simplified. It is quite daunting for someone entering the market for the first time to fill page after page of forms merely to open a demat account. The equally cumbersome procedure of registering with a broker should also be standardised and minimised.

### **6.2 Bond Market Access for Retail Investors**

The debenture and bond market should be made accessible to retail investors. Even the Reserve Bank of India is attempting to sell government securities directly to the retail market. Therefore, all restrictions that currently impede retail participation in the corporate bond market should be reviewed and liberalised.

### **6.3 Unsecured Paper and Junk Bonds**

It is desirable to amend the relevant provisions of the Companies Act and remove the 18-month ceiling on the issuance of unsecured paper. Junk bonds issued by blue-chip companies could offer retail investors better returns. At present, the bond market is almost entirely dominated by the mutual fund industry and domestic financial institutions.

### **6.4 Compliance Burden for Stockbrokers**

The compliance burden imposed on stockbrokers by SEBI should be drastically reduced. The original objective of SEBI was to protect the retail investor. However, the ever-growing number of circulars and requirements has made life for brokers and investors far more difficult than originally envisaged.

In particular, the regulations imposed on Registrar and Transfer Agents (RTAs) concerning companies with non-resident investors based overseas are excessively onerous and are actively deterring NRI investment into India.

## **7. Taxation**

### **7.1 Dividend Taxation**

Dividends paid by a company should not be taxed in the hands of shareholders, as this constitutes double taxation, since the company has already paid tax on the same profits. For many years, dividend income in India was tax-free.

It is recommended that dividend income up to ₹10,00,000 be made tax-free. This would provide relief to small and medium investors without extending the benefit to the ultra-rich.

### **7.2 Capital Gains Tax**

With the erosion of purchasing power over time, it is recommended that capital gains tax for investments held for three years or more be reduced to zero. This would ensure that long-term investors are not penalised for remaining invested in the market.

## **8. OTC and SME Platforms**

### **8.1 OTC Exchange**

The OTC Exchange was launched with much fanfare but soon became defunct, and its promise was never fulfilled.

### **8.2 SME Platform**

The SME platform was a positive development. However, the concern is that while stock exchanges and SEBI permitted SME companies to make public issues, knowing fully well that these are inherently riskier than main-board listings,

SEBI is now targeting companies, their promoters, and merchant bankers long after the IPOs have been completed. Just as mutual funds are required to state, “Mutual fund investments are subject to market risk. Please read the offer documents carefully before investing,” the same principle should be applied to the SME platform.

A clear and prominent warning should be included in all SME offer documents, stating that SME issues carry higher risk, are less liquid than main-board listings, and may involve first-generation entrepreneurs or promoters without a long track record. Investors should be fully aware of these risks before investing.

Rather than conducting a post-mortem after the event, investors should be suitably cautioned at the time of the public issue itself. It must also be acknowledged that investor greed has contributed to many SME issues being heavily oversubscribed. The author does not oppose SME issues as such, but advocates for stronger investor warnings instead of punitive action after the fact.

## 9. Conclusion

In conclusion, India’s capital market has made great strides and has considerably deepened over the decades. However, the average retail investor, who was supposed to be the primary beneficiary of SEBI’s protection, is instead burdened with unnecessary paperwork.

The heavy compliance requirements imposed on brokers, and the severe punishment meted out even for minor infractions, have caused many long-established brokers to exit the stockbroking business entirely and become sub-brokers to larger firms.

It is the duty of both the Government of India and SEBI to genuinely become investor-friendly by simplifying processes, broadening the range of available instruments, rationalizing taxation, and ensuring that regulation serves its original purpose: protecting and empowering the ordinary investor.

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