

# Stock Exchanges in India Down the Streams of Time

By  
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## Antonio to Salanio:

“Believe me, no: I thank my fortune for it,  
My ventures are not in one bottom trusted,  
Nor to one place; nor is my whole estate  
Upon the fortune of this present year:  
Therefore my merchandise makes me not sad”.

## Merchant of Venice: Scene 1

“ Most of the time common stocks are subject to irrational and excessive price fluctuations in both directions as the consequence of the ingrained tendency of most people to speculate or gamble... to give way to hope, fear and greed”. *Benjamin Graham*

## Prologue

Four factors have primarily been responsible for the creation of stock market and trading in shares. Three of these are deeply rooted in history and the fourth is inherent in human behaviour.

The first was the invention of the wonderfully innovative and ingenious institution called the joint stock company. In the early sixteenth century, there existed in England and elsewhere in Europe too, the “Merchant Adventurers” who made their living by exporting cloth to countries in Europe<sup>2</sup>. To finance their voyages they developed a long-term financial arrangement: the joint stock company. Shakespeare’s title character Antonio, in Merchant of Venice is one such merchant adventurer (though from Venice) who had his financial interests tied up in overseas shipments when the play begins<sup>3</sup>. Indeed Shakespeare himself was one of the first to share risks in the Globe Theatre Company set up by him and the two brothers Richard and Cuthbert Burbage, who were actors in Shakespeare’s plays.

The joint stock company enabled merchants to put up money in the company and buy shares in the capital of the company. Unlike in copartnery, which was till the late

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<sup>2</sup> The Merchant Adventurers Of England: Their Laws And Ordinances With Other Documents  
William E. Lingelbach

<sup>3</sup> William Shakespeare: Merchant of Venice: SCENE I.

sixteenth century the most popular form of organisation, no member in a joint stock company, could demand payment of his share from the company; but each member could without the others' consent, transfer his share to another person, and thereby introducing a new member. The value of a share in a joint stock was always the price which it would fetch in the market; and this may be either greater or less, in any proportion, than the sum which its owner stands credited for in the stock of the company.

The second factor was the concept of liquidity. Putting money in the shares of the company required that an opportunity is also available to get back the money by selling of shares to any willing buyer, at a price which may be higher or lower than what he paid initially. This required the availability of a place and a mechanism so that those who have the shares could buy and sell the shares at the best possible price determined through an auction process by a group of willing buyers and sellers.

The third was the concept of risk and its measurement. Renaissance in Europe had replaced the Greek and Roman number systems of letters by the Indian-Arabic number system introduced by Fibonacci<sup>4</sup> to Italy. This number system brought in the games of chance and probability, took away man's need to depend on the far away stars and planets for the determination of his future, and enabled measurement of risks. The merchant adventurers risked losing their merchandise by ship wreck; this would impact the fortunes of the joint stock company. The value of shares of the companies was linked to the fortunes of the joint stock companies which depended on the success of the voyages undertaken by the merchant adventurers.

Anthropological evidence suggests that gambling behaviour is deeply rooted in all human cultures across all times in all human societies. Gambling is the very essence of risk taking. It was for no mean reason that Adam Smith who was a masterful student of human behaviour talked about the "*overweening conceit which the greater part of men have of their own abilities [and] their absurd presumption in their good fortune*"<sup>5</sup>. It is this tendency which enables a person who has put in his money in the shares of a company, to try to anticipate the fortunes of the company and take a calculated risk in choosing his next course of action, to buy more shares or sell the existing shares if the price is right according to his estimates. A stock market adventurer risks losing his investment in the stock market like the "Merchant Adventurers" of the sixteenth century risked losing their fortunes in a ship wreck. Survival of both in their respective business

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<sup>4</sup> Against the Gods – Peter L. Bernstein

<sup>5</sup> An Inquiry into the Nature And Causes of the Wealth of Nations – Chapter X, Adam Smith

depended on the ability to take risks. There is fine line between gambling and speculation, but both are connected to risk taking. Stock market could not do without either. This was the fourth factor.

### **The concept of stock exchanges gains ground in the West**

Stock exchanges are also called bourses. The origin of the term "bourse" is from the Latin word "bursa" meaning a bag because, in 13th century in the Belgian town of Bruges, the sign of a purse was hung on the front of the house where merchants used to meet. Another version of the story has it that in the late 13th century commodity traders in Bruges gathered inside the house of a man called Van der Burse, and in 1309 they institutionalized the informal meeting and gave the name the "Bruges Bourse". The idea spread quickly around Flanders and neighbouring counties and "Bourses" soon opened in Ghent and Amsterdam<sup>6</sup>.

Unofficial markets where shares were traded became popular across Europe through the 1600s. During those days buildings were less in number; there were more open spaces with large leafy evergreen trees under which people could easily assemble and there were coffee houses. These proved to be the convenient birthplaces of several major stock exchanges in the world. Brokers would meet under the trees or outside or in coffee houses to make the trades. The Amsterdam Stock Exchange was created in 1602 outside a coffee house in Amsterdam. It became the first official stock exchange when it began trading shares of the Dutch East India Company which was the first company to issue stocks and bonds. In 1688, the trading of stocks began on a stock exchange in London. By the early 1700s there were fully operational stock exchanges in France and England. The United States followed in the later part of the century.

"Wall Street, read a sinister old gag, is a street with a river at one end and a graveyard at the other"<sup>7</sup>. On May 17, 1792, twenty four supply brokers signed the Buttonwood Agreement outside 68 Wall Street in New York underneath a buttonwood tree. On March 8, 1817, the property was renamed as New York Stock & Exchange Board. In the 19th century, exchanges (generally famous as futures exchanges) got substantiated to trade futures contracts and then choices contracts.

In the early days of the stock exchange, while trading flourished, scandals and crashes flourished too. There was little or no regulation and almost anyone was allowed to participate in the exchange.

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6 Against the Gods – Peter L. Bernstein, History of Economics, J. K. Galbraith and other sources

7 Where Are the Customers' Yachts? Fred Schwed, Jr

### **The early days of trading in shares in India**

Early records show that in India, trading in debt securities both of private banks and government began and picked up much before the trading in shares. In fact there was a time, when traditional households proudly possessed “government paper” kept secure at the bottom of iron trunks or in iron safes. In fact in the first decade of 1800, the principal business done was in the loan securities of the East India Company. Share trading was then not in vogue, nor was it institutionalised. Interestingly, the National Stock Exchange which was set up in 1994 also began its journey as an exchange primarily for the trading in debt securities.

By 1930, trading in shares had commenced in India. Among the prominent shares traded were those of Oriental Bank, the Commercial Bank, the Chartered Mercantile Bank and the Bank of Bombay. In Calcutta, the Englishman news paper published in 1936 quotations of shares in Bank of Bengal<sup>8</sup>. These shares were traded at a premium and there were differential premia for buying and selling between Rs 5000 to Rs 7500. Though the trading list expanded by 1840, the number of brokers in Bombay was around a dozen. In 1850, the Companies Act was enacted and the concept of limited liability was introduced. This made a significant difference to share trading.

By 1850s the communication systems in India improved, facilitating trade and commerce. Railroads were developed and telegraph was introduced. Domestic demand for European goods increased and so did the demand in Europe for our exports. Around that time, there was a gentleman by the name of Premchand Roychand, well known for his financial acumen. Besides being a broker, he was an entrepreneur who had directed his genius to manifold enterprises, which earned him the reputation of a “financial genius”. He was also a great philanthropist who had donated large sums of money to the Universities of Calcutta and Bombay. The number of brokers in Bombay had increased to around 60 with Premchand Roychand being their acknowledged leader. By 1856, he monopolised the broking business in government securities, shares, bullion, cotton in the markets of Bombay and Calcutta. The Englishman newspaper wrote of him that he had diversified his business “with the rapidity of the prophet’s gourd”. The Bank of Bombay put in its Report that the old Bank of Bombay was virtually his. The share market boom which he engendered was fascinating indeed even by today’s standards.

Between 1861 till the beginning of 1865 there were no shares which did not command a premium. A huge amount of money coupled with lack of investment avenues triggered large-scale speculation. All the trappings of a rising market were in evidence; tips-rumours-astrological forecasts-press interview. People gambled on anything; stocks,

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<sup>8</sup> This section has been written on the basis of documents available with Bombay Stock Exchange

silver, and even rainfall. A share of Colaba Land Company rose from Rs 10,000 at par to Rs 1,20,000. People were willing to pay Rs 55,000 for a Rs 5,000 share of Back Bay Reclamation. Mazagon Land share sold at a premium of Rs 9,000, the Elphinstone land share commanded a premium of Rs 500. Share mania had gripped the city of Bombay with the market functioning from three different places; between 9 a.m. to 7 p.m. at the junction of Medows Street and Rampart Row; from day break till 9 a.m. and from 7 p.m. to the early hours of next morning at Bazargate. There were 31 banks, eight land reclamation companies, 16 cotton-pressing companies, 20 insurance companies and 62 joint stock companies and 250 brokers. The American Civil War had broken and the cotton supply from the US to Europe stopped. The price of cotton also swelled in a speculative boom.

But as all speculative booms, this one also came to an end with disastrous consequences. People lost money, they committed suicide. On the ill fated day of July 1, 1865, hundreds of "time bargains" had matured which no one was in a position to fulfil. The slump overwhelmed the city of Bombay. The Bank of Bombay shares which had touched Rs 2850 could only be sold at Rs 87 and the Backbay Reclamation shares did not fetch more than Rs 1750 against the peak price of Rs 50,000. "Never had I witnessed in any place a run so widely distributed nor such distress followed so quickly on the heels of such prosperity," thus wrote Sir Richard Temple, who served as the Governor of Bombay. J.M. Maclean (1835-1906) a high-ranking British official was reported to have said, "I have made more money out of these shares than I have saved during all my service in India and I don't mean to give up<sup>9</sup>."

In the widespread desolation that followed, there were only a few companies which were left solvent. A special legislation had to be enacted to deal with mass failure swiftly and expeditiously. Liquidation went on till 1872. Premchand Roychand and his circle of brokers were anathematised.

The share mania had two lasting effects. It was realised by the brokers that shares could no longer be traded in an informal way and second that there was a need for establishing a liquid capital market.

Till 1855 the brokers in Bombay used to trade under the widespread banyan trees in front of the Town Hall in the present Horniman Circle area. After 1855, they shifted their market place under other banyan trees in the area which is now opposite the Central Bank of India Head Office building. At the end of the American Civil War and the share mania, brokers were considered as a great nuisance and had hardly a permanent trading place, till they found till they found a place in what is now known as the Dalal

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<sup>9</sup> *ibid*

Street. In 1875, “on or about the 9th July, a few native brokers doing brokerage business in stocks and shares, resolved to form an association to protect their character, status and interests and to provide a hall or a building for their use<sup>10</sup>”. In 1887, a formal deed was executed, the first managing committee was appointed. The Society was named as the Native Share and Stock Broker Association. In 1895, the exchange acquired a premise in the street which was inaugurated in 1899. The Bombay Stock Exchange is now housed in the Jeejeebhoy Towers -- the construction of which started in 1972

When the Bombay Exchange was constituted the entrance fee for new members was Rs 1 and the number of members had grown to 318. By 1916 the number of members was 362 and the fees were raised to Rs 1000, which jumped to Rs 48,000 by 1920. Today the stock exchange has been demutualised, and the voting and trading rights have been separated<sup>11</sup>.

### **Stock exchanges are established in other Indian cities too**

The establishment of stock exchange in Bombay was quickly followed by other major centres. Ahmedabad had gained importance next to Bombay as a fledgling centre for cotton textile industry and by 1880 there were a number of textile mills in Ahmedabad. Share trading in the city was also on the rise. In 1894, the brokers formed "The Ahmedabad Share and Stock Brokers' Association. What the cotton textile industry was to Bombay and Ahmedabad, the jute industry was to Calcutta. Tea and coal were the other major industrial groups in Calcutta. After the share mania in 1861-65, there was a sharp boom in jute shares in 1870, which was followed by a boom in tea shares in the 1880's and 1890's; and a coal boom between 1904 and 1908. In June 1908, some leading brokers of Calcutta formed "The Calcutta Stock Exchange Association at the Lyons Range. A number of stock exchanges in other states followed as a consequence of increased industrial activity. The Madras Stock Exchange was formed in 1937, Uttar Pradesh and Nagpur Stock Exchanges in 1940 and the Hyderabad Stock Exchange in 1944. In Delhi there were two stock exchanges - Delhi Stock and Share Brokers' Association Limited and the Delhi Stocks and Shares Exchange Limited. In June 1947, these were amalgamated into the Delhi Stock Exchange Association Limited.

### **Stock exchanges and share trading becomes a regulated activity in India**

In 1956, the Government of India enacted the Securities Contracts (Regulation) Act to regulate the business of dealing in securities and to grant recognition to stock exchanges. This was the first time that a formal regulation was in place to regulate the buying and selling of securities and the market in which trading took place, i.e. the

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<sup>10</sup> The Bombay Stock Exchange

<sup>11</sup> *ibid*

stock exchanges. Only Bombay, Calcutta, Madras, Ahmedabad, Delhi, Hyderabad and Indore, the well established exchanges, were recognized under the Act.

### **The number of stock exchanges grows in India in the decade of eighties**

During the early sixties there were eight recognized stock exchanges in India. The number virtually remained unchanged, for nearly two decades. During eighties, however, many stock exchanges were established. A couple of factors were responsible for increase in the number of stock exchanges. First, there was a conscious attempt on the part of government to spread the development of industries across the country and to encourage industries in backward areas. The companies were set up with registered offices in different states. Second, there was also a conscious attempt to spread the equity cult across the country by encouraging the household sector to invest in the equities. In the absence of telecommunication, this could happen only if there are a number of stock exchanges across the country. There was therefore a proliferation of stock exchanges in the next few years.

Thus the Cochin Stock Exchange was set up in 1980, the Uttar Pradesh Stock Exchange Association Limited in 1982, the Pune Stock Exchange Limited in 1982, the Ludhiana Stock Exchange Association Limited in 1983, the Gauhati Stock Exchange Limited in 1984, the Mangalore Stock Exchange Limited in 1985, the Magadh Stock Exchange Association in 1986, the Jaipur Stock Exchange Limited in 1989, the Bhubaneswar Stock Exchange Association Limited in 1989, the Saurashtra Kutch Stock Exchange Limited in 1989, the Vadodara Stock Exchange Limited in 1990. These exchanges apart, the Over The Counter Exchange of India Limited was set up in 1990, the National Stock Exchange of India Limited as the first national stock exchange with automated electronic trading in securities was incorporated in 1992 and began operation in the wholesale debt market segment in 1994. There are of course two exchanges which have been set up for trading in commodities – the Multi Commodity Exchange of India and the National Commodity and Derivatives Exchange of India. None of these exchanges have been allowed to trade in equities, though the former has been allowed to trade in currency derivatives.

### **Growth pattern of the securities market since independence till 1990**

Till the 1950s India's capital markets had helped mobilise the financial resources for the corporate sector. The importance of these markets then diminished, because subsidized credits were available from commercial and development banks, equities had to be issued at a discount substantially below market value, the capital market lacked liquidity, and investor safeguards were inadequate. A reform of the Foreign Exchange Regulations Act in the early 1970s limited the expansion of foreign-owned and foreign-controlled companies. In response, many companies decided to become Indian companies. This led to the issue of substantial quantities of company shares at low

prices. The market's revival continued in the 1980s, as various measures were introduced to stimulate both demand and supply. Incentives for equity and debenture issues included reducing the corporate rate of tax for listed companies and fixing the permitted interest rate for debentures above that for fixed deposits but below that for bank loans. The government also authorized the use of cumulative, convertible preference shares and equity-linked debentures and gave generous fiscal incentives to investors.

The growth of the Indian capital markets since the 1980s has been impressive. Equity market capitalization on the Bombay Stock Exchange increased from \$11.8 billion to \$19.4 billion between the end of 1980 and 1987; average capitalization ratios remained roughly equal to 6.5 percent of GNP (*Table 1*). The number of listed companies on all exchanges increased from 2,114 in 1981 to 6,017 in 1987. New issues of debentures also multiplied. However, there were also abuses, such as the use of misleading prospectuses and insider trading. In addition, the processing of new issues, which were heavily oversubscribed because of their low prices, was plagued by delays in share allocation.

**Table 1: How the Indian stock market compared globally in 1991**

Country	Average market capitalization <sup>a</sup> (percentage of GNP)	Turnover ratio <sup>b</sup> (percentage of average capitalization)	Number of companies listed
<i>High-income countries</i>			
Japan	92	93	1,912
United Kingdom	80	72	2,135
United States	58	93	7,181
Germany, Fed. Rep. of	21	161	507
France	18	56	650
<i>Developing countries</i>			
Jordan	60	15	101
Malaysia	58	23	232
Chile	27	11	209
Korea, Rep. of	19	111	389
Portugal	10	44	143
Zimbabwe	10	4	53
Thailand	9	114	125
Mexico	8	159	233
Brazil	7	43	590
Philippines	7	62	138
Venezuela	7	8	110
India	6 <sup>c</sup>	19 <sup>c</sup>	6,017
Greece	5	18	116
Pakistan	5	9	379
Nigeria	4	1	100
Colombia	3	8	96
Turkey	3	6	50
Argentina	2	16	206

a. Average market capitalization is a five-quarter average of the total value of listed stock, based on year-end data, assuming constant exponential growth during the year.

b. Turnover ratio is the value of stocks actually traded as a percentage of the average total value of listed stock.

c. Bombay exchange.

Source: IFC.

Source: *World Development Report 1997*

## Growth Pattern of the Indian stock market till 1991

The Table given below portrays the overall growth pattern of Indian stock markets since independence. It is quite evident from the Table that Indian stock markets have not only grown just in number of exchanges, but also in number of listed companies and in capital of listed companies. The remarkable growth after 1985 can be clearly seen from the *Table 2*, and this was due to the favouring government policies towards security market industry.

**Table 2: Share trading in India till the economic reforms of 1992**

As on 31 <sup>st</sup> December	1946	1961	1971	1975	1980	1985	1991
No. of Stock Exchanges	7	7	8	8	9	14	20
No. of Listed Cos.	1125	1203	1599	1552	2265	4344	6229
No. of Stock Issues of Listed Cos.	1506	2111	2838	3230	3697	6174	8967
Capital of Listed Cos. (Cr. Rs.)	270	753	1812	2614	3973	9723	32041
Market value of Capital of Listed Cos. (Cr. Rs.)	971	1292	2675	3273	6750	25302	110279
Capital per Listed Cos. Lakh Rs.)	24	63	113	168	175	224	514
Market Value of Capital per Listed Cos. (Lakh Rs.)	86	107	167	211	298	582	1770
Appreciated value of Capital per Listed Cos. (Lakh Rs.)	358	170	148	126	170	260	344

*Source: The Bombay Stock Exchange*

## Government sets up a statutory regulatory body for the development and regulation of securities market in India

The economic reforms in India began in 1992. Though the idea of establishing an autonomous regulatory body to regulate the securities market and protect the investors was mooted in 1988, and the Securities and Exchange Board of India (SEBI) was established as a non statutory body in April 1988, it became a statutory regulatory body by an ordinance issued by the Central Government on 30th January 1992. The ordinance became an Act in April 1992. SEBI was a product of economic reforms. This was the first time that investor protection was recognised as the corner stone for the development of securities market.

## Looking back on the market of yesteryears

The stock market in India today bears little resemblance with the stock market before 1992. The changes have been transformational in nature and have often occurred so fast, that it was difficult to recognise the market from year to year. These changes did

not occur by chance but have been the outcome of a concerted and deliberate policy action of SEBI and the Government.

### **The market culture and trading practices then...**

Looking back at the stock market, it would seem strange that once upon a time, not so long ago, a decade and four years to be nearly accurate, the Indian stock market had earned a reputation of a casino. It would also seem strange that not so long ago did the stock exchanges in the country function as closed clubs with the Bombay Stock Exchange being the biggest of them all. The stock exchanges till the early nineties were run and controlled by a few cliques or cartels of large brokers hailing mainly from Mumbai, Kolkata and Ahmedabad, to which rest of the broking community necessarily paid obeisance and acknowledged their suzerainty for securing their business and livelihood. In that sense nothing much did change since the days of Premchand Roychand. A strong sense of "biradiri" (*brotherhood, all in the family*) in the broking community provided a multipurpose bulwark. It allowed easy flow of insider information, transferring exposure on the books of one broker to that of others in the same *biradiri*. Second, large business houses had house-brokers, just as they had a house-dhobi, house-jewellers, and house-saree suppliers. In other words, these brokers were loyal to their masters and would do business only on their behalf and for the sake of business efficiency were privy to inside information. Third, two books of accounts could be easily maintained by the brokers. Fourth, cases of individual default in both the books could easily be hushed up and settled in a manner befitting and upholding the dignity of the biradiri.

Trading on the stock exchanges was thin and the stock prices were largely manipulated. The closing value of the BSE's Sensex depended on the last traded price of the Sensex stocks fixed by some of the more influential brokers. Kerb trading swayed the prices on the secondary market. In fact the lobbies of the Ambassador Hotel and the erstwhile Natraj Hotel in Mumbai were the best places to learn about the next day's opening price of a security and the market gossip. Alternatively one could listen to the "tarvaniwallas" chat among themselves while sipping tea in the tea shacks on the Dalal Street.

Trading took place in the "pit" by the open outcry system, as was the practice then in most stock exchanges around the world and the brokers shouted the prices and quantities of shares in a language which could be understood only by another broker in the pit. When the deals were struck, these were recorded in small cloth bound notebooks called "chopris". Since there were no other records and time stamping, there was no guarantee whether the genuine prices were recorded in the chopris.

In the absence of speedy communication systems, rumors had a field day and could not be easily checked. The settlement took place every fourteen days, but the fourteenth day

of the account period varied from exchange to exchange. As a result a broker could easily transfer his position across exchanges. The varied settlement calendar which was the USP of the exchanges and absence of quick communication system together resulted in high arbitrage opportunities. The settlement period of fourteen days however often existed on paper, because if the broker cliques decided (depending whether bull cliques were in control of the market or the bear cliques) that the settlements should be postponed, the stock exchange management readily agreed to aggregate the settlement cycles. This delayed payments to investors. They often received payments of money or securities after a month since the execution of trade and the payments were many a time partial depending on the convenience of the broker. It was a common practice not to give the contract notes to the investors, so that the investors did not have any evidence of having placed any order. There was also no assurance that the price quoted by the broker was the actual executed price of the transaction. Stock exchanges levied margins in consultation with the brokers who would congregate in the President's room and collectively decide the extent of the margin, which will be sufficient to alter the direction of the market. The stock market functioned on trust of the brokers and the investors had little choice but to be at the mercy of the broker for the money and the shares.

### **The primary market then...**

If this was the state of the secondary market, the primary market was no different. Companies made IPOs with prospectuses which were written in the smallest of fonts. These were not meant to be read by the investors. The valuation, the timing of the issue and the number of shares to be issued were determined by the Office of the Controller of Capital Issues, who administered Capital Issues Control Act which had its origins in the Defence of India Rules principally to rationalise the allocation of capital during the World War II. The real price discovery on listing was determined by the unofficial grey market in all IPOs. The shrewd investors tracked the market. The primary market raised an average of Rs 5000 crore annually through public issue.

There was hardly any regulation for taking over a company and investors and shareholders would wake up one fine morning and learn that the company which was manufacturing widgets has been sold off to another company which manufactures safety pins and they had no say in the matter. There were very few mutual funds – in fact seven of them, all set up by the public sector banks and there was the UTI. But UTI was known as UTI to the lay household and not as a mutual fund and to the market it was the big bull. It could stand in the market and hold the sway or change the direction of the market, especially when the government required it to do so.

### **The plight of the investor**

What was the plight of the investors? By the early eighties equity cult was growing firmly in the country, thanks largely to Reliance Industries and investors were getting into investing in the equity market. By the late eighties some of the companies ventured to access the market to raise capital – the amounts being relatively large (above Rs 100 crore) to coin the term “mega issues” for the first time. The condition of the investors was appalling. Mere subscription and allotment to an IPO was no guarantee that the investors will receive the shares on time, for the share certificates may be lost in transit. Besides if an investor was lucky, he would receive the certificate in three months, during which his liquidity would have been blocked. If he was not lucky to get allotment, he may not receive the refund within six months. If he has traded in the secondary market, he would not know when his order was executed and what price; he may have paid the money or shares to the broker or the sub broker, but that was no guarantee that he will receive his shares or money after settlement, in any event not before a month after the trade. If he bought shares and got share certificates and sent these to the company for transfer, more often he would find that the company’s share transfer agents would return the shares after several months saying the shares are forged or fake or the signatures didn’t tally. Shares might also have been lost in transit.

### **The establishment of SEBI**

The establishment of SEBI changed everything. SEBI was set up in 1992 as a non statutory body, a precursor to a statutory body. Four years later and after protracted deliberations with the Government, on what should be its appropriate functions and powers, given that such a regulatory body was being set up for the first time, SEBI became a statutory body through an ordinance issued by the Government on January 30, 1992. The Act was passed by the Parliament in April 1992.

The establishment of SEBI as a statutory body was milestone in the history of India’s financial system. The Government took two other measures almost simultaneously. One, it abolished the office of Controller of Capital Issues and allowed private sector companies to raise capital freely. Second, it also opened up the Indian stock market to foreign institutional investors, who could freely buy and sell Indian securities, bring in foreign capital and repatriate it freely at market rates.

### **The 1992 market irregularity and the impact**

In 1992, before SEBI could assume charge, irregularities in the government securities market surfaced, the effects of which spilled over to the stock exchanges as well. It shook the foundations of the financial system of the country. Though the irregularities were in the banking system and concerned trading in government securities which did not fall under the regulatory purview of SEBI, SEBI had an indirect role in bringing out the irregularities. As regulation is a service, SEBI like other securities market

regulators in the world had levied fees on intermediaries who will be registered with SEBI under the SEBI Act. Brokers refused to be registered with SEBI or pay registration fees, because that will mean that they accepted their new master. In protest they went on strike and shut down the stock exchanges. This broke an important link in the cycle of fund flow which was sustaining the irregularities. The market misdemeanour surfaced almost as soon as the brokers went on strike.

## **The transformational milestones in Indian securities market since 1992**

### **The establishment of NSE**

Government responded to broker recalcitrance in a manner which was bound to have long term implications for Indian stock market. The government proposed the establishment of a new, modern nationwide securities exchange with the financial support of institutions like the Industrial Development Bank of India and other all India financial institutions. The National Stock Exchange of India Limited (NSE) began operation in 1994 as a corporatised, demutualised, for profit exchange, which was subject to payment of Income Tax. The NSE offered electronic trading facilities across the breadth of the country, using satellite communication network technology to make modern trading systems available to individual investors as well as to large institutions. Investors loved the new system. For the first time, an investor anywhere in the country could see their order inputted into a computer and the transaction completed on the electronic screen. The prices were transparent and the broker commission gradually fell to a fraction of what was charged in the past. This drove BSE, though after a lot of doubt, persuasion and debate to give up its open outcry system and launch electronic trading, a year later. In the next few years, SEBI cajoled all the remaining stock exchanges to operate as screen-based trading systems. In February 2000, the NSE launched internet trading, which gave investors direct access to the cash market, and the BSE followed in March 2001.

### **Electronic trading**

As electronic trading picked up, speed of transactions increased and foreign portfolio investments flowed in, trading volumes soared and other exchanges felt the effect. But new risks emerged. Settlement of trades was still done with paper securities and this posed a huge risk to the stock exchanges. Settlement guarantee funds were mandated by SEBI in all exchanges. The screen-based, order-driven system aggregated securities from sellers from all over the country to meet a large buy order. But trades are settled once a week, but weeding out forged paper and authenticating share certificates from the company became a nightmare for the clearing houses. There was a huge overload of paper on the clearing houses. To allow electronic book entry and move to paperless trading the depositories were set up. The National Securities Depository (NSDL) was set

up in 1996. A second depository, the Central Depository Services, was set up by the Bombay Stock Exchange a few years later.

### **Dematerialisation**

Dematerialisation began in phases when SEBI mandated that trading in eight stocks in 1996 (a step then considered by most, as small, inconsequential and meaningless) will be settled dematerialised securities. In the next two years, when the market realised the advantages of dematerialised settlement, the entire trading transactions were covered. The transaction charges and the cost of ownership of securities collapsed almost overnight. More importantly, bad paper was weeded out of the market and delays in transfer, fake and forged shares were nightmares of the past.

### **Change over to rolling settlement**

The main business of India's regional exchanges emanated from a system in which trades were settled on an account period basis – once a week, with different account settlement days for each exchange. This coupled with “badla” had allowed speculators a free hand, as they could shift open positions from one exchange to another without settling them. Market misconducts sometime have positive outcomes. These often help in heralding reforms which were difficult to implement earlier. There was a major market misconduct in 2000 which necessitated the setting up of Joint Parliamentary Committee by the Parliament. This crisis forced several regulatory responses, which were hitherto difficult to adopt due to the obduracy of the exchanges and brokers. In July 2001, all exchanges were forced to adopt rolling settlement. Initially, the settlement of equity trades was shortened to T+5, and then to T+3 in April 2002 and finally to T+2 in April 2003. The transition was smooth and contrary to the naysayer's opinion, market flourished.

### **Abolition of “badla” and derivatives trading**

At about the same time (July 2001) the age old indigenous product, the “badla”, which embedded the features of futures, margin trading and stock lending, and was the cause of a number of market misconducts, was abolished and derivative trading was introduced by SEBI.

The stock market in India was not new to derivatives trading. During the inauguration of the Native Brokers Hall on January 18, 1899 Mr Shapurjee Burjorjee Bharucha, addressing a huge gathering of European and native brokers said, "India being the original home of the option, a native broker would give a few points to the brokers of other nations on puts and calls.<sup>12</sup>"

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<sup>12</sup> Bombay Stock Exchange

The first step towards introduction of derivatives trading in India was the promulgation of the Securities Laws (Amendment) Ordinance, 1995, which withdrew the prohibition on options in securities. SEBI set up a 24-member committee under the Chairmanship of Dr.L.C.Gupta on November 18, 1996 to develop appropriate regulatory framework for derivatives trading in India. The committee submitted its report on March 17, 1998 prescribing necessary pre-conditions for introduction of derivatives trading in India. SEBI also set up a group in June 1998 under the Chairmanship of Prof.J.R.Varma, to recommend measures for risk containment in derivatives market in India. The Securities Contract Regulations Act (SCRA) was amended in December 1999 to include derivatives within the ambit of 'securities' and the regulatory framework was developed for governing derivatives trading.

Derivatives trading commenced in India in June 2000 after SEBI granted the final approval in May 2001. SEBI permitted the derivative segments of two stock exchanges, NSE and BSE, and their clearing house/corporation to commence trading and settlement in approved derivatives contracts. To begin with, SEBI approved trading in index futures contracts based on S&P CNX Nifty and the Sensex. This was followed by approval for trading in options based on these two indexes and options on individual securities. The NSE holds almost a monopoly position in the derivatives market.

There are four equity related derivatives which are traded on the stock exchanges – viz. stock futures and stock options, and index futures and index options. Initially stock futures was the most popular instrument, followed by index futures, The data from NSE shows that trading in index options have increased now, accounting for the 48% of the market share, while stock futures accounted for 22% and index futures accounted for 28%. Besides options and futures, trading in currency and interest rate derivatives have also been recently permitted on the stock exchanges. The Indian stock market has thus moved from a single product market to a multi product market in a very short period of time.

### **Regional exchanges**

If the spread of terminals of the NSE and BSE had threatened the existence of the regional exchanges, rolling settlement rendered them economically irrelevant. The only survival kit available to them was the subsidiary route through which brokers of these exchanges could trade on the two national exchanges. But a survival kit only helps to survive and not to grow and develop. Survival kits in the financial world soon outlive their utilities, which the regional exchanges were soon to find out.

Today though there are 22 stock exchanges on paper, in reality, trading takes place in only two stock exchanges, with NSE having a near monopoly position.

### **Risk management system, counterparty risk and margins**

The stock market was prone to price manipulation and the new rules introduced by SEBI sought to make manipulation difficult, costly and punishable, thereby improving the integrity of the market. Margining norms and risk management systems introduced by SEBI were predicated on scientific foundations and replaced ad hocism and subjectivity. The BSE and the clearing corporation of NSE now monitor the exposure limits of trading members online in real time and there is an automatic disablement of broker terminal's in case there is breach of margins. An index-based, market-wide, circuit breaker system was put in place which came into effect when the BSE Sensex and S&P CNX Nifty moved either way by 10%, 15% and 20%. These circuit breakers could bring trading in all equity and equity derivatives markets in India to a halt when the limits were breached. On May 17, 2004, when the country was in a state of political uncertainty, the market fell by a record of more than 10% in one hour and 15 minutes of trading. The risk management systems of the stock exchanges successfully went through one of the severest of stress tests and there were no broker defaults. These measures put the Indian securities markets ahead of the G30 recommendations which prescribe that final settlement for all trades should occur no later than T+3. Thereafter there has been three more breaches in the market wide circuit breakers since then.

### **Mutual funds, takeovers**

The perambulations have so far traversed the secondary market. This is not as if to say that the reforms were not all pervasive or did not touch other segments of the market which would not be having an impact on securities trading. There is now a well regulated, transparent and growing market for corporate control. Investors have benefited through participation in takeover offers. The number of mutual funds has multiplied and foreign mutual funds have also been established. Investors now have a choice of over 400 schemes to invest in. New changes have been initiated by SEBI to make the mutual funds more investor friendly and a cost effective and efficient savings mechanism. Mutual funds would now be available to the investors through the stock exchanges.

### **Disclosures and accounting standards**

Significant changes were made in the disclosure standards for public issues and continuing disclosures have improved by leaps and bound; from virtually nonexistent prospectuses, the prospectuses today have become dull bulky documents with a surfeit of information about the project, promoters, financing requirements, information on the financial position of the company and its associates, risk factors, details of litigations. Continuous disclosures have been introduced through the listing agreement. Quarterly reports are now mandatory for any listed company and consolidated accounts, segment reporting, related party disclosures, and deferred tax treatment found a place in annual

and half yearly results. More importantly these disclosures were made available to all investors.

### **Corporate governance**

SEBI set out the corporate governance standards through the listing agreements of the stock exchanges, not in response to any crisis but as a reform measure by itself. Indeed in terms of disclosures, and corporate governance, the Indian standards compare with the very best in world. These have been commented upon internationally. Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, in their working paper titled “What works in Securities Laws?” appearing in NBER Working paper series states that “India scores 100% as far as disclosure standards are concerned ” . Reena Aggarwal, Leora Klapper, Peter D. Wysocki of the CALPERS wrote in their article titled “Disclosure Quality and Emerging Market Mutual Fund Investment” that Indian Accounting Standards scores a maximum of 3, according to CALPERS’ Permissible Equity Market Analysis.

### **Exchange governance**

The exercise of improving the exchange governance which first began by empowering the office of the executive director of the exchange and having 50 % non broker representative on the governing boards of the exchanges, was carried to its logical conclusion by corporatising and demutualising the stock exchanges, thus separating ownership and trading rights of brokers.

### **Compliance with international standards of IOSCO**

Notwithstanding the three episodes of major market misconduct in the last thirteen years, in 1992, 1998 and 2000, each of which evoked suitable policy responses, the economic benefits of reform to the securities market have been enormous. The IOSCO sets out three core objectives of securities regulation. Although there would be local differences in market structures in countries, these objectives form the basis for an effective system of securities regulation. These objectives are:

- The protection of investors;
- Ensuring that markets are fair, efficient and transparent;
- The reduction of systemic risk.

The three objectives are closely related and, in some respects, overlap. Many of the requirements that help to ensure fair, efficient and transparent markets also provide investor protection and help to reduce systemic risk. Similarly, many of the measures that reduce systemic risk provide protection for investors. Further, matters such as thorough surveillance and compliance programs, effective enforcement and close cooperation with other regulators are necessary to give effect to all three objectives. The reforms in India’s securities market and the regulatory framework established by

SEBI have to a large extent been able to meet the fundamental objectives of securities market regulation.

The reforms in the securities market have been an integral part of the financial sector reforms and indeed of the wide ranging economic reforms initiated in India in 1991. Since the economic reforms were designed to create a more competitive economy, with a larger role for the private sector and market forces, the reforms in the securities market were needed to support a greater role of the market in the efficient allocation of capital in the economy. While the economic reforms were set in the broad perspective of large fiscal deficit being identified as a major factor of macroeconomic imbalance, the securities market reforms were set in the broad framework of investor protection, market transparency, efficiency, and integrity. The reforms have been comprehensive in scope and gradualist in implementation. Besides, what was important was the sequencing of the reforms; all the pieces fitted together to complete the puzzle; for example, introducing dematerialisation without electronic trading, would not have optimised the results. Similarly, rolling settlement could not have been introduced without dematerialisation or electronic trading. Policy changes were typically implemented through a consultative process taking on board the views of various market participants. This approach had obvious advantages, most notably the wide acceptance of reforms which allowed their easy adoption and firm implementation.

### **The epilogue**

Prof Amartya Sen while speaking on the subject of economic reforms at a conference identified three factors which should be of major concern in the task of initiating and implementing a major reform. These are: reach, range and reason. In terms of reach, it is important to always keep in mind what the proposed reform does for the people it affects; one must pay attention, specifically, to the reach of reform. As far as range is concerned, reforms must recognize that the means to pursue the ends of reform involve a variety of institutions, not just a few magic bullets. Finally, the reformers must constantly be willing to ask themselves why they are pursuing a particular course of reform or choosing a certain policy instrument over another. If this conceptual framework outlined by Prof Sen is adopted to evaluate the reforms in the Indian securities market, then the reforms could be said to have done well for themselves. The reforms have reached out to every participant of the securities market – the investor, the issuer and the intermediary. The range of the reforms has been wide – affecting every segment of the securities market, introducing new markets for new products, spawning new institutions, while making the existing ones more transparent and efficient and transforming the existing market structure into a modern, transparent and efficient one.

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