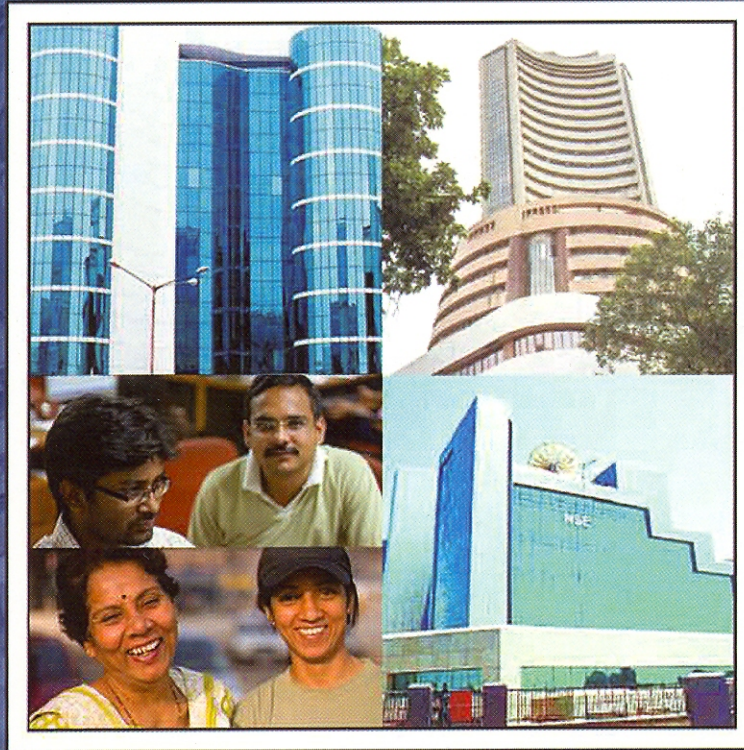


Deepening India's Capital Market: The Way Forward



USAID Financial Institutions Reforms and Expansion -
Regulatory (FIRE-R) Project
Indian Capital Market Reform

November 2007



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Foreword

India's capital market has come a long way since economic reforms began in early 1990s. The size of India's equity market equals its GDP - similar to G7 countries. Transaction costs have come down considerably and now are less than the average in developed markets. State-of-the-art market infrastructure combined with increasing profitability and competitiveness of Indian companies has attracted significant foreign portfolio investment. The Securities and Exchange Board of India is now widely perceived as a robust institution, a role model for regulators in emerging markets.

Impressive though these achievements are, there are several areas where the market still falls short of international benchmarks. Less than one-fifth of equity is owned by retail investors. In a country of over 1 billion people, less than 25 million individuals participate directly or indirectly in the market. The non-governmental bond market, which has the potential to provide long-term funding options to companies and infrastructure projects at lower cost than what is offered by banks, is very much underdeveloped; the same for the municipal and state bond markets. Participation of pension funds, insurance companies and mutual funds is low compared to developed markets.

The U.S. Agency for International Development (USAID) has had a long engagement with the Securities and Exchange Board of India and the Ministry of Finance under the bilateral Indo-U.S. Financial Institutions Reform and Expansion (FIRE) project. This report emerges from these experiences and has been prepared by a team of international and Indian experts led by Abt Associates and the National Institute of Securities Markets. The report analyzes the key forces that are driving market momentum and that should continue promoting market growth over the short to medium term. It also recommends steps to strengthen the long-term bond market and improve the quality of financial statements and the reliability of audits. The report advocates creation of a new self-regulatory regime that will provide regulations for investment advisory services and protection for investors.

We hope that the report will stimulate discussion among policy makers, regulators, and market participants and enable informed decisions on key issues critical to further development of India's already impressive capital market.

George Deikun
Mission Director
USAID/India

November 2007
New Delhi

Foreword

Indian Capital Markets have grown exponentially in the last few years. The growth has been in every sphere, in the amount of capital raised through primary issuances, in exchange trading turnovers, in the market indices and market capitalization, in mutual fund assets and foreign institutional investment. Corporate earnings are growing at healthy pace and the markets are a reflection of the health of the Indian economy.

However none of this would have been possible if the Indian markets had not developed a world class market and regulatory infrastructure. The efforts of the last decade in developing an efficient market infrastructure have created a market that has made transactions transparent and settlements safer. The new derivative market has provided a transparent avenue for managing risk to a wide variety of investors.

SEBI's objective has been to encourage the development of the market while protecting the interests of investors. The task is however only partly done.

Rapidly expanding markets require the industry and regulators to continually shore up their skills and resources. The establishment of the National Institute of Securities Markets is an effort to develop securities market skills and knowledge across the board for investors, students, market intermediaries and professionals and regulators.

The retail Indian investor is still not aware or confident of investing opportunities in the markets. We need to improve investor protections and investor awareness to encourage him to look at securities markets as a feasible investment option. There is a need to improve the quality of investment advice being provided to investors and to regulate those who interface with the retail investor. Further new products and markets need to be developed.

The US Agency for International Development through its FIRE Project has for the last many years provided immense support to our efforts at reforming India's markets. Their suggestions dovetailed the experience of international markets with knowledge and understanding of the Indian environment. I am sure that this report shall also provide a fresh and practical look at the needs of the Indian markets and will lay out a path for their further transformation to the benefit of India's investors and the Indian economy. I congratulate USAID and NISM for developing this report.

M. Damodaran
Chairman
Securities and Exchange Board of India

November 2007
Mumbai

Acronyms

ADB	Asian Development Bank
AMC	Asset Management Company
AMFI	Association of Mutual Funds in India
ASX	Australian Stock Exchange
AUM	Assets Under Management
BOM	Board of Management
BSE	The Stock Exchange, Mumbai
CAA	Chartered Accountants Act (1949)
CBOE	Chicago Board Options Exchange (US)
CCI	Controller of Capital Issues (India)
CFA Institute	Chartered Financial Analyst Institute
CFTC	Commodity Futures Trading Commission (US)
CICA	Capital Issues (Control) Act (1947)
CRD	Central Registration Depository
DCA	Department of Company Affairs
EDIFAR	Electronic Data Information Filing and Retrieval System
FIMMDA	Fixed Income Money Market and Derivatives Association of India
FINRA	Financial Industry Regulatory Authority (US)
FIRE	Financial Institutions Reform and Expansion – USAID Technical Assistance Program
FSA	Financial Services Authority (UK)
GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
GIC	General Insurance Corporation of India
GIPS	Global Investment Performance Standards
HPEC	High Powered Expert Committee on Making Mumbai an International Financial Centre established by the MoF
IASB	International Accounting Standards Board
ICAI	Institute of Chartered Accountants of India
ICICI	Industrial Credit and Investment Corporation of India
IDA	Investment Dealers Association of Canada
IDBI	Industrial Development Bank of India
IExRO	Inter-Exchange Regulatory Organization
IFIC	Investment Fund Institute of Canada
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Commissions
IPO	Initial Public Offering
IRDA	Insurance Regulatory and Development Authority (India)
LIC	Life Insurance Corporation of India
MCX	Multi-Commodity Exchange of India Limited
MFDA	Mutual Fund Dealers Association (Canada)

MoF	Ministry of Finance (India)
MOU	Memorandum of Understanding
MSCI	Morgan Stanley Capital International
NASD	National Association of Securities Dealers (US)
NASDAQ	National Association of Securities Dealers Automated Quotations (a US stock market)
NASDR	NASD Regulation
NCDEX	National Commodity and Derivatives Exchange Limited (India)
NISM	National Institute of Securities Markets
NSDL	National Securities Depository Limited
NSE	National Stock Exchange of India Limited
NFA	National Futures Association (US)
NYSE	New York Stock Exchange (US)
PAN	Permanent Account Number issued by the Indian income tax authority
PCT	Professional Corporate Trustees
PFRDA	Pension Fund Regulatory and Development Authority (India)
RBI	Reserve Bank of India
RS	Market Regulation Services Inc. (Canada)
S&P CNX Nifty	Leading index for large companies on the NSE
SBI	State Bank of India
SCRA	Securities Contracts (Regulation) Act (1956)
SEBI	Securities and Exchange Board of India
SEBI Act	Securities and Exchange Board of India Act (1992)
SEC	Securities and Exchange Commission (US)
SGX	Singapore Stock Exchange
SIPF	Securities Investors' Protection Fund
SIOS	Securities Investors' Ombudsman Service
SRO	Self-Regulatory Organization
TA	Trade Association
TSX	Toronto Stock Exchange (Canada)
USAID	US Agency for International Development
UTI	Unit Trust of India

Currency equivalent used in this report is US\$1 = Rs. 40 except for quoted figures.

Executive Summary

In a relatively short period of 15 years, India's capital market has transformed into one of the most active and modern around the globe. This report begins by describing that transformation in Chapter 1, highlighting five major achievements that have helped to propel the stunning changes in India's market from early 1992 through mid-2007:

- Building an appropriate and responsive regulatory environment
- Leveraging technology to develop state-of-the-art market systems and infrastructure
- Developing a rapidly expanding derivatives market
- Developing a robust mutual fund industry
- Increasing transparency through convergence of accounting standards.

Chapter 2 describes how each of these achievements was realized. It suggests that the market can sustain momentum by promoting competition, stimulating institutional innovation, promoting communication and cooperation among regulators, improving transparency and accountability, and permitting wider market access.

Chapter 3 briefly describes the principal forces that are driving momentum to promote market growth over the short to medium term. These include an expanding base of retail investors and intermediaries, increasing foreign portfolio flows and pension reforms.

Chapter 4 focuses on the remaining challenges to continued market growth. The report reconfirms the need to strengthen two

market segments: the domestic retail base and the long-term corporate bond market.

Chapter 5 recommends ways to enhance regulation of India's capital market, emphasizing the need to strengthen front-line regulation, financial adequacy standards, investor redress mechanisms, inter-exchange surveillance, and India's corporate bond market.

The report's principal thrust is the need to create new Self-Regulatory Organizations (SRO) as front-line regulators of market intermediaries, and to improve inter-exchange cross-market surveillance and enforcement. The report identifies the attributes needed by such a regulator (or regulators) and essential ingredients of the enhanced regulatory environment envisioned. Notable attributes include effective financial adequacy protection and more meaningful and accessible investor protection and complaint redress mechanisms. The report underlines the need for enhancing knowledge standards of current and future market participants and for significantly expanding the national investor education and financial literacy effort through the National Institute of Securities Markets (NISM). The report also makes recommendations to make accounting and audit standards more effective. Finally, the report broadly endorses the recommendations of the World Bank's report *Developing India's Corporate Bond Market* (December 2006), suggesting how India would benefit through a comprehensive program establishing a well-functioning long-term corporate bond market.

The Transformation of India's Capital Market: 1992-2007

Chapter 1

1. India's Capital Market- Pre-Reform

In 1991, facing a crisis in foreign currency reserves, India started the process of liberalization of its economy. This transition was accomplished by allowing market forces — competition and creativity - combined with greater foreign participation, to revive the country's flagging economy.

Prior to the 1991 reforms, a comprehensive system of State controls assured the State's almost complete domination of the financial markets. Under the Capital Issues (Control) Act, the Ministry of Finance (MoF) controlled the price and quantity of initial public offerings through the powers of the Controller of Capital Issues (CCI) and set interest rates on fixed income products, which limited access to capital and financial services. There were few private banks and those faced significant limitations on business expansion. Interest rates were administered by the Reserve Bank of India (RBI). Entry barriers throughout the financial sector limited opportunities to start banks, mutual funds, securities exchanges, brokerage firms, insurance companies and pension funds. State-owned banks had only minimal equity capital and lacked prudential norms of accounting, asset classification, and provisioning. Government controls funneled insurance funds and pension funds to Government bonds and bank deposits.

The description below of the capital market's operation and of its regulatory structure at that time provides a starting point for measuring how much India's markets have changed.

□ Stock Exchange Environment

The oldest and the largest Indian stock exchange in 1992 was the then-member-owned Bombay Stock Exchange (BSE), established in 1875. It traded for only two hours a day with an open outcry system. It was also a closed market in another sense. It was managed in the interests of its member brokers, predominantly individuals, many of whom had inherited their seats. Their operations were often small, undercapitalized and nontransparent. The market capitalization of the 6,480 companies whose shares were listed on the BSE on March 31, 1992, was Rs. 3,541.87 billion (US\$144.6 billion)¹. Few stocks listed on the BSE were actively traded. Many were small, closely held and illiquid, which made them easily susceptible to price rigging.² Oversight of the exchanges was minimal and speculation was common. In addition to the BSE, India had another 21 regional exchanges, of which the Delhi, Ahmedabad, and Calcutta exchanges were most prominent. All were paper-based and open outcry exchanges, unconnected except for dual listings.³ Each exchange was managed by its own board. The MOF's Capital Markets

¹ NSE, Indian Securities Markets Review, 2006.

² See "Market Manipulation and Collapse" in the next section below.

³ The Companies Act made it compulsory for an issuer to list at the exchange in the region where the company is headquartered. Because the BSE was more liquid than the other exchanges, it was common practice for issuers to list on both their regional exchange and the BSE. The regional exchanges also looked to the BSE for price discovery, and their prices correlated closely with the BSE's prices for such dually listed stocks. To facilitate such pricing alignments, regional exchanges opened after the BSE opened for trading.

Division, then the oversight regulator, named one representative to the board of each exchange.

□ Settlement of Securities Transactions

Settlement posed significant risks to counterparties in a securities market transaction. Securities were in physical form, but not held in street name⁴. Transfer of ownership involved stamped transfer deeds. Counterfeit paper was a risk, and securities, with accompanying documents, were subject to lengthy and inconsistent verification procedures. The settlement process was long and lacked transparency. Few if any deadlines for settlement were imposed or observed. The “badla,” or carry-forward, system in place was inherently nontransparent and risky. As a result, “settlements were prone to errors, mistakes, delays, and in extreme cases, unethical or criminal practices at each step of the process.”⁵ A market plagued by uncertainty and distrust of the system and procedures discouraged longer-term investors.

□ Institutional Investors

In 1992 the only institutional investor with significant participation in the market was the government-owned Unit Trust of India (UTI). Large government institutions, such as the Industrial Development Bank of India (IDBI) and Life Insurance Corporation (LIC), remained marginal players, either because prudential regulations did not permit them to invest in equities, or because they were not actively trading the equities in their portfolios. Speculators and retail investors dominated the market. Until SEBI promulgated its Foreign

Institutional Investors Regulation in 1993, the market was closed to foreign investors.⁶

□ Retail Investors and the Unit Trust of India (UTI)

In 1992, the average Indian interested in investing regularly in securities,⁷ would have had one main option: UTI, a government-operated trust that was also a vehicle for financing Indian enterprises. It was structured as an investment trust that issued redeemable securities somewhat similar to those of a mutual fund. As of March 31, 1992, UTI’s total assets were Rs. 357,370 million (nearly US\$ 14.5 billion), or over 90 percent of total mutual fund assets in India.⁸ UTI had approximately 21 million unit holder accounts in the 40 schemes it operated.⁹ In 1991-92 alone, about 12 million unit holders invested over Rs. 110 billion (US\$ 4.5 billion) in UTI schemes.¹⁰ Despite a structure that created issues of investor protection and accountability, discussed later in this report, in 1992, UTI in effect was India’s mutual fund industry and a pillar of the Indian market.

□ Market Manipulation and Collapse

In 1991, Harshad Mehta was a wealthy stock broker with a “rags to riches” personal success

⁴ Securities held in the name of a broker on behalf of a customer.

⁵ Tadashi Endo, *Indian Securities Market: A Guide for Foreign and Domestic Investors*, (1998) p.21.

⁶ Prior to SEBI’s issuance of the Foreign Institutional Investors Regulation, the only vehicles for foreign participation in the Indian market were the four offshore funds launched by UTI and State Bank of India (SBI).

⁷ Starting in the late-1970s, Indian households had also taken advantage of the Controller of Capital Issues’ underpricing of initial public offerings (IPOs) of equities. See discussion of the Capital Issues (Control) Act, 1947, later in this chapter.

⁸ NSE, *Indian Securities Markets Review*, 2006, Resource Allocation of Mutual Funds, p.54.

⁹ Lillia C. Clement and Roberto S. Mariano (Eds), “Asian Capital Markets: Dynamics of Growth and World Linkages,” *Asian Securities Industry Institute* (1993). Dave, Surendra “Recent Developments In Indian Capital Market), pp 141-148.

¹⁰ NSE, *Indian Securities Market Review*, 2006, p143.

story. He had been christened “The Big Bull” of the trading floor because of his apparent ability to move not only the price of specific scrips, but also the course of the BSE Sensex¹¹. Between April 1991 and June 1992, Mehta was supposed to have accumulated large positions in a select group of stocks, allegedly using multi-crore¹² funds acquired by manipulating the Indian banking system. When the manipulation was discovered, the banks and financial institutions from which he had taken the funds called on Mehta to return them. In April 1992, as Mehta liquidated his trading positions, a panic followed and the market collapsed.

This was the first of several securities market scandals that would stimulate significant market reforms. These scandals focused attention on the need for stronger investor protection and a more efficient regulatory regime. The 1992 market collapse stimulated the Government of India to strengthen SEBI and, through the major financial institutions it controlled,¹³ to create the National Stock Exchange (NSE) as a demutualized exchange which became a strong competitor to the BSE.¹⁴

□ Legal Framework – Pre-Reform

Prior to 1992, the regulatory system of India’s planned economy was marred by dispersed and uneven regulatory responsibilities, obsolete definitions, regulatory gaps, uneven regulatory responsibilities, and lack of accountability. Key

elements of the legislative framework are presented in the Text Box 1.1.

2. 2007: A Modern Dynamic Capital Market

The market has been transformed in the 15 years since SEBI emerged as the statutory regulator of India’s securities market. India’s market in 2007 features a developed regulatory environment, a modern market infrastructure, a steadily increasing market capitalization and liquidity, better allocation and mobilization of resources, a rapidly developing derivatives market, a robust mutual fund industry, and increased issuer transparency. Table 1.1 compares some key market statistics for Indian markets in 1992 and 2007.

Table 1.1 - Key Market Characteristics 1992 vs. 2007

Key Market Characteristics	1992	2007
Market Capitalisation (\$billion)	144.6	987.2
Market Capitalisation to GDP (%)	57	87
Number of registered foreign institutional investors	0	987
Number of mutual funds	6	38
Number of demat accounts	0	6362845
Value traded to listed stock (%)	11%	71%
Turnover ratio (%)	20%	82%
Market volatility (%)	3.3%	1.1%
Annual derivative volumes (\$bn)	0	1601

Source: RBI, *Handbook of Currency and Finance, 2007*;
NSE, *Indian Securities Market Review, 2006*;
SEBI, *Handbook of Statistics on Indian Securities Market, 2007*.

□ A Credible Market Regulator

Legislative initiatives and the emergence of SEBI as a credible market regulator with greater investigative and enforcement powers and effective leadership has enhanced investor protection, accountability, and transparency. It enables competitive forces to shape a more efficient market in which many systemic and infrastructure risks that existed earlier have been greatly reduced.

¹¹ The 30 share BSE Sensitive Index.

¹² A unit of the Indian numbering system that is equivalent to 10 million.

¹³ Among the promoters of the NSE were The Industrial Development Bank of India (IDBI); Life insurance Corporation of India (LIC); General Insurance Corporation of India (GIC); Industrial Credit and Investment Corporation of India (ICICI); Industrial Finance Corporation of India, Ltd. (IFCI); The State Bank of India (SBI); and The Unit Trust of India (UTI).

¹⁴ N. Ninan, “Would Harshad ever have dreamt of this?” Home News Business, October 9, 2004.

Text Box 1.1: Key Elements of the Pre-Reform Legal Framework

Capital Issues (Control) Act of 1947 (CICA)

The Capital Issues (Control) Act was designed to check the access of the private sector to capital market. It limited the amount of capital a private company could raise in the capital market. The Controller of Capital Issues (CCI) approved all aspects of private companies' issuances of capital: the instruments, the volumes and the offer price. The price was based on historical earnings, a practice which often resulted in under-pricing of public offerings of equity shares.

Chartered Accountants Act of 1949 (CAA)

The CAA placed governance of the accounting profession, including standards setting and discipline, under the Institute of Chartered Accountants of India (ICAI). However, compliance with the standards was not mandatory, and the ICAI lacked the power to enforce them.

Companies Act of 1956

The Companies Act dealt with issue, allotment, and transfer of securities, and various aspects of company management. It placed responsibility for registration and oversight of all companies, whether closely held or listed and widely traded, under the Department of Company Affairs. The ability to prosecute errant companies for misleading information in their offer documents and other periodic disclosures remained with the Company Law Board, under the Department of Company Affairs.

Securities Contracts (Regulation) Act of 1956 (SCRA)

The SCRA's objective (as stated in its preamble) was "to prevent undesirable transactions in securities by regulating the business of dealing therein." It governed stock exchanges, securities contracts, and listing of securities. It also declared options in securities illegal, and, until 1999, its definition of "securities" was limited to listed stocks and debentures and "exchange" referred only to the "trading floor," without including an electronic trading platform.

Unit Trust of India Act of 1963 (UTI Act)

The UTI Act established the Unit Trust of India (UTI), accountable only to the Parliament as a hybrid development bank and mutual fund. It was the first and only mutual fund-like investment available in the Indian capital market throughout the first 40 years of its existence until 1987. The UTI Act, among other things, did not require the investment assets to be valued at market prices, nor mandate portfolio disclosures.

Securities Exchange Board of India Act of 1992 (SEBI Act)

A key element of the reform strategy was building a strong independent market regulator. The SEBI Act, which came into force on January 30, 1992, established the Securities Exchange Board of India (SEBI) as an autonomous body "to protect the interests of investors in securities and to promote the development of, and to regulate, the securities market and for matters connected ... or incidental thereto." SEBI was given authority to regulate the stock exchanges, stock brokers, share transfer agents, merchant banks, portfolio managers, market intermediaries, collective investment schemes, and primary issues. The SEBI Act granted SEBI licensing, rule making, investigative, and directive powers, and broadly empowered SEBI to achieve its goals "by such measures as it sees fit." The Act also enumerated specific regulatory approaches SEBI could take.

SEBI was empowered to control entry to the market; monitor market participants; issue regulations and guidelines to establish market standards; prohibit fraudulent and unfair trade practices; regulate substantial acquisitions of shares and takeovers; and to enforce the securities laws.

SEBI was formed in 1988, but was not granted the statutory powers described above until speculative price rises in the secondary market made clear the need for a stronger regulator. The impact of the regulations SEBI would subsequently adopt shaped much of the institutional structure of India’s capital markets.

Application of Advanced Market Technology

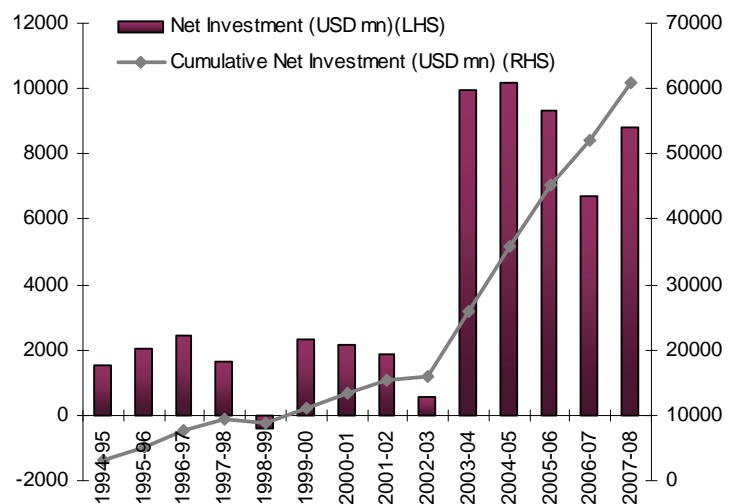
Technological innovation was largely propelled by the National Stock Exchange (NSE), a demutualized electronic exchange incorporated in November 1992 by major public sector financial institutions. The NSE began trading in June 1994, effectively utilizing the most advanced market technology at that time. It introduced a modern market infrastructure with fully-automated, screen-based trading systems and settlement systems equal to any in the world. By the end of 1996, liquidity of the most frequently traded securities had shifted to the NSE. Competitive pressures reduced brokerage fees by a factor of five, from 2.5 percent to approximately 0.50 percent, and increased daily traded volumes by more than 100 percent.

The BSE protected its competitive position by converting to a modern market infrastructure by 1997. The systems put in place by NSE and BSE, under SEBI’s oversight, created more efficient, liquid, and transparent stock exchanges, and were instrumental in minimizing market systemic and settlement risks. By mid-2007, 99.9 percent of trades settled in dematerialized form in a rolling T+2 environment.

Significant Participation of Foreign Institutional Investors

The changes in market structure, regulation and technology brought about significant qualitative

Figure 1.1 – Foreign Portfolio Investment in Indian Securities Markets



Source: SEBI Bulletin, October 2007, Volume 5 Number 10.

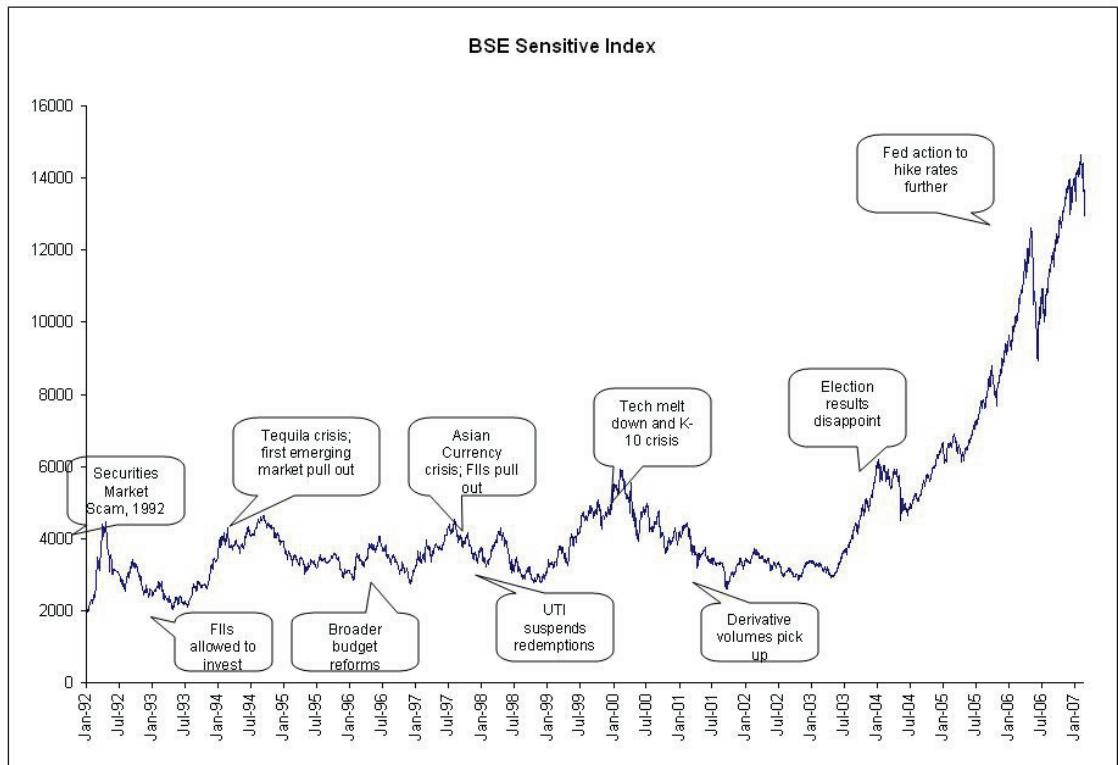
changes in the Indian securities market, greatly reduced systemic and settlement risks, and helped create more transparent, liquid and efficient securities markets. Increasing confidence in the fairness and efficiency of the market, and the elimination of barriers to foreign institutional investment in 1994, fueled the growth of foreign portfolio investment. Portfolio Investment by Foreign Institutional Investors (FIIs) in India has grown every year since then, except for 1998, when the Asian crisis led to a major exodus across all markets. Figure 1.1 shows the FII investments in Indian markets since 1994-95.

□ Strong Market Performance

The changes in the microstructure and institutional mechanism of the Indian securities market had been put in place before the economic recovery, took off in the 2000s. The market indices have reflected the growing investor interest, both local and global, in the markets. By the end of 2005, according to the World Bank's World Development Indicators,

36.8 percent between 2001 and 2006, and by mid-2007 had added another 16.8 percent. Other indices of less capitalized and traded issues also have attracted increased activity and have reached new performance levels. By September 2007 BSE's and NSE's market capitalization had increased to nearly US\$ 1,305 billion and US\$ 1,211 billion respectively. The NSE and BSE accounted for 99.9 percent of

Figure 1.2 BSE Sensitive Index, 1992-2007



Data Source: Bombay Stock Exchange

the market capitalization of India's 4,763 listed companies represented 56.1 percent of India's GDP. Listed Indian companies had a market capitalization of over US\$ 834 billion in 2006, nearly 91.5 percent of GDP.

As of July 2007, India's major market indices, the Sensex and the Nifty, were in the upper ranges of their price and trading levels. The Morgan Stanley Capital International (MSCI) India Index registered an annualized gain of

the trades and listed 1,319 and 4,871 companies respectively. Figure 1.2 shows the growth of the market from 1992 to 2007 as reflected by the Sensex.

Increased market valuation translates directly into opportunities for additional growth. For these and other Indian companies, rising market valuations present opportunities for local and global acquisitions, investment in domestic projects, acquisition of suppliers or distribution

networks, assurance of a better flow of raw materials, attracting the best talent, and raising additional capital.

This steadily increasing flow of funds has enabled India’s capital market to better allocate and mobilize resources and help to strengthen India’s economy. During 2006, India’s economy experienced a real growth rate of 9.2 percent.¹⁵ During the 12 months

Increased Derivatives Market and Liquidity

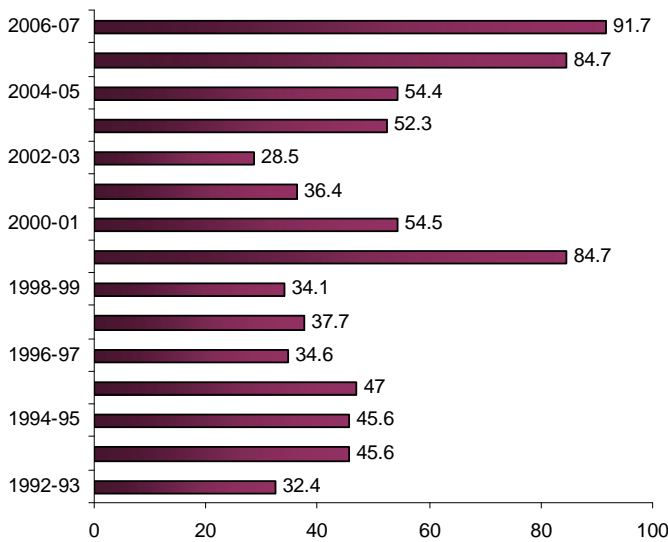
Market liquidity increased greatly between 1992 and 2007. This was a function of changes in settlement rules and the introduction of derivatives trading. The NSE introduced trading in equity derivative products in June 2000. It has since become the largest exchange in single stock futures

and it ranks fourth globally in the number of stock index futures contracts traded.

The move from fixed period to rolling settlements, shortened settlement periods, and a dramatic increase in derivatives trading contributed to steadily increasing market liquidity.

India’s 2005-06 turnover ratio was approximately 79 percent, compared to 50.9 percent in 1993-94 and only 34.4 percent in 1994-95. By mid-2007, it ranked third globally in number of trades in the equities market. The NSE’s average daily traded value in equities approximated Rs.13,302 crore (US\$ 3.3 billion) in September 2007.

Figure 1.3 – Market Capitalization to GDP Ratio



Source: SEBI, Handbook of Indian Securities Markets, 2006
NSE, Monthly Market Statistics

ended March 31, 2007, India’s economy grew at (9.3%).¹⁶ The ratio of market capitalization to GDP has increased over this time, to now rank among the best in the world, at over 100% by September 2007. The market cap to GDP ratio for China, for example was 33% in January 2007, for Japan 96%, and for South Korea 96%. Figure 1.3 shows the change in market capitalization to GDP for India.

Figure 1.4 below shows the growth in turnover on the stock markets.

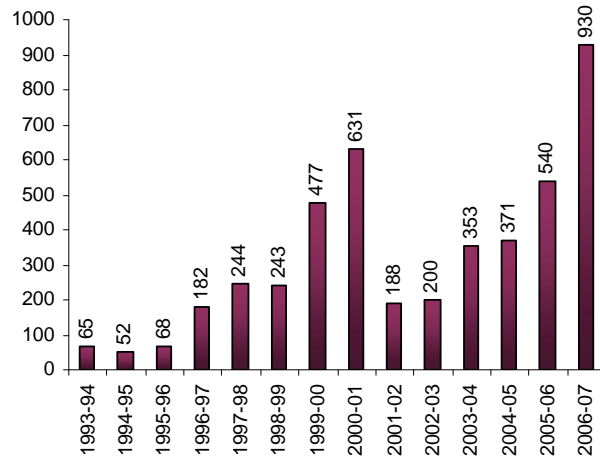
Robust Mutual Fund Industry

The mutual fund industry, like the market, has expanded at an accelerating rate over the period 1992-2007. In 1993, private sector players, including international asset managers were permitted to set up mutual funds. Assets Under Management (AUM) grew nearly ten-fold from Rs.43,000 crore (US\$ 14billion) in June 1993 to Rs.400,842 crore (nearly US\$ 100 billion) on June 30, 2007. The number of mutual fund schemes went up from less than 100 to 772 over the same period. Figure 1.5 below traces the growth of the industry’s AUM from March 1992 through September 2007.

¹⁵ China’s 2006 real growth rate was slightly higher, 10.7 percent. By contrast, the United States’ economic growth rate has been running below 3 percent.

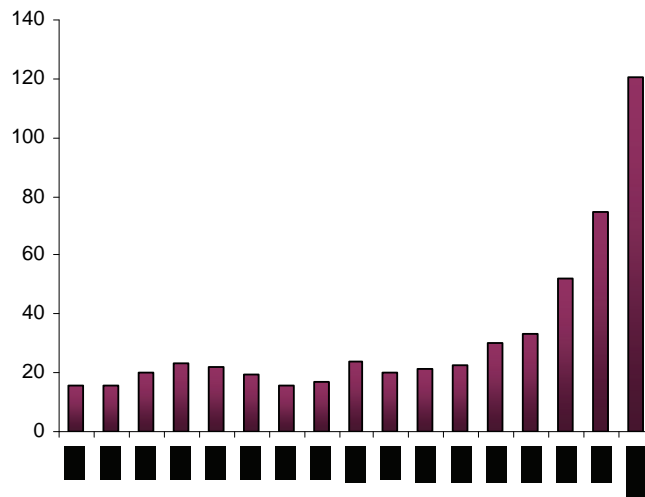
¹⁶ Central Statistical Organisation, Government of India.

Figure 1.4 – Growth in Stock Market Turnover (\$billion)



Source: SEBI, NSE

Figure 1.5 – Assets under Management (US\$billion)



Source: Mutual Fund Fact Book, 2000 and AMFI

The Association of Mutual Funds in India (AMFI) has played an important role in the industry's growth. This fund trade association, comprised of 32 asset management companies, helps develop and maintain high professional and ethical standards in mutual fund operations. AMFI's guidelines have set industry standards and more recently it has established a program for training, testing, and certifying all mutual fund intermediaries. SEBI later made this program mandatory for intermediaries.

□ Convergence of Accounting Standards and Increased Transparency

The growing number of Indian issuers whose stocks are listed and traded in US or European markets (and who must comply with the financial disclosure and corporate governance standards of those markets) has led to increasing acceptance of international disclosure requirements. Changes in SEBI regulation have also encouraged greater acceptance of international accounting standards in the Indian market. For example, SEBI has regularly upgraded its Listing Agreement requirements to bring them closer to international standards, most recently through new Clause 49 of the listing agreement. Starting in 2000, the ICAI adopted several new accounting standards that differ very little from International Financial Reporting Standards (IFRS). SEBI also adopted electronic reporting as well as electronic dissemination of financial reports and other issuer information in 2002. In 2003,

the Auditor's Report Order, under the Companies Act, set forth what an auditor's report must contain. In July 2007 the ICAI Council announced that it would move to full convergence with IFRS for accounting periods starting on or after April 1, 2011, for public interest entities, which include entities whose securities are publicly traded.¹⁷

¹⁷ The significance of full convergence of Indian GAAP and IFRS, and the further reforms needed

3. Summary

The regulatory initiatives and institutional reforms described above have put the Indian securities markets in 2007 well beyond the crisis-ridden 1990s. The adoption of international quality trading and settlement mechanisms and the reduction of transaction costs, have generated enormous interest among institutional investors, who in turn have helped introduce and disseminate improved disclosure standards and create growth in market volume and liquidity. In 2007, the Indian securities markets present a picture of better efficiency, liquidity, transparency and regulatory oversight, so crucial to fostering investor confidence and participation.

to make convergence fully effective in India are discussed under a subsequent section, "Strengthen Oversight of the Accounting and Auditing Profession" below, and in R. Narayanswamy, "Globalisation and Indian Accounting Standards," *The Chartered Accountant*, January 2006, pp. 962-974.

A Closer Look at the Major Achievements to Date

Chapter 2

1. Reform of the Legislative Framework

The difference between India's capital market in 1992 and 2007 is astounding (see Table 2.1). The transformation of the Indian market began with the enactment of the SEBI Act of 1992. Since its inception its mandate has been two-pronged: regulate but also to promote the market. SEBI has become, over time, more adept at balancing the need for discipline and accountability of professional participants in the market with the need to encourage free market forces and bring about change. Text Box 2.1 provides details of post 1992 legislative reforms.

2. Enhanced Market Surveillance and Efficient Enforcement

In addition to modernizing the legal and legislative frameworks for market regulation, SEBI took steps to significantly strengthen and broaden its ability to oversee the markets and exchanges. Most noteworthy was the implementation of an integrated market surveillance system (IMSS) and the development of expanded enforcement tools.

□ IMSS

On December 1, 2006, SEBI activated its IMSS, a modern comprehensive electronic surveillance system that enables the regulator to quickly detect suspicious market activity in any market and across all markets.¹⁸ IMSS

collects, collates, and sorts data related to all cash and derivatives market transactions on the NSE and BSE (99.9 percent of all equity transactions in India). It also collects and correlates data daily from the National Securities Depository, Ltd. (NSDL), Central Depository Services (India) Ltd. (CDSL), clearinghouses, and clearing corporations.

IMSS immediately transforms the raw data it receives into an integrated report of all the transactions on both exchanges. It enables regulators to detect such unfair market practices as creation of artificial volume, demand-supply side manipulations, artificially influencing price movements, insider trading, front running, wash sales, and synchronized trading.

SEBI has placed significant screening responsibilities on the exchanges as the front-line market regulators. Because the IMSS produces hundreds of alerts on suspect price and volume movements, SEBI's role continues to be oversight of the exchanges. An effective surveillance system must also provide information about the activities of market entities, individuals in the business of distributing securities, and large investors. To do this a unique identification number (UIN) is necessary. In 2006, the MoF promulgated the Prevention of Money Laundering Act that requires all participants in the securities markets to comply with "know your client"

¹⁸ Before the introduction of the IMSS, information sought by SEBI from the exchanges could be obtained only after a significant delay. With IMSS, information

required for an investigation is immediately available to SEBI.

Text Box 2.1: Reform of the Legislative Framework

SEBI Act, 1992

The SEBI Act of 1992 provided SEBI with rule-making and monitoring authority to oversee India's exchanges and brokers, and to register and authorize all initial public offerings (IPOs). To protect investors, the Act authorized SEBI to regulate matters relating to issue of capital, transfers of securities and other matters incidental thereto, the ways in which such matters may be disclosed by companies, and the requirements for listing and transfer of securities and other related issues.

In addition to the broad power given SEBI to carry out its mandate "as it thinks fit," the SEBI Act spelled out other measures that SEBI could take:

- Regulating the business in stock exchanges and any other securities markets
- Registering and regulating stock brokers, sub-brokers, underwriters, portfolio managers, investment advisers, and collective investment schemes, including mutual funds and other intermediaries who may be associated with the securities markets
- Promoting and regulating self-regulatory organizations
- Prohibiting fraudulent and unfair trade practices related to securities markets and insider trading in securities
- Promoting investors education and training of intermediaries of securities markets
- Regulating substantial acquisition of shares and takeover of companies
- Calling for information from, undertaking inspection, and conducting inquiries and audits of the stock exchanges, intermediaries, and self-regulatory organizations in the securities market.

SEBI issued regulations for Stock Brokers and Sub-brokers, Merchant Bankers and Insider Trading and Disclosure Investor Protection Guidelines. SEBI asserted authority over mutual funds, other than UTI, through the issuance of Mutual Fund Guidelines, in 1993 and regulations in 1996. Over the ensuing decade, SEBI issued a range of regulations and guidelines that shaped market operations.^a

1. Depositories Act of 1996

India took a major step toward market modernization with the enactment of the Depositories Act of 1996. This act established the rights and obligations of depositories, participants, issuers, and beneficial owners. Section 9 of the act requires that all securities held by a depository shall be dematerialized and in fungible form. Because the Depositories Act ensured the free transferability of securities with speed, accuracy, and security, it was fundamental to the market's transformation. The act allowed the market to move from a slow, risky, paper-based settlement to electronic dematerialized securities that eliminated many of the pre-existing impediments to swift and safe settlement. Dematerialization was the first step in applying systems such as straight-through processing (STP), real-time gross settlement (RTGS), and electronic funds transfer that led to the securities market achieving T+2 settlement.

2. Legislation on Derivatives Trading

Three legislative steps cleared the path for derivatives trading in India:

- The Securities Laws (Amendment) Ordinance of 1995 withdrew the prohibition on options in securities.
- The Securities Contracts Regulation Act (SCRA) was amended in December 1999, to include derivatives within the ambit of “securities.” Derivatives were defined to include “(a) a security derived from a debt instrument, share, loan, whether secured or unsecured, risk instrument or contract for differences, or any other form of security, and (b) a contract which derives its value from the prices, or index of prices, or underlying securities.”
- In March 2000, the Government rescinded the three decades old Notification which prohibited forward trading in securities.

3. The Dhanuka Committee Recommendations

In 1997, a prestigious committee under the leadership of Justice Dhanuka reviewed the SEBI Act and recommended enactment of a broader securities law that, among other things, would have given SEBI enhanced enforcement powers; spelled out explicit jurisdiction and provisions regarding the regulation of mutual funds; and clarified SEBI’s authority to require and enforce disclosure requirements for listed securities (now approached indirectly through SEBI’s power to prescribe listing requirements).

4. SEBI (Amendments) Act of 2001

Just as the 1992 market scandal prompted regulatory and market reforms a decade earlier, in 2001, another scandal prompted a strong regulatory and market response. In the spring of 2001, it was revealed that prices of several market scrips had been manipulated on several prominent exchanges financed through unauthorized funds of banks and brokers. The revelation shook confidence in the market and in the ability of the exchanges and regulatory structure to police the market. The Joint Parliamentary Committee (JPC) appointed in April 2001 to investigate the issue concluded that SEBI needed to decisively improve its procedures, vigilance, enforcement, and control mechanisms. It also recommended amending the SEBI Act to enhance SEBI’s investigative and enforcement powers.

Following JPC’s recommendations, in 2002 several amendments to the SEBI Act of 2001 were adopted. Key among these amendments were those that identified SEBI as the primary regulator of the securities market, giving it search and seizure powers and the ability to impose meaningful penalties.

^a These rules and guidelines, too numerous to discuss individually, include regulations relating to the issuance and buy back of securities; corporate governance in listed companies; custodians; depositories and participants regulations; derivatives; fit and proper person; foreign institutional investors (FIIs) and venture capital investors; investor protection; market participants (central database); mutual funds; portfolio managers; the Securities Appellate Tribunal; securities lending and borrowing; self-regulatory organizations; straight-through processing; stock brokers/sub-brokers; takeover regulations; and vanishing companies.

(KYC) norms.¹⁹ SEBI then mandated that all dematerialized accounts comply with the PAN requirements by December 31, 2006. The MoF mandated in February 2007 that the PAN issued by the income tax authority (Central Board of Direct Taxes, CBDT) be the single identification number for all securities market transactions. SEBI has now mandated that by December 31, 2007, PAN be quoted in all mutual fund transactions²⁰.

□ More Effective Enforcement

As a further response to the JPC's recommendations and as good practice, SEBI has taken steps to make its enforcement program more effective and efficient. On April 20, 2007, SEBI adopted Guidelines for Consent Orders and for Considering Requests for Composition of Offences and published forms and FAQs on consent orders. These guidelines signal a new SEBI approach on enforcement, one that is common in the United States. The guidelines cite the practice of the U.S. Securities and Exchange Commission that settles over 90 percent of its administrative and civil cases by consent orders.²¹

¹⁹ SEBI previously had relied on the MAPIN system to provide that identifier, but its effectiveness was delayed because of controversies over implementation, and the system has been replaced by the PAN.

²⁰ PAN was earlier required only for mutual fund transactions whose value exceeded Rs.50,000 (approx US\$1,250).

²¹ The SEBI Circular No. EFD/ED/Cir-1/2007 (April 20, 2007) explains that consent orders may provide flexibility because they permit a wider array of enforcement actions. Consent orders would achieve the twin goals of an appropriate sanction and deterrence without long drawn-out litigation before SEBI/Tribunal/Courts. SEBI also cited, as benefits of the use of consent orders, reducing regulatory costs and saving time and effort in enforcement actions that then could be used more effectively for cases requiring the full processes of enforcement action and for policy work.

In sum, SEBI, through its regulations and guidelines, better surveillance tools, increased training and professionalism, and strong leadership has instilled greater accountability in the market and developed into a more professional and credible regulator.

3. State-of-the-Art Market Systems and Infrastructure

India has capitalized on significant technological advances to improve the efficiency and transparency of its securities market. Technology has driven much of the change in the market. The technology-based systems and innovations helped to:

- Minimize systemic and settlement risk, such as through securities trading in dematerialized form with settlement in T+2; straight-through processing (STP); real-time gross settlement (RTGS); electronic fund transfer (EFT) used by securities market clearing banks; and the real-time, state-of-the-art systems at the clearing corporations.
- Improve SEBI oversight of exchanges, brokers and investors; increasing the accountability of professional market participants; and helping to detect and discourage insider trading, manipulations, and market scams, as through SEBI's Integrated Market Surveillance System (IMSS);
- Broaden the scope and reach of intermediaries, enabling them to establish electronic networks to expand throughout India and to develop internet trading accounts
- Improve the transparency of major market institutions, such as the websites maintained by SEBI, exchanges, and AMFI, and the transparency of the issuers whose securities are registered with SEBI and listed and traded on India's stock

exchanges such as through SEBI's EDIFAR System.

One of the principal engines of change in the operation of exchanges and in market culture was the competition to provide first-class service, much of it enabled by technology. As NSE's transparency, risk controls, and simpler settlement mechanism made it the leading market in India, it prompted the BSE to install its own similar systems and create its own depository, the CDSL by 1997.

A decade later, in mid-2007, both the BSE and the NSE were utilizing state-of-the-art technology. Electronic funds transfer (EFT) was introduced in 2003, and an automated transaction process, straight-through processing (STP), made possible T+2 settlement. The NSE's trading system was easily accessible through 40,000 strategically placed terminals around India.

Table 2.1 below briefly indicates some of the changes in the oversight and operations of India's capital market between 1992 and 2007.

4. Creating New Financial Instruments: The Derivatives Market

Of the many achievements in the Indian capital market over the past 15 years, the most sudden, recent, and dramatic is the development of the derivatives market. It has catapulted the market to new levels of sophistication and maturity.

Derivatives trading in India began in June 2000, with trading in stock index futures contracts. By the fourth quarter of 2001, each of India's two largest exchanges had four equity-derivative products: futures and

options for single stocks, and futures and options for their respective stock indices.²² By June 2007, derivatives trading had surged. During the seven years since June 2000, the NSE has become the largest exchange in single stock futures in the world, and by June 2007, it ranked fourth globally in trading index futures, a sign of an evolving and maturing market. See Table 2.2 below.

5. Developing the Mutual Fund Industry

The blossoming of the mutual fund industry in many ways parallels that of India's exchanges and derivatives market. Indian mutual funds started as a public sector monopoly. They lacked transparency, trained salesmen, and accountability, and eschewed many essential investor protections. India's mutual fund industry has now become a robust, transparent, well-regulated, professionally managed industry that offers a wide variety of mutual fund products and trained, tested, and certified sales representatives. To a large degree, as in the case of India's exchanges, its asset management companies have strong global ties; are well-informed and professional;

²² Trading was introduced in four steps:

1. **June 2000: Stock-index futures contracts** begin trading on the BSE's BSE-30 (Sensex) and the NSE's S&P CNX Nifty Index.
2. **June 2001: Stock index options** on these indices are introduced on the BSE and the NSE.
3. **July 2001: Single-stock options** on the 31 most actively traded stocks regardless of where listed begin trading on both the BSE and the NSE.
4. **September 2001: Single-stock futures** trading on the same 31 most actively traded stocks is approved by SEBI, and trading in them begins shortly thereafter.

Table 2.1 - Qualitative Comparison of Indian Securities Markets 1992-2007

Feature	Description	
	1992	2007
Regulation	Information disclosures in Indian Companies Act, Issue provisions in Capital Issues (Control) Act, Trading regulations in Securities Contract Regulation Act	Securities Contract Regulation Act is administered by SEBI. SEBI has a range of regulations covering various aspects of the capital markets.
Regulator	Central Government Departments	SEBI
Capital Market Access by Companies	Controlled by CCI	Free access subject to compliance with Disclosure and investor protection guidelines of SEBI
Organization of exchanges	Association of persons with limited or unlimited liability	Corporate structure
Management of exchanges	Boards made up of members and few public representatives	Demutualised format with management that is independent of membership
Membership pattern of exchanges	Dominated by individuals who inherit memberships.	Increased share of institutional members. Membership on the basis of capital adequacy requirements.
Pricing of Issues	Determined by CCI	Determined by the market forces. Book building process with red herring prospectus.
Issue Process	Limited institutional participation. Retail distribution by brokers and merchant bankers.	Separate subscriptions by institutional and retail investors
Trading mechanism	Floor based open outcry system	Screen based electronic open order book
Trading hours	11 am to 2pm	10 am to 3.30 pm
Execution of trades	Through market makers	On-line anonymous execution
Concentration of trades	BSE and Mumbai	Wider geographical spread of trading. Dominated by NSE terminals
Access to markets	Through broker offices and telephone	Internet Access to broker networks
Price information	Electronic display within exchanges. End of day prices published	Real time dissemination of prices through multiple electronic and media channels
Brokerage	Included and grossed into price (gala). Estimated at 3.5% -4%	Separately disclosed. Estimated at 0.50% for retail 0.10% for institutional investors
Settlement of trades	Batch settlement. 15-day account periods. Settlement cycle completion in 21 days.	Rolling Settlement. T+2 cycles
Custody of Securities	Physical holding in lockers	Electronic holding with custodians
Trade confirmation and pay-in/pay-out obligations	Bilateral end-of-batch process. Several trades fell into 'objections' (vanda).	Straight through processing and electronic confirmation of pay-in and pay-out.
Payment mechanism	Cheques	Electronic Fund Transfer
Delivery of securities	Physical form	Demat form
Transfer of ownership in books	Executed through physical transfer of documents, along with transfer deeds.	Executed through demat accounts implemented electronically.
Counter party risk	High. Incidence of bad delivery and fraudulent transfer high.	Eliminated through Clearing corporation and settlement guarantee funds.
Derivatives	Forward trading in indigenous form, known as badla. Counter party risk high due to low levels of transparency.	Futures and options in securities and index. Clearing corporation eliminated counterparty risk.
Risk Management	Ad hoc margining system imposed by exchanges.	VaR based margins computed using risk management systems, multiple times of the day.

Table 2.2 Top Five Equity Derivative Exchanges in the World – 2006

A. Single Stock Futures Contracts		
Exchange	No. of contracts	Rank
National Stock Exchange, India	100,430,505	1
Jakarta Stock Exchange, Indonesia	69,663,332	2
Eurex	35,589,089	3
Euronext.liffe	29,515,726	4
BME Spanish Exchange	21,120,621	5
B. Stock Index Futures Contracts		
Exchange	No. of contracts	Rank
Chicago Mercantile Exchange	470,180,198	1
Eurex	270,134,951	2
Euronext.Liffe	72,135,006	3
National Stock Exchange, India	70,286,258	4
Korea Stock Exchange	46,562,881	5

Source: World Federation of Exchanges.

follow appropriate risk-management standards; and are attracting investments at an accelerating pace. Like the exchanges and the derivatives market, the mutual fund industry also has the potential to play a much larger role in the continuing development of India's capital market.

□ Early Days

For 30 years, until 1993, India's mutual funds were sponsored and operated only as and by public sector institutions (beginning with the establishment of UTI by the UTI Act of 1963, as an initiative of the Government of India and the RBI until the repeal of the UTI Act). SEBI adopted its first mutual fund regulations in 1993, and in 1996, honed them into a more fully realized regulatory structure, paralleling those in more mature markets.

AMFI was incorporated as a not-for-profit industry organization on August 22, 1995; and, with the restructuring of UTI, the industry shifted from preponderantly public sector sponsors to private sector sponsors, including many foreign joint ventures.

For almost the entire first decade of SEBI's existence, its mutual fund regulations applied to substantially less than half of the industry's assets under management. This uneven and

anomalous regulatory pattern at best skewed competition within the industry by encouraging regulated funds to adopt strategies similar to UTI's (offering assured returns) and confused the investing public; at worst it bred distrust, not only of UTI, but also of the entire fund industry. UTI's difficulties, and those of the other funds that were sold on the basis of assured or indicative returns, were not the only challenges that the fund industry had to meet. The

launch of the Morgan Stanley closed-end fund in 1994 demonstrated how poorly understood the fund concept was and made foreign sponsored funds suspect in the eyes of some investors.

Despite the problems left by the Morgan Stanley launch, many reputable, well-established mutual fund management companies recognized the opportunities available in the Indian market. Several of the most trusted and accomplished firms in India were quick to sponsor private sector mutual funds. Others established joint ventures with foreign partners, whether predominantly Indian or predominantly foreign, that sponsored Indian mutual funds.

□ Influence of Global Players

Successful Indian entrepreneurs' experience and knowledge of the Indian market were complemented by the international mutual fund expertise of their joint venture partners. Established foreign asset managers are trained and experienced in observing international standards. Their international securities operations are usually reviewed by their home office compliance offices and in certain cases can be subject to review by foreign regulators. Even if not required by

Indian standards to apply such norms, these foreign asset managers would apply them as a matter of good practice. Competition within the industry and the blending of approaches through cooperation in joint ventures promoted convergence of international and Indian mutual fund standards and business practices. By 2003, when it implemented mandatory registration of mutual fund advisors, AMFI was a well-respected professional organization that many regarded as akin to a mutual fund self-regulatory organization.

Mutual fund AUM on June 30, 2007, was Rs.4,00,842 crore (US\$ 100.21 billion). Private sector asset management companies managed 82 percent of those assets. Banks and institutions managed 18 percent, including ICICI Prudential Mutual Fund, which accounted for just over 10 percent of total AUM. More than half (52 percent) of the industry's assets were under the management of joint ventures. Six predominantly Indian joint ventures accounted for 35 percent of the AUM and nine predominantly foreign joint ventures accounted for the remaining 17 percent. By 2003, uniform mutual fund regulations applied to all funds and their managers, including UTI.

□ **Product Range and Expanded Services**

The fund industry now offers a wide variety of financial products. As of June 30, 2007, nearly three-quarters of the industry's assets were in open-end schemes. Of 772 total schemes, 495 were open end, with a total AUM of Rs. 295,334 crore (US\$73.8billion), or 74 percent of the total AUM; while 277 were closed end, with a total AUM of Rs.105,508 crore (US\$26.37billion), or 26 percent of total AUM.

Table 2.3, provides AUM by the type of schemes. The table also reveals the addition of several other newer specialized types of funds:

Equity linked saving schemes (ELSS), with 3 percent of total AUM; ETFs, with 2 percent, and Gold ETFs and Gilts, each with less than 1 percent. Not separately identified are Fund of Funds, which as the name implies holds shares of other funds in their portfolio.

□ **Registering Mutual Fund Intermediaries**

In January 2002, AMFI launched the AMFI Mutual Fund Certification and Registration Programme, "to give ... fund distributors the knowledge and insights required for them to become both better intermediaries and more informed mutual fund advisors."²³ SEBI soon mandated that any entity/person engaged in marketing and selling mutual fund products, including employees of corporate distributors, pass the Advisors Module Certification Test and obtain a registration number from AMFI before canvassing mutual fund business. As of June 30, 2007, approximately 56,000 intermediaries had passed the Advisors Module test and had been certified and registered by AMFI.

The mutual fund industry has grown at an accelerating pace over the past four years. A primary reason is that it came out from the shadow of UTI and now operates in a rational regulatory environment applicable to the entire industry. The industry has benefited from rising market prices as well as the shared experience and expertise of its global joint venture partners and trusted Indian entrepreneurs. This expertise has enabled the industry to apply computerized systems, technology and customer services systems and techniques perfected in mature markets to India's market. AMFI, working closely with SEBI, has provided dedicated responsible leadership. For the industry to continue to reach its full potential it must redouble its efforts to build professionalism,

²³ AMFI website, AMFI Mutual Fund Testing Programme (www.amfiindia.com).

Table 2.3 AUM by Type of Scheme , as of June 30, 2007 (Rs. Crore)

	Open End	Closed End	Total	% to Total
Income	70,180	80,733	150,913	38
Growth	105,352	21,016	126,368	31
Balance	9,023	1,772	10,795	3
Liquid	91,201	—	91,201	23
Gilt	1,963	—	1,963	a
ELSS	10,346	1,987	12,333	3
Gold ETF	255	—	255	a
Other ETF	7,014	—	7,014	2
Total	295,334	105,508	400,842	100

a = less than 1 percent

Source: AMFI Monthly, June 30, 2007

to educate the investing public, and to expand its market penetration to tap into the new and expanding Indian middle classes.

6. Improving Disclosure Standards and Transparency

Milestones on the Road to Convergence

Propelled by globalization and needing to attract foreign direct and indirect investment and to satisfy international and institutional investors, with support from issuers, SEBI and the ICAI, India's accounting standards moved toward greater transparency and full convergence. Again, this movement has been marked by a number of milestones:

- SEBI's acceptance of international disclosure requirements alongside its own requirements.
- SEBI's establishment of an Accounting Standards Committee as a standing committee in 1998-99.
- SEBI's regular upgrading of its listing agreement requirements to bring them closer to international standards, most recently with new Clause 49 of the listing agreement.

- The recommendations of the Kumar Mangalam Birla Committee on Corporate Governance that India move speedily to adopt international standards, with specific recommendations for presentation of consolidated financial statements, segment reporting, and disclosure of related party transactions,

which were realized in 2000 through SEBI's changes in the listing agreement.

- The recommendations of the Narayana Murthy Committee on Corporate Governance that management justify any accounting treatment different than that required by an accounting standard realized by SEBI's changes in new Clause 49 of the listing agreement.
- Establishment by the government of the National Advisory Committee on Accounting Standards (NACAS) in 2001.
- SEBI's implementation of EDIFAR in 2002 to permit electronic reporting and dissemination of financial reports and other issuer information.
- Movement of SEBI and the Institute of Chartered Accountants of India (ICAI) toward adoption of the International Accounting Standards Board's (IASB's) International Financial Reporting Standards (IFRS), including, since 2000, adoption by the ICAI of many new standards that differ very little from IFRS.
- Recommendations of the Naresh Chandra Committee (NCC) in 2002

designed to strengthen corporate audits, and by doing so, the quality of financial statements.²⁴

- Adoption of Auditor's Report Order, 2003, under the Companies Act, which sets forth what an Auditor's Report must contain.
- SEBI's appointment in July 2007 of a Standing Committee on Accounting and Disclosure Standards (SCODA) to harmonize the ICAI's accounting standards with IFRS.
- The ICAI Council's announcement in July 2007 that it would move to full convergence with IFRS for accounting periods starting on or after April 1, 2011, for public interest entities.²⁵

7. Effects of Equity Market Reforms

As noted above, the transformation of the securities market has had numerous significant economic effects.²⁶ These include the impact of competition; the BSE's total remodeling of itself to meet competition from the NSE; increased access to the market, including from foreign firms, yielding more vigorous competition among securities brokers and mutual funds; entrepreneurs more readily able to access equity financing compared to debt financing; and greater availability of capital in the economy reflective of the increasing importance of securities markets in resource

allocation and the dominance of equity financing.

Although reforms in other sectors have not been as dramatic and successful as those in the equity markets, the effectiveness of the equity market reforms has boosted confidence in reform processes throughout the financial market, "strengthening the regulator and building market institutions to improve competition in the sector."²⁷ Among processes that have been followed in different sectors are, in banking, improved competition and prudential norms in line with international norms, increased disclosure levels, and improved autonomy of public sector banks; in insurance, diminished State involvement in the commodities markets, establishment of the Insurance Regulatory and Development Authority (IRDA), and opening the sector to a competitive market structure and free market pricing; in the debt market, creation of a clearing corporation for debt market trades (Clearing Corporation of India, Ltd., CCIL), trading interest rate products, and creation of the Negotiated Dealing System (NDS) and its evolution into an electronic limit order book.²⁸

²⁴ For a more detailed discussion, see "Strengthen Oversight of the Accounting and Auditing Profession" in Chapter 5.

²⁵ For a more detailed discussion of the significance of these steps, see R. Narayanswamy, *Globalisation and Indian Accounting Standards, The Chartered Accountant*, January 2006, pp. 962-974.

²⁶ Susan Thomas, "***How the financial sector in India was reformed,***" 2005, pp. 32-37.

²⁷ Thomas, op. cit., pp. 18-26.

²⁸ For a detailed discussion of needed debt market reforms, see Chapter 5 below.

Dynamic Forces that Can Help Sustain Continued Market Growth

Chapter 3

The Past is Prologue

The Indian securities market has concluded a stunning “prologue.” It has switched from a paper-based to an electronic market. It has seen the building of state-of-the-art electronic market infrastructures. SEBI has followed suit with its integrated market surveillance system (IMSS) and by providing skillful leadership and adapting its regulatory structure to the new market realities, becoming a respected regulator. The period has also witnessed the transformation of such legacy institutions as UTI and BSE, and the development of stronger, well-regulated institutions, including the NSE and BSE and the fully regulated mutual funds that comprise AMFI. In addition, India’s securities market has transformed itself into a major global market by developing the hugely successful derivatives market, improving the transparency of the market, and steering toward convergence of Indian and international accounting standards.

Indian securities market institutions have developed the know-how to continue the reform process and build on the market’s previous successes. Furthermore, parts of the needed foundations to build investor confidence and support these market segments’ growth are already planned and are in early stages of implementation. These elements include creation of the National Institute of Securities Markets, which will help to expand financial literacy; professional skills and knowledge; financial education; securities market research; and corporate governance reforms.

A number of the characteristics and trends in today’s market, if fully realized, could significantly enhance the development of the Indian securities market.

1. An Expanding Pool of Potential Domestic Investors

An expected six-fold expansion of India’s middle class will continue to drive the growth of the Indian capital market. A recent report by the McKinsey Global Institute predicts that India’s middle class (and thus the pool of potential Indian investors) would expand dramatically over the next two decades.²⁹ The report suggests that if India continues its recent growth, average household incomes will triple over the next two decades, and the country will become the world’s fifth largest consumer economy by 2025, up from twelfth now.³⁰ In the process, the report says, “almost 300 million people will move out of desperate poverty and India’s middle class will balloon from 50 million people to almost 600 million.”

The potential benefits of expanding the domestic retail base are enormous. Invigorating the domestic market base will give India’s growing middle class a greater stake in India’s economy and provide individuals and families opportunities for

²⁹ “The ‘Bird of Gold’: The Rise of India’s Consumer Market,” McKinsey Global Institute, May 2007.

³⁰ “Tracking the growth of India’s middle class,” *The McKinsey Quarterly*, 2007, No. 3. This article is based on the report quoted in footnote 29.

long-term financial rewards. It will also add stability by balancing the flow of foreign funds, protecting against possible decreases in the rate of foreign investment or any large sudden movements of foreign investment to other growing international markets.

Text Box 3.1 shows data on Indian retail investors and current trends in their investments. Looking at this data it appears that, despite the market and regulatory reforms already implemented, domestic retail investors still lack confidence in the market.

To permit a growing number and proportion of Indian families to participate more directly in, and enjoy the benefits of, the expanded market economy, it will be necessary to build knowledge of the market, and to establish trust and confidence in its fairness. Critical issues are how investors will be treated by intermediaries, the fairness of the regulatory system, especially in the protection that it offers to small investors, and investor awareness and confidence in these protections.

2. Rapid Expansion of Retail Financial Intermediaries

India is in the midst of a rapid, broad expansion and modernization of its brokerage houses and investment advisers/financial planners – focused on capturing increased numbers of retail investors. Brokers, whose businesses once focused only on traditional exchange transactions and IPOs, have adopted a dynamic business model that covers thousands of branches, agents, and employees, and that enables them to reach greater numbers of retail investors. Striving to become “one-stop shops” for investors’ financial needs, they are transforming traditional brokerage businesses and the retail securities market by attracting more customers and providing advice on, and sales of, financial products. Many newer brokerages, including those that began as

internet-based businesses, have also established similar operations. They feature depository services, portfolio management (discretionary and nondiscretionary), commodities and distribution of insurance (agency, broking, or both), mutual funds, and retail debt instruments. Some larger non–exchange intermediaries are also beginning to provide similar services through expanded networks, products and services. These networks are supplemented by thousands of small firms and individual distributors and advisors. This energetic and expanding distribution network, with proper regulation and protections, is poised to play a major role in expanding Indian financial markets.

3. Flow of Foreign Funds

The steady and continuing flow of investments from foreign and domestic institutional investors has boosted India’s market indices to record levels. During the period April – September 2007, FIIs had invested nearly US\$11.5 billion as compared to US\$6.7 billion in the whole of 2006-2007. The flow of foreign funds into the Indian capital market (see Figure 1.1 in Chapter 1) is one of several indicators of the strength and outlook for continuing market development.

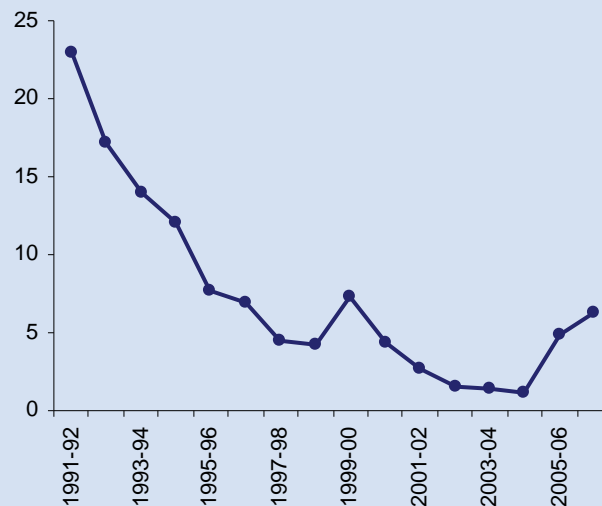
4. The Catalytic Force of Pension Reform

In January 2004, India began to roll out a new pension system (NPS) that will move employees of the central and state governments, as well as non-government workers, to individual accounts in defined contribution pension schemes. Although relevant legislation is still pending, implementation of the NPS is moving forward.

Text Box 3.1: RETAIL INVESTORS — RELUCTANT INVESTORS

Currently, there is very limited retail participation in India's securities markets. The Sensex has experienced a historic price rise over the five years 2002–07, virtually quintupling, from approximately 3,000 points in August–November 2002, to approximately 15,000 in July 2007 (see Figure 3.1). India's citizens took very little advantage of this market rise. India's retail investors, that is, individual savers and investors with intermediate to long-term investment horizons, invested a smaller percentage of their savings in shares, debentures, mutual funds, and UTI units in 2005–06 (4.9 percent) than in 1993–94 (13.5 percent). This value was as low as 0.1 percent in 2003–04 and 1.1 percent in 2004–05, and has only seen an increase with the booming markets of 2005–07.

Figure 3.1: Percentage of Household Savings in Securities Market



Source: Reserve Bank of India, Handbook of Currency and Finance, 2007

The relatively low participation of employed workers in the equity markets was also confirmed by an IIMS Dataworks survey in 2007:^a

Nearly 190 million people, or 60 percent, of the paid workforce had financial savings distributed across formal and informal finance. Conventional savings vehicles such as bank deposits (144 million savers), postal savings (36 million), and life insurance (105 million) were the preferred vehicles among the 190 million savers.

Less than 6 million, or 2 percent, of the Indian paid workforce, or 3 percent of the workforce savers, had a “demat” account (an account with a securities depository required for investing and trading in shares).^b

5.3 million, or less than 2 percent of the paid workforce, had invested in mutual funds.

The IIMS survey also found that “three in every four of the 94 million earners in urban India are risk averse and are disinclined to take risks with their investments. And nearly 80% understand the correlation between risk and returns Equities are seen as high-risk instruments, with ... 92% of the respondents ... terming them so.”

A very high percentage of persons earning more than Rs. 2 lakh (\$5,000) believed that the share market is a risky investment and that the market is too volatile. The adverse publicity generated by periodic scams and “bubbles” has discouraged India’s investors. Lack of financial literacy and low levels of market awareness remain major constraints to retail investment in India. On the other hand, the survey indicates that large percentages of those persons who invested in shares understood the benefits of investing over the long term.

Other studies also confirm the avoidance of risk among investors in mutual funds. AMFI statistics^c show that, on June 30, 2007, more than 61 percent of mutual fund AUM was in fixed income securities, out of which 23 percent of AUM, almost all of it from corporate and institutional investors, was in liquid/ money market funds which are the least volatile funds.^d For the quarter April to June 2007, while income and liquid/ money market funds gathered Rs. 46, 915 crores (\$11.7 billion), net inflow in equity growth funds was only Rs. 1,937 crores (\$484 million).

Table 3.1: Net Inflows into Mutual Funds (April-June 2007)

Type of Fund	Net Inflows (Rs. Crore)	% to Total
Income Funds	28304	55.01%
Growth Funds	1937	3.76%
Balanced Funds	99	0.19%
Liquid Funds	18611	36.17%
Gilt Funds	-327	-0.64%
Equity Linked Savings Schemes	487	0.95%
Exchange Traded Funds	2339	4.55%
Total Inflow	51450	100.00%

Source: AMFI, Quarterly Update, Volume VII, Issue 1, July 2007.

^a “Invest India Incomes and Savings Survey– 2007,” *Mint*, July 16, 2007. The survey is based on a paid workforce of 321 million workers, ages 18-59, of which 227 million were rural and 94.4 million urban.

^b The National Securities Depository Limited (NSDL) had nearly 7.8 million demat accounts at the end of June 2007. India’s second securities depository, Central Depository Services (India) Limited (CDSL), had nearly 2.6 million demat accounts on June 30, 2007.

^c Source: AMFI Update, April–June 2007, Vol. VII, Issue I

^d See Chapter 2; Table 2.3 “AUM by Type of Scheme as of June 30, 2007”

Pension reforms currently underway could push the market to around Rs 406,400 crore (nearly US\$100 billion (at current exchange rates) in 2025 from Rs 56,100 crore (nearly US\$ 14

billion) in 2002.³¹ The shift from an unfunded,

³¹ An April 2007 paper by the Federation of Indian Chambers of Commerce and Industry (FICCI) and KPMG prepared for a FICCI Conference on Pension Reforms in India: Opportunities and Challenges on April 10, 2007.

defined benefit system to a defined contribution system focused on individual pension accounts invested in India's financial market could catalyze the market's development. The potential for those assets to inject additional vitality into India's equity and long-term debt markets is enormous. The extent of pension funds' impact will depend, among other things, on the flexibility of pension fund investment regulations, the availability of relevant financial products (such as fixed income securities), and Indian workers' acceptance of investment in the capital market. Like many retail investors, pension fund investors have a long-term perspective and differing risk tolerances. Investment instruments and mechanisms will need to be tailored to meet the funds' needs. A varied mix of equities, longer-term corporate bonds, fixed income instruments and government bonds, and skilled fund managers will all be needed. There are additional benefits of pension reform success. The experience of Chile, Argentina, and other countries demonstrates that successful pension reforms can increase financial sector sophistication and innovation.

5. Multiplier Effect of Increased Market Valuation

A corollary of the flow of foreign funds is that the increased market valuations they create multiply opportunities for additional growth, whether through acquisitions, further expansion by investing in domestic projects, buying suppliers or distribution networks, attracting the best talent, or raising additional capital. Many of these opportunities are already being witnessed. Merger and acquisition (M&A) deals in India through May 2007 had reached the US\$46.8-billion mark. Driven by large capital and global liquidity, M&As, including inbound and

outbound deals, were expected to cross the US\$100 billion mark in calendar 2007.³²

6. Strengthened Connections to Global Markets

Recent investments in Indian exchanges as well as plans to develop an International Financial Center in India strengthen the connections with global markets. Deutsche Bank (DB) and the Singapore Stock Exchange (SGX) each bought a 5 percent stake in the BSE. The NYSE Group, owner of the NYSE, and three international investment groups — General Atlantic, Goldman Sachs, and Softbank Asia Infrastructure Fund (SAIF) — purchased a 20 percent stake in NSE. The NSE announced early in 2007 that each of these four entities would acquire a 5 percent stake from existing promoters, who are institutions.

These alliances bring to India's capital market the extensive resources, experience, and networks of some of the world's preeminent financial market groups, groups that are strongly positioned in North America, Europe, and Asia. They will significantly improve NSE's and BSE's strategic positions, reinforce their global ties, and strengthen India's stock exchanges and its capital market. Because the development of technology to run trading platforms is one of the largest expenses of an exchange, the relationship should also help the NSE and BSE, as well as other members of their extended networks, to continually upgrade and maintain technological superiority at a lower cost than if each had to do so independently.

India is also considering ambitious efforts to develop an International Financial Center³³

³² "Indian M&A to top US\$100 billion," *Financial Express*, June 28, 2007, reporting on a conference on "Mergers & acquisitions: An effective way of creating value," organized by Dun & Bradstreet and Citibank.

that will integrate India with the global markets, make India a leading provider of international financial services, improve financial intermediation for India, and accelerate GDP growth as investment resources are more efficiently allocated.³⁴

³³ A recent report by the High Powered Expert Committee on “Mumbai—An International Financial Centre” has provided several far reaching recommendations to move Indian financial markets to the next level. The recommendations are under consideration of the government.

³⁴ Ibid.

Challenges to Sustained Market Growth

Chapter 4

As promising as the opportunities in front of the Indian capital market now appear, they cannot be fully realized without significant additional reforms involving greater cooperation among regulators. They also require creation of new market institutions and regulatory structures: front-line regulators for market intermediaries and cross-market trading, an oversight board for the accounting and auditing profession, a strengthened market regulatory infrastructure, and clearer definition of regulatory responsibilities for the corporate debt market.

1. Regulatory Framework Issues

□ Incomplete Regulation of the Retail Interface

Increasingly, investors find themselves in a more integrated retail market, in which intermediaries sell or provide advice about a wide variety of financial products and services. Financial intermediaries seek and change products as these products move in and out of favor.³⁵ In the future, intermediaries will distribute and advise clients regarding an even greater variety of retail financial products, such as commodity futures and personal pensions.

In contrast to the market's integrated distribution system, the regulatory system

under which the market still operates is fragmented. It regulates products, rather than intermediaries. Because it fails to treat the entire distribution process as integrated, the existing regulatory system provides piecemeal and uneven protections to retail investors. Persons who receive investment advice or purchase securities and other financial products do so largely without regulatory protections. As shown below, the firms and individuals that provide advice on securities and distribute investment products carry on these activities with surprisingly limited regulatory oversight.

Exchange brokers (and registered sub-brokers) are regulated by SEBI and the exchanges. However, exchanges regulate only the exchange segment of the brokerage business, not distribution of mutual funds or other products. Because SEBI regulates brokers through exchange self-regulatory organizations (SROs), it can be assumed that broker activities such as distribution of mutual funds, other products, and financial planning are not regulated through this mechanism. Similarly, IPO distribution originates with brokers and extends through the numerous channels described above. In most cases, this means little more than distribution of application forms. While the brokers (i.e., exchange members) are regulated entities, no other intermediaries in the chain are regulated.

SEBI restricts entry into mutual fund distribution by requiring registration with AMFI. However, AMFI is a trade association, not an SRO. Therefore, the regulation of

³⁵ In the recent past, intermediaries were large-scale distributors of company and non-bank financial companies' (NBFC) fixed deposits. The high interest rates (and commissions) then offered made them attractive. In the booming real estate markets of the last few years, some intermediaries became real estate agents.

distributors starts and ends with obtaining their AMFI registration numbers.

Fixed deposits from companies and NBFCs are distributed through agents registered by the issuing companies. Similarly, agents registered with post offices distribute post office and national savings products. Registration is a means of providing their commissions rather than regulation.

Advisers who have custody and discretion are required to register with SEBI as portfolio managers. The net worth requirement for SEBI registration is Rs. 50 lakhs (US \$125,000). Only about 130 portfolio managers, including brokers and mutual funds, have registered with SEBI. “Fee only” planners are rare, and there is no registration or regulation of this activity. No registration category applies to financial planners and investment advisers other than the SEBI portfolio manager regulation, which imposes excessive minimum capital requirements for providing financial planning and investment and transaction advice to retail investors.

In sum, existing regulation does not reach intermediaries who provide advice and distribution services to the average Indian retail investor. This is a significant gap in the Indian regulatory system.

□ **Potential Conflicts of Interest at the Demutualized Exchanges**

SEBI has historically implemented market regulation through exchanges, the only SROs in India.³⁶ However, exchanges cover only a

³⁶ Although industry trade associations, such as AMFI, the Association of Merchant Bankers of India (AMBI), and Registrars Association of India (RAIN), may be thought of popularly as SROs, they cannot expel members or enforce adherence to the guidelines and standards that they adopt, nor does SEBI register them as such.

part of the market; have authority only over their members; and no authority to regulate markets beyond their own.

SEBI encouraged the demutualization³⁷ of exchanges as a response to the conflict of interest issues raised during the spate of allegations of market irregularity in 2001. The NSE was established as a demutualized exchange. The Stock Exchange, Mumbai (BSE), recently completed its demutualization. Although demutualization of India’s exchanges was perceived of as a solution to the conflict of interest issues, international experience and regulatory responses suggest that these issues can be exacerbated with the conversion of nonprofit market utility type exchange structures into for-profit and, in many cases, publicly listed corporate structures.³⁸ India will soon have to devise ways to address these conflicts.

□ **Lack of a Cross-Market Regulatory Organization**

SEBI regulates securities trading on exchanges only through the exchanges whose jurisdiction is limited to their markets. Cross-market trading information is not available to individual exchanges. Each exchange can focus solely on regulating and supervising its own market. As the current regulatory structure lacks a cross-market SRO, it appears that market activity has advanced more rapidly than the regulatory structure.

³⁷ Demutualization is the process through which a non-profit member-owned entity becomes a shareholder-owned organization, generally a for-profit corporation.

³⁸ The Australian Stock Exchange, Germany’s Deutsche Börse Group AG, the London Stock Exchange plc, Singapore Exchange Limited, and NASDAQ Stock Market, Inc., are some of the publicly listed major exchange operators.

In a market with two major exchanges and many common memberships and common listings, the surveillance function can best be performed only if aggregate information on transactions and firms is available to a single surveillance entity. Prudential regulation and registration/identification of intermediaries/investors are also functions that require cross-market emphasis. Without a cross-market SRO, and with no other regulatory organization having a broader mandate, SEBI is the only regulatory authority that can perform cross-market surveillance and directly regulate retail distribution of financial products.

2. Incomplete Surveillance Infrastructure

□ Integrated Market Surveillance

SEBI has historically delegated front-line market surveillance responsibility to the SROs, the exchanges that have developed sophisticated, electronic and real-time surveillance programs.

It is believed that, in 2001, a group of traders attempted a market manipulation across several exchanges, causing a run-up in the price of several market scrips. When the market bubble burst, it eventually became clear that no regulatory body was monitoring trading across markets and exchanges, a situation that most likely allowed the attempted manipulation to continue for some time.

A report of the Joint Parliamentary Committee (JPC report),³⁹ established to review the market events and resulting problems, concluded that a very strong surveillance mechanism should be in place, at the levels of both the stock exchange and the

regulator. It recommended that surveillance systems in both stock exchanges and SEBI should be examined in a holistic manner with an outlook to the future. To put a system in place that will effectively detect financial misconduct quickly is an inescapable necessity.

SEBI set the highest priority on strengthening its own market surveillance program, as well as those of the exchanges. This required building and operating its own system, a system that integrates information across markets and exchanges, provides access down to the client level, and allows SEBI to verify that exchanges are conducting adequate surveillance programs. Such an infrastructure must consist of three major components:

The first component of a fully functioning electronic market surveillance infrastructure, SEBI's IMSS, activated early in 2007, is an electronic surveillance system that integrates all derivatives and equities market data into a database that can detect potential insider trading; fraudulent trading practices, including violations such as synchronization/wash sales; fraud by misrepresentation; manipulations, such as market domination; marking the opening or the close; intermarket price manipulations (between equity and derivative markets and across exchange markets); and other stock/derivative manipulations.

The second component, is a central database that provides information about market participants, market intermediaries (including firms and individuals who distribute securities or provide investment advice on securities), and key personnel associated with issuers and brokers. The UIN proposed for all intermediaries and large investors is expected to provide one part of the second component.

The third component is a financial adequacy monitoring system that receives and analyses continuous timely information about the

³⁹ Report of the Joint Committee on Stock Market Scam and Matters Relating Thereto (Thirteenth Lok Sabha) (Volume I—Report), presented to Lok Sabha December 19, 2002, Lok Sabha Secretariat, New Delhi, p. 476.

business activities of market intermediaries that affect their financial condition and operational capacity awaits development.

□ **The need for professionally trained surveillance and enforcement staff**

Although, the IMSS provides the technology to meet the first of these three objectives, technology is only the beginning of the process. It must be effectively utilized by a trained professional staff. While SEBI continues actively to recruit and train professionals, it lacks the required levels of trained staff to conduct effective surveillance, investigation, and enforcement. More staff and significant additional staff training are required. To raise SEBI's surveillance and enforcement to international best practice, changes are required in SEBI's human resources capacity and systems to facilitate significant acquisition and retention of needed human resources. As a governmental body, SEBI cannot pay the market rate for professional personnel or close to it. SEBI frequently is confronted with situations where it recruits, trains and provides experience to staff that leave for higher paying jobs. When experienced and skilled staff leaves, institutional knowledge and memory leaves with them. Advanced training requires time and attention. High staff turnover makes it difficult to maintain the required professional level. Moreover, for a market of India's size, potential market regulatory capacity must be significantly enhanced, a major issue for Indian regulators.

□ **The Need for a Central Registration Depository (CRD)**

While IMSS provides SEBI with a degree of inter-exchange surveillance capacity, in addition to staff constraints, SEBI lacks immediate access to specific information about brokerage firms and their associated individuals. Information about intermediaries is scattered and inaccessible. As of June 30, 2007, registration information filed by intermediaries or otherwise determined, including

job/residence and conduct histories, was recorded in various systems, including on paper, in several places, either at individual exchanges or at SEBI.

In addition, SEBI has delegated to the newly created National Institute of Securities Markets (NISM) the responsibility for various certification programs. NISM would also be required to maintain records of each intermediary's qualifications, including completion of continuing education requirements. To manage registration information, including certification information for several thousands of intermediaries, SEBI and the industry need a CRD, along the lines of the US institution.⁴⁰

□ **Lack of Effective Financial Adequacy Protections**

India's exchanges utilize deposits⁴¹ to protect themselves, clearinghouses, and the settlement system. The deposit system proved its effectiveness for these purposes by settling and clearing all trades on May 18, 2006. On that day,

⁴⁰ The US Central Registration Depository (CRD), managed by the National Association of Securities Dealers (NASD), maintains comprehensive data on all intermediaries, including information on background, identity, education, employment, certifications, and conduct. The Investment Adviser Registration Depository (IARD), also managed by NASD on behalf of the Securities and Exchange Commission (SEC) and state regulators, maintains similar information for all registered investment advisors.

⁴¹ "An entity seeking membership in the CM segment is required to have a net worth of Rs. 10 million and keep an interest free security deposit of Rs. 12.5 million and collateral security deposit of Rs. 2.5 million with the Exchange/ NSCCL. The deposits kept with the exchange are taken as base capital to determine the member's intra-day trading limit and/or gross exposure limit. Additional base capital is required to be deposited by the member to take additional exposure," NSE Indian Securities Market Review, 2006, p. 112.

the Sensex declined 826 points, or 6.76 percent — so stress on the system was at its highest. However, the deposit system fails to adequately protect investors and does not provide adequate notice of market weaknesses to the regulator. Neither do the “investor protection funds” of the exchanges. These funds are limited to exchange transactions only. In the case of broker insolvency, there is no protection for the customers’ assets. Because of the deposit system, brokers’ net capital may be tied up almost entirely in exchange deposits that are used only to meet exchange obligations. Thus, if a broker becomes insolvent — not an unlikely occurrence in any market — investors may lose the assets left with their brokers.⁴² Moreover, because an exchange’s jurisdiction is limited to its own members, it cannot examine those members for violation of another exchange’s capital regulations.

SEBI lacks current information about the financial and operational status of regulated exchange member firms. SEBI and the exchanges have adopted capital regulations and calculation rules that require a relatively low level of instruction and interpretation compared with other regulators’ instructions. Trading firms are required to file balance sheets with capital calculations semiannually with their exchange. Audited annual financial statements should be reported to exchanges within six months of year-end. By the time these reports are filed, they would be of no assistance in the early discovery of potential problems and may be only of historic interest.

The low frequency of reporting capital calculations in India, contrasts sharply with the frequent financial reporting required by regulations in the US, UK, Singapore, Hong Kong and Australia. The lack of liquid capital rules requiring frequent reporting makes it risky for SEBI or the exchanges to rely on a firm’s apparent net worth or liquid net capital. This inability may harm investors in at least two ways. Failures of brokerages and other intermediary firms will undermine investors’ trust; and losses of investors’ assets will drive them to other investment vehicles. The lack of reporting also impairs regulators’ ability to discover and therefore prevent or manage market failures. For example, if capital information had been periodically filed (and reviewed), this would likely have led to early discovery of the leverage underlying the regional exchange settlement failures in 2001.

To complete India’s market surveillance and enforcement infrastructure, the Indian markets must implement a CRD and a single financial adequacy requirement with frequent periodic reporting. Accomplishing this involves not only closing regulatory gaps, but also devoting large staff and financial resources to intermarket surveillance and enforcement and to the regulation of investment advisers and securities distributors.⁴³

3. Lack of Accessible, Simplified Means of Customer Redress

Retail investors do not know which intermediaries and sales processes are regulated,

⁴² Anecdotal evidence from the Indian markets suggests that investors do leave assets, signed depository instruction slips, and such with their brokers for ease and convenience of trading. In addition, Internet brokers providing integrated banking, depository, and broking accounts require investors to sign powers of attorney providing them access to customer assets.

⁴³ In the UK, the Financial Services Authority (FSA), the financial market regulator, has a budget of £312 million (US\$650 million) and a staff of 2659, of which approximately one-third, are involved in regulating the securities market. In addition, its FSA Ombudsman has a staff of about 1,000 and the Compensation Scheme another 108 persons. Compensation for FSA staff is generally in line with that of the financial services industry.

nor by whom. SEBI and professional associations advise investors to deal only with registered intermediaries, but retail investors generally do not know if their intermediary is regulated, nor whether, if the intermediary is regulated, relevant regulation applies to the product they are being offered. Many competing products are offered by different intermediaries, as noted above. The same salesperson may be regulated for the sale of some of these products, but unregulated for the sales of others. Distributors and advisers, including financial planners, who are not regulated by either SEBI or an exchange, or are unknown to regulators, offer a broad range of products.

Finding the responsible party to resolve a market transaction problem can be difficult and may require approaching several institutions. For instance, an investor who does not receive a refund when a subscription to a new issue is unfilled may ask for the deficiency to be corrected by either the banker to the issue, the registrar to the issue, the issuer, or SEBI. Although the banker holds the money, the registrar is responsible for returning funds, and both act as agents for the issuer. Retail investors may find that a framework that protects investors' assets in another part of the market does not apply to their transaction or to their problem. Too often, when investors submit requests for solving a problem, the answer they receive is, "that is not my responsibility."

□ Limited Financial Literacy of Investors

Financial markets have become increasingly more sophisticated. New and more complex products are offered to the public. Consumers have increased access to sophisticated credit and savings instruments that are provided by a gamut of financial intermediaries.

Increasing life expectancy and the changing pensions and "guaranteed returns" culture are putting pressure on investors to understand the financial market products offered to them.

While the Indian markets have made spectacular progress in the last few years, the presence of the retail Indian investor is still limited, constrained by the inability to come to grips with concepts of market risks and returns, and the inability to accept market investment as a tool for promoting long-term savings and wealth creation.

Investors express extreme reactions to market events. It appears that these reactions persist for long periods of time and have been exacerbated by adverse publicity generated by periodic scams or "bubbles." A major reason for this lack of investor confidence in the markets is a widespread lack of understanding of the workings of financial markets by investors and professional participants alike.

To stimulate investor education, in 2003 SEBI launched the Securities Markets Awareness Campaign. It included development of investor brochures and educational material, development of a website, and numerous workshops throughout the country. Since that time, India's Ministry of Company Affairs has taken steps to promote investor education. However, enhancing investor education and financial literacy is an ongoing process and requires significant, continual, focused effort. This need requires the development of specialized skills in the areas of adult education and financial markets.

Enhanced levels of financial education are likely to lead to financially educated consumers who will further strengthen securities markets through various means:⁴⁴

⁴⁴ *Improving Financial Literacy—Analysis of Issues and Policies*, OECD Publishing, October 2005. ISBN Number: 9264012575.

- Demanding better products and encouraging providers to develop new products and services, thus increasing competition in financial markets, along with innovation and quality improvements.
- Being more inclined to save and to save more than their less literate counterparts. The increased savings associated with greater financial literacy should have positive effects on both investment levels and economic growth. In emerging economies, providing both information and training to consumers on the operation of markets and on the roles of market participants contributes to making the most of their developing markets.
- Being better placed to protect themselves on their own and to report possible misconduct by financial intermediaries to the authorities. Thus, better-informed investors would facilitate supervisory activity and, in principle, allow for lower levels of regulatory intervention. As a result, regulatory burdens on firms would be reduced.

□ **Cumbersome Investing Mechanics**

Customers like one-stop service: a single point at which the different systems that service the customer come together. Retail secondary market investors do not experience that kind of convenient service. The multiple requirements of India's new market account opening and trading processes can be cumbersome, time-consuming, and daunting for the retail investor.⁴⁵

To open an account, an investor must provide a copy of his PAN card (and the original for verification) to a broker, depository participant and bank, fill out multiple copies of account opening documents, and provide multiple photographs and proofs of residence. To avoid cumbersome processes, investors must surrender a degree of control of their assets. Some brokerage firms require customer powers of attorney authorizing them to act on the customers' behalf in certain processes. Expansion of that practice would smooth account operation and further the development of Internet trading accounts, already a growing part of the retail market.

Financially strong intermediaries and financial surveillance, including frequent periodic net capital reporting, would foster investor confidence in market intermediaries, as the investors surrender the control of their assets to the intermediaries for the sake of convenience. Strengthening financial literacy will increase investors' understanding of the required processes.

4. Accounting Unaligned to Global Norms

Accounting and auditing reform can improve the quality of financial reporting and the reliability of issuers' audits. Accomplishing these critical goals will help to build investor confidence and strengthen issuers. India has already taken substantial strides toward achieving them. Full convergence of Indian GAAP and IFRS, with complementary reforms in enforcement and oversight of the accounting profession, would significantly improve the quality of Indian financial reporting. Such convergence would also provide the kind of information that improves investors' ability to evaluate performance. Accounting reform could permit issuers to reduce the cost of capital. Making financial statements more useful for investors, issuers, and market professionals

⁴⁵ The untimely delivery of a "delivery instruction slip" can result in a trade cancellation and an auction with losses and costs paid by the investor.

would help strengthen India's securities market and establish greater confidence in it. Adopting IFRS could also enhance management decision-making. Improvements in accounting standards will change more than procedures, they will provide better insight to managers, analysts, and investors, helping them achieve improved results.

5. Undeveloped Corporate Bond Market

Benefits of a Well-Developed Indian Corporate Bond Market. A well-developed bond market helps ensure efficient allocation of resources and could act as a buffer against sudden interruptions in bank credit and international capital flows. A corporate bond market would also improve the efficiency and stability of the financial system and the economy's growth. Until 1993, development financial institutions⁴⁶ (DFIs) provided long-term loans to India's corporate sector. With DFIs' limited access to long-term funds and their conversion to universal banks, the corporate bond market was expected to replace the DFIs by playing a decisive role as a reliable source of long-term corporate borrowing. Without DFI funding, and with banks focused on lower risk retail lending, a better developed corporate bond market is needed to provide long term financing to the private sector. Enhancing investors' and issuers' willingness and ability to utilize the corporate bond market would increase financial diversification and make it easier to obtain necessary financing to benefit

⁴⁶ DFIs were national financial institutions established by the Government of India as specialized providers of long term finance to the Indian industry. They included Industrial Development Bank of India (IDBI), Industrial Credit and Investment Corporation of India (ICICI) and Industrial Finance Corporation of India (IFCI) among others. ICICI is now a Bank after its reverse merger with its subsidiary ICICI Bank and IDBI is in the process of becoming one.

companies at all levels of the ratings scale, as well as developers of infrastructure. The Indian corporate bond market should play a significant role in supplying the infrastructure to support economic growth. India's Planning Commission has estimated that investments in varied infrastructures will be on the order of Rs. 1,450,000 crore (or US\$320 billion) during its eleventh five-year plan (2007–08 to 2011–12). In terms of a percentage of GDP, this would require almost doubling infrastructure investment from 4.6 percent to 8 percent during the plan period. The Planning Commission's Consultation Paper "Projections for Investment in Infrastructure in the Eleventh Plan, October 2007" estimates a total investment requirement of Rs. 2,027,169 crore or US\$494 billion.

The recent World Bank report that analyzed India's bond market pointed out: "As infrastructure policy and regulatory frameworks emerge and reforms advance, a better developed financial system, particularly a long-term domestic bond market, can accelerate access to finance by infrastructure projects."⁴⁷

The Current Bond Market. In India today, corporate debt capital is raised through private placements and international issues. Corporate debt instruments are predominantly simple fixed-rate coupons. There are very few innovative instruments or derivative or hedging devices that would help investors protect against credit risk. The World Bank report found that "a comparison of the size and composition of the domestic debt market in India and seven other prominent emerging market countries puts India ahead of only Mexico in the size of its corporate bond market."⁴⁸

⁴⁷ World Bank, *Developing India's Corporate Bond Market*, December 2006.

⁴⁸ *ibid.*, p. *i*.

A Recipe for the Continued Transformation of the Capital Market

Chapter 5

The continued transformation of India's capital market will depend, in great part, on implementing six critical reforms:

- Expanding regulatory coverage to retail financial intermediation.
 - Completing the surveillance infrastructure.
 - Providing enhanced investor protections that will build retail investors' confidence in the market.
 - Improving education and financial literacy of potential investors and the population at large.
 - Strengthening oversight of the accounting and auditing profession.
 - Developing the architecture and the legal framework of the corporate bond market.
- A Capital Market Regulator – India has SEBI, a credible regulator.
 - Front Line Regulators, usually SROs, that provide regulatory coverage (both supplementing and enhancing the power of the market regulator) to various aspects of the market:
 - Activities of exchanges and the brokers operating at exchanges – India's NSE and BSE are demutualized exchanges that function as the SROs for their own markets and brokers.
 - Intermarket activities – India does not have a front line regulator that regulates intermarket activities.
 - Retail financial intermediaries – India does not have a front line regulator for this segment of the market.

Developing the Regulatory Structure

1. Gaps in the Regulatory Structure

No single regulatory model of other countries fits the facts and circumstances of India's market. The recommendations of this report are based primarily on features of the regulatory systems of the US, UK, and Australia while taking into account circumstances and experiences unique to India. Based on the experience of the leading capital markets, the regulatory structure for a potentially large and diverse market such as India should include:

□ The Need for Front Line Regulators in India

The magnitude of the universe of retail intermediaries. Implementing retail intermediary regulation requires significant resources and reach to keep pace with the growing universe of retail intermediaries.

Because there are no registration requirements for retail intermediaries, nor a single place where information on them is captured, the total number of retail securities intermediaries is unknown and only partially discoverable. Partial data indicates that the number of the intermediaries is significant: 56,000 Mutual Fund advisors have registered with AMFI and more than 1.1 million agents are affiliated with the Life

Insurance Corporation of India (LIC). Large Indian brokerage houses now employ thousands of “relationship managers” (retail brokers by another name) in hundreds of branches. A Dun & Bradstreet study, “India’s Leading Equity Broking Houses – 2007”⁴⁹ (“D&B Study”) estimates that the top 15 brokerage houses employ nearly 40,000 people in addition to more than 20,000 sub-brokers.

The number of retail intermediaries is poised to grow significantly to match the growth in the number of retail investors. A recent McKinsey study estimates that the stunning recent growth of India’s market is only the beginning. “India will witness the rapid growth of its middle class—households with disposable incomes from 200,000 to 1,000,000 rupees a year. That class now comprises about 50 million people, roughly 5 percent of the population. By 2025 a continuing rise in personal incomes will spur a tenfold increase, enlarging the middle class to about 583 million people, or 41 percent of the population.”⁵⁰

Using an estimate of four individuals per average middle class household, India would have a potential investor base of 150 million middle class households in less than 20 years. If each individual intermediary were able to serve, on an average, a client portfolio of 100 investor households, there would be 1.5 million individual intermediaries. If each firm, on an average, had 100 individual intermediaries, there would be 15,000 large firms. These rough estimates of the growth of the market reflect the enormity of the

regulatory task that will expand with the middle class and the market.

The need to strengthen cross-market regulation. As discussed above, the two major Indian exchanges list and trade certain stocks in common. A number of large member firms are also members of both the BSE and NSE. The D&B Study reveals that, “in the cash equities market, around 34% firms trade at NSE, 14% at BSE and 52% trade at both exchanges. In the derivative segment, 48% trade on the NSE, 7% on the BSE and 45% at both, whereas in the debt market, 31% trade on the NSE, 26% on the BSE and 43% on both the BSE and NSE,” see Chart 5.1.

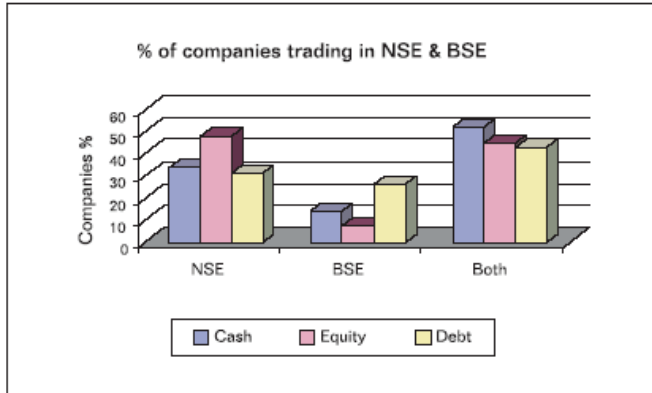
Even though SEBI, through its Intermarket Surveillance Group, coordinates the regulatory efforts at the two exchanges, the exchanges’ efforts are separate and do not expand into the inter-exchange trading. Additional efforts are required to complete the surveillance infrastructure that cuts across exchanges. Fundamental are developing an integrated broker and affiliate database, financial adequacy requirements, financial and operations reporting and strengthening surveillance and enforcement for the exchange markets. As no entity other than SEBI has a cross-market emphasis, SEBI is expected to perform all these functions. Responsibility for cross-market frontline regulation would put an enormous burden on SEBI’s regulatory resources.

Direct SEBI Regulation is not practical. In view of SEBI’s limited resources and its many other critical market safety and supervisory responsibilities, regulation of the expanding retail market and direct cross-market regulation by SEBI would not be feasible. As noted above, the regulatory task would be enormous. As of March 31, 2006, SEBI had 441 employees in

⁴⁹ The publication **India’s Leading Equity Broking Houses 2007** from Dun & Bradstreet India profiles 210 broking firms, providing services primarily in the area of equity markets.

⁵⁰ McKinsey Quarterly, “Tracking the growth of India’s middle class,” August 2007.

CHART 5.1: Percentage of Broking Companies Trading on the NSE and BSE



Source: Dun & Bradstreet Study (India's Leading Equity Broking Houses – 2007); www.dnb.co.in

various grades (of which 288 were officers⁵¹). Despite the significant growth of the market and intermediaries over the past five years, SEBI's staff has not increased by the same degree. The use of IT based regulatory solutions has been a two edged sword: enhancing SEBI's regulatory reach while creating additional specialized staffing requirements. As indicated in Chapter 4, although SEBI has expanded its staff and taken other measures to shore up its resources, keeping pace with the workload requirements of a frontline regulator of the intermediary and investment advisory business and carrying out cross market surveillance and enforcement would raise serious financial and professional challenges.⁵²

Despite SEBI's continued best efforts, it remains constrained in recruiting and retaining

⁵¹ SEBI Annual Report, 2005-2006.

⁵² As a comparison, in 2006-07, the UK FSA had a budget of 312 million pounds and a staff of 2659. In addition, the FSA Ombudsman had a staff of about a thousand and the Compensation Scheme a staff of 178. In the US, the SEC had a budget of 447 million pounds and 3788 staff, while the NASD had a budget of 310 million pounds with 2425 employees. See Table 5.1.

professional staff. There is a wide differential between staff compensation at SEBI and in the industry.

The ADB Mutual Fund Report⁵³ noted that, "Regulators everywhere have trouble in retaining staff, and it would seem that SEBI is no exception. Our understanding is that remuneration of SEBI personnel is at levels substantially less than those available to the private sector, as is commonly the case for financial sector regulators, so it is common for the industry to

seek to recruit from those who have gained experience amongst SEBI's ranks, since they are familiar with fund regulation and compliance issues. Unfortunately, there is no real solution to this other than the necessity to pay remuneration that is more in line with the private sector – a move that the US SEC is increasingly having to make. It is generally recognised that financial services regulators' pay structure has to be de-linked from normal civil service rates in order to attract a sufficient caliber of personnel."

The change in pay structure suggested above is desirable and would somewhat ameliorate SEBI's resource constraints, but it appears that it may be difficult to implement in the near term.

Table 5.1 "Costs of regulatory authorities in other jurisdictions" shows the regulatory resources used by regulators and SROs in the US, UK and Hong Kong.⁵⁴

⁵³ Asian Development Bank (ADB) consultants Cadogan Financial in association with A F Ferguson & Co. presented a report on "Reform of Mutual Funds in India" in March 2004.

⁵⁴ Financial Services Authority, Annual Report 2006/07, Appendix 1, p. 102.

Table 5.1: Costs of Regulatory Authorities in Other Jurisdictions

Area of responsibility	Hong Kong	UK	USA
Credit institutions – prudential supervision	Hong Kong Monetary Authority (HKMA): £13m, 224 staff	Financial Services Authority (FSA): £53m	Federal Reserve (FED) £342m, 3,062 staff Federal Deposit Insurance Corporation (FDIC): £426m, 3,886 staff Office of the Comptroller of the Currency (OCC): £291m, 2,812 staff
Insurance companies (life, pensions and non-life) – prudential supervision	Office of The Commissioner of Insurance (OCI): £6m, 93 staff	FSA: £28m	National Association of Insurance Commissioners (NAIC): £544mn, 11,478 staff
Securities firms and fund management firms – prudential supervision	Securities and Futures Commission (SFC): £10m, 143 staff	FSA: £21m	Securities and Exchange Commission (SEC): £447m, 3,788 staff National Association of Securities Dealers (NASD): £310m, 2,425 staff Commodity Futures Trading Commission (CFTC): £49m, 490 staff National Futures Association (NFA): £18m, 267 staff (Note 6)
Supervision of and standards for exchanges / clearing and settlement systems / market service providers	HKMA: £454,000, 6 staff (Note 1) SFC: £10m, 116 staff	FSA: £4m	NASD: Costs included above CFTC: Costs included above
Supervision of, and standards of conduct on, capital markets (including transaction reporting but excluding exchange's own rules)	SFC: £5m, 56 staff	FSA: £4m	NASD: Costs included above CFTC: Costs included above
Standards for / approval of listing of securities		FSA: £13m	CFTC: Costs included above
Regulation of collective investment schemes / fund management		FSA: £24m	CFTC: Costs included above
Regulation of financial advice / advisers and of the selling / marketing of retail financial products (excluding occupational pension schemes)		FSA: £82m Financial Ombudsman Service (FOS): £55m Financial Services Compensation Scheme (FSCS): £13m	NASD: Costs included above CFTC: Costs included above Office of Thrift Supervision (OTS): £118m, 969 staff
Regulation of Credit Unions		FSA: £1m	National Credit Union Administration (NCUA): £72mm, 929 staff
Regulation of the provision of mortgages		FSA: £17m	
Total costs of regulators	£44m	£312m	£2,617m
Total staff in regulatory agencies	638	Total staff for FSA: 2,659 FOS: 1,000 FSCS: 108	30,106
Total banking assets	HKMA: £538bn		£6,009bn (Note 10)
Total equity market capitalisation	£850bn		£9tr (Note 2)
Total insurance premiums	£10bn		£671bn

Source: Financial Services Authority, Annual Report 2006/07, Appendix 1, Page 102

Text Box 5.1: SROs as Front-Line Regulators

SROs and self-regulation have significant advantages in a front-line regulatory role^a:

More responsive to a complex, fast-changing marketplace. Effective regulation of markets requires that the regulators have a close understanding of their workings. This becomes more crucial as the industry becomes more sophisticated, larger, technology based and global. Regulators to be effective have to keep pace with these changes. Regulators face tremendous pressure to upgrade the skills of their staff to meet the challenge of a fast changing marketplace. Market participants are likely to be more aware of industry processes and practices and technical issues. Regulation by market participants is best positioned to ensure that industry expertise is available for effective regulation. Self-regulation makes industry expertise available to deal with sophisticated technical issues. An SRO being at the front-line of regulation has the expertise and direct market contact, is close to the changes in an increasingly complex industry and hence can be more responsive in its rule-making, monitoring and enforcement programs. The regulator also would benefit from the SRO's knowledge and expertise.

More efficient regulation. An SRO's expertise and experience would also help it to design and implement more effective compliance and enforcement programs. Though an SRO also needs a well qualified staff to be able to meet these objectives, it is likely to have better access to and the financial resources to recruit, train and retain these professionals, than a regulatory organization that may be bound by rules of government that may not allow it sufficient flexibility to match resources to market needs. Effective self-regulation also allows the statutory regulator to focus its limited resources on areas that are most at risk. Because in self-regulation, market participants are involved in drafting market rules, it is likely that the rules would maximize the regulatory benefits while keeping at a minimum the business costs to market participants of implementing them. It is also more likely that market participants would perceive these rules as practical and reasonable and would be more proactive in their compliance. Self-regulation ensures industry participation and hence its support in successful implementation. Industry input and representation contribute to a strong and effective compliance culture. Overall, self-regulation fosters integrity in the marketplace and among participants.

Paid for by industry, not taxpayers. The costs of self-regulation are entirely borne by the industry, while in most cases the costs of the government regulator are borne by the taxpayers. Industry financing thereby reduces the amount of government funding needed to support the regulatory framework for financial markets.^b Self-regulation generally imposes fewer costs than government regulation.

Extended beyond statutory powers through contractual relationships. The contractual relationship that an SRO has with the individuals and entities it regulates can be more flexible, more powerful and can have a global reach. Contractual reach can go beyond what statutory powers can provide. SRO rule changes can be implemented more easily than regulatory law changes and this flexibility can help SROs react quickly to market changes. IOSCO's Principles state that SROs may require the observance of ethical standards, which go beyond government regulations.

Challenges in applying the SRO model for front-line regulation

There is an inherent conflict of interest between being an association of market participants and an SRO. Participation of market players in their own regulation (the 'self' in 'self-regulation') can create conflicts that adversely impact "regulation." This conflict can arise with:

- ***The SRO's membership:*** The SRO staff may be unable to vigorously enforce rules against its members.
- ***Market operations:*** SROs that operate markets directly or through affiliated organizations face business and competitive pressures that may dilute their enforcement role. As markets compete for new listings, there may be pressure on the SRO to dilute listing standards and their enforcement.
- ***Shareholders of the exchange:*** In a demutualized exchange SRO conflicts may arise with shareholders of the exchange. Their goal, maximizing profits may reduce the importance of, and resources allocated to, the regulatory function.

However, an SRO may take many steps to ensure that conflicts do not lead to poor regulation.

- A broad based board that includes public directors may enhance public trust. If public directors are outvoted on any policy issues, the oversight regulator should be aware of and discuss those issues. Public directors should sit on all governance committees -- including the executive, audit, and regulation oversight committees.
- Once the statutory regulator has approved all of the rules and regulations of the SRO, the SRO must fairly ensure compliance with those rules and regulations.
- SROs regulatory operations must be separate from other parts of the organization. Technology systems must maintain built-in internal firewalls. Non-regulatory staff should not have access to information belonging to regulatory functions.
- Enforcement staff and processes should be protected from interference by persons with power seeking to influence their decisions.
- SROs must provide a means for clients to seek redress when necessary through a market-wide arbitration system.

^a See "Model For Effective Regulation", Report of the SRO Consultative Committee of the International Organization of Securities Commissions (IOSCO), May 2000 and "The Public Interest in Self-regulation," Joseph J. Oliver, President & C.E.O. Investment Dealers Association of Canada, June 18, 2001.

^b "For example, in a CFTC Report, it was estimated that National Futures Association's operations during its formative years during the 1980s resulted in \$3.5 million in direct savings by the government agency and \$16.2 million in avoided additional costs over a three year period,"- Model for Effective Self-regulation," Report of the SRO Consultative Committee of the International Organization of Securities Commissions (IOSCO), May 2000, p. 6.

2. SRO Model for Front-Line Regulation in India

India has hardly had a positive experience with self-regulation⁵⁵. Its experience resulted from the perceived or real regulatory

⁵⁵ Indian exchange SROs were perceived to be ridden with conflicts. In response to allegations of impropriety in 2001, SEBI initiated the move to demutualize all exchanges, effectively limiting the role of exchange members in exchange governance.

deficiencies that had their genesis in the conflicts of interest between exchange members and investors. To avoid repeating that experience, SROs should, from the beginning, be structured and governed to reduce potential conflicts of interest while retaining the positive advantages of self-regulation. The industry should be involved in SRO rule-making but play a limited role in SRO governance. Its Board should be largely independent and its management professional.

See Text Box 5.2 for evolving international SRO governance approaches.

This report recommends the creation of separate SRO front-line regulators for retail financial intermediaries and for intermarket trading. The SRO model is recommended for the following reasons:

- This model merges the positive points of self-regulation while also considering the need to significantly expand India's regulatory capacity and India's experience with self-regulation.
- The ability to recruit, retain, train and motivate professional staff is one of the very critical elements of the success of any organizational endeavor. Indian regulators are currently constrained in this ability because they have limited freedom to create their own compensation structures. Separate independent private SROs mandated by law and not completely under the industry's control will be in a position to develop human resource and compensation policies that help to recruit, retain and motivate talented professionals.

The model, as discussed later in this chapter, has the potential ultimately to restructure regulation on the basis of function rather than on exchange membership or on products. An SRO could be responsible for regulation and enforcement of functions such as intermarket surveillance, activities of securities firms and their employed professionals, monitoring liquid capital requirements and financial reporting. Exchanges could continue regulation related to trading rules in their respective markets. Similarly, an SRO that regulates retail intermediaries would be in a position also to obtain acceptance by other

regulators and to regulate distribution of all retail financial products in one place.

The proposed SROs should be:

- Authorized by the Government of India or SEBI;
- Professionally managed regulatory organizations;
- Registered as non-profit corporations;
- Self-regulating in the sense that they would eventually be self-financing;
- Directed by and subject to SEBI oversight;
- Financed initially by SEBI or the Government, but eventually self-financing and owned by the industry as industry utilities; and
- Managed by strong executive officer structures and small boards constituted of a majority of independent directors.

□ **SEBI's Role as the Oversight Regulator in an SRO model**

SEBI's role would not change after creation of the front-line SROs. SEBI would be responsible for oversight of these SROs, including approval of their rules and budgets and reviewing and conducting oversight of their performance. SEBI would also need to develop regulations regarding standards for:

- Registration with the SRO of each firm and individual;
- Building and maintaining a database of registrants, including the history, experience, prior and current violations of conduct regulations, and complaints;
- Certification, including "grandfathering" provisions;
- Continuing education;
- Data privacy;
- Financial adequacy, maintaining books and records, and financial reporting; and
- Supervision by firms of their affiliates and employees.

Text Box 5.2: International approaches to SRO Governance

Most SROs started as trade associations (TA). The role of a TA differs from the role of a SRO. While a TA represents the interests of the trade, a SRO has the prime objective of investor protection.

Historically there was little difference between TAs and SROs. Most securities exchanges were associations of brokers who also performed the functions of regulating their own markets. This was true of well-established exchanges such as the NYSE (and, closer to home, of the Bombay Stock Exchange). The governance structure of other industry SROs such as the US National Association of Securities Dealers (NASD) was also similar. The Board of Governors and the disciplinary and regulatory committees were primarily constituted of industry members.

However, with the increasing importance of markets to the economy and increasing investor participation in the markets, investor protection became the overriding objective of market regulators.

SROs' conflicts of interest and ability to police and take action against their members have frequently been questioned by market commentators and regulators. Moreover, with the demutualization and transformation of exchanges into profit making market operators, regulators have been under pressure to ensure that regulation does not lose its effectiveness or importance.

In response to this criticism, over time, the SRO structure in developed markets has evolved from being that of a member-owned and managed "private club" to a more professional and independent structure. The challenge has been to reduce the potential conflicts of interest while keeping the "self" in self-regulation.

USA: In the US, acting on the Rudman Committee Report^a, the NASD, in 1995, adopted the Principles of Effective Governance recommended by the Committee, including a recommendation that the NASD board be composed of a majority of public representatives. The NASD which also operated the NASDAQ stock market became a holding company and separated the "for profit" NASDAQ Inc. from its regulatory arm, the NASD-R, the SRO, with the clear objective of investor protection.^b

In 2003, the NYSE changed its governance structure to reduce conflicts of interest with respect to members. Specifically, the NYSE established:

- A fully independent board of directors composed of 6 to 12 fully independent directors, the NYSE Chief Executive Officer ("CEO"), and the NYSE Chairman.^c
- A fully independent board committee, the Regulatory Oversight & Regulatory Budget Committee, tasked with overseeing the NYSE's regulatory plans, programs, budget and staffing proposals on an annual basis.
- A new Chief Regulatory Officer position reporting directly to the Regulatory Oversight & Regulatory Budget Committee .
- An additional fully independent committee, the Human Resources & Compensation Committee, to set staff compensation.
- Other fully independent committees including the Audit Committee and the Nominating & Governance Committee, which was designed to ensure that governance procedures are appropriate and to administer the board's annual self-review process.^d

Recently the NASD R and the NYSE regulatory functions of member regulation, enforcement and arbitration were merged to form the Financial Industry Regulatory Authority (FINRA). FINRA is now the self-regulatory body for the US securities market. FINRA too has a majority independent board.

The National Futures Association (NFA), the industry-wide SRO for the U.S. futures industry, has a 25 member board with representatives from all segments of the futures industry and public directors.

The CBOE is in the process of demutualization. Post demutualization the CBOE board will be reduced in size to 13 directors, consisting of five industry directors, seven non-industry directors plus the CEO.

Canada: In Canada, the Investment Dealers Association (IDA), the SRO for investment dealers, performed the functions of TA and SRO for many years. The IDA Division of Industry Relations and Representation performed the role of representation of the positions of the securities industry on legislative and regulatory policy and the Division of Member Regulation performed enforcement functions.

In 2005, while stating that the dual mandate did not undermine IDA's effectiveness as an SRO, IDA conceded that the dual mandate posed a perception problem that had to be periodically confronted. IDA also felt that the optical disadvantages of the dual mandate were starting to outweigh its substantive advantages.^e Effective April 1, 2006, IDA split into two separate and independent organizations: the new trade association (Investment Industry Association of Canada) and the continuing self-regulatory organization. IDA also adopted a governance structure with equal industry and independent representation on the board.

In 1998, in response to the Stromberg report^f the IDA and Investment Fund Institute of Canada (IFIC, the Canadian mutual funds trade association) formed the Mutual Fund Dealers Association (MFDA) as the SRO for mutual fund dealers and their representatives. The MFDA has a governance structure with equal industry and independent representation on the board.

^a "The Report of the Select Committee on Structure and Governance," headed by former U.S. Senator Warren B. Rudman.

^b "The creation of NASD Regulation means first and foremost that there is now one organization whose first and only responsibility is investor protection. We have an unclouded mission: strong enforcement and strict compliance. We don't worry about market share, we don't worry about competition for listings, we don't worry about marketing. We worry about ensuring investors an environment that is fair and honest." Speech by Mary Shapiro, President, NASD Regulation, Inc., April 3, 1996.

^c The concept of "independence" under the NYSE rules was redefined with respect to directors to exclude essentially all persons with any relationship or association to the exchange, an exchange member, or an exchange listed issuer. Because the new definition of independent director excluded most users of the NYSE's services, an advisory Board of Executives was also created to ensure that NYSE constituents continued to have a meaningful voice in the affairs of the exchange.

^d US Securities and Exchange Commission: Concept Release No. 34-50700.

^e Investment Dealers Association of Canada, Annual Report 2005-2006.

^f Regulatory Strategies for the mid-'90s; Recommendations for regulating Investment Funds in Canada: Glorianne Stromberg, Commissioner, Ontario Securities Commission.

Front-Line Regulatory Solution for Retail Intermediation

□ Essentials of Intermediary Regulation

In most markets a broker is a market intermediary who helps investors to buy and sell securities, usually broadly defined as “investment contracts”. In India a broker is an “exchange member” who helps investors transact through exchanges. The rest of the “non-exchange” securities market is unregulated and all evidence suggests that for the retail investor the non-exchange market is bigger.

Although depending on market size, culture and historical evolution, different markets may regulate various pieces of the market differently, in most developed markets, every intermediary (not just every exchange broker) and every investment adviser is registered within the regulatory system and subject to regulation.

In India the business of providing investment advice and distributing financial products is currently vibrant, but economically inefficient and disorganized. To use India’s savings more efficiently, the regulatory structure must fully cover financial intermediation (i.e., regulate distributors and the distribution process and those who provide financial and investment advice). Like the retail market, the approach to regulation must be integrated. Improving investors’ trust and increasing the average rate of return on invested savings requires better qualified, professional and regulated advisers and sales persons. Certified and regulated intermediaries that meet minimum standards will be better disciplined, bring greater skills to the marketplace and will increase investor confidence and participation in securities markets.

For investors to have any confidence in a regulatory scheme and for it to be effective:

- regulation of intermediaries must apply to all those who interface with clients, whether they are providing investment advice or distributing financial and securities products;
- all of an intermediaries’ employees in the investment advice and distribution function must be registered, regulated and like firms, subject to enforcement actions by regulators (Staff engaged only in clerical or administrative tasks need not be registered or regulated);
- investors must know that they are dealing with a regulated entities (the extent of regulation of each entity should be calibrated based on specific functions, e.g., those intermediaries who carry less risk would have lower net capital requirements than those with more); and
- a single investor grievance mechanism is required, as is an investor compensation scheme that provides investors limited protection against intermediary default and fraud (discussed later below).

□ Technology based Regulation

In a modern market, especially one with India’s size and potential with a wide range of intermediaries and financial products, regulation will have to depend on information generated digitally by regulated firms and individuals, through their transactions and other reporting. Examinations and disciplinary actions that make the marketplace safer for investors can be generated by electronic analysis of the information reported by regulated market firms and individuals. Uniform regulations and tech-centric handling of information should be at the center of market regulation. Registration and other processes should be electronic and automatic. Expanded use of technology would also make regulatory compliance quicker, easier and more convenient.

A corollary to requiring automated regulatory systems, is that reporting entities also must be required to use electronic reporting, whether in-house or through service bureaus, to comply with regulations requiring uniform record-keeping, frequent reporting, and early warning notices⁵⁶.

□ Professional Market Intermediaries

Investors rely on the knowledge, expertise and professionalism of their intermediaries for guidance and support. Securities industry professionals represent various degrees of professional competence. To provide a truly professional marketplace where investors and issuers can participate with a sense of confidence and comfort, competency levels of all intermediaries need to be upgraded. A basic program for upgrading should require:

- **Criteria referenced examinations.** Criteria referenced examinations ensure entry-level competence of intermediaries. Entry barriers that require intermediaries to demonstrate required knowledge help them render more competent services.
- **Continuing professional education requirements.** Continuing professional education maintains and enhances competence. Persons already in business understand the qualification standards they need to maintain to survive in the industry.
- **Continually raising qualification standards.** Frequent examinations of intermediaries educate professional market participants.

- **Frequent communications, educational conferences and meetings.** Such communications keep professionals aware of industry developments about current market issues, enforcement actions, policies and other developments.

4. Create a Single Front-Line SRO for Retail Intermediation

A new SRO should be established to become India's front-line provider of regulatory services for the currently largely unregulated retail intermediaries⁵⁷.

This SRO would help to bring integrity to the markets and confidence to investors by regulating the activities of all retail intermediary firms, their branch offices, associates and sales forces. It would register all firms and individuals that interface with retail investors providing either distribution, financial planning or investment advice services. The SRO would touch virtually every aspect of the retail financial intermediary industry from oversight to education.

Regulation: This SRO would develop and issue regulations that establish:

- Registration categories and requirements;
- Application procedures and disciplinary procedures;
- Appeal process;
- Market conduct regulations that include standards for:
 - Advertising and communication,

⁵⁶ Regulations must require intermediaries to always conform to minimum liquid capital requirements. They must also be required to give an early warning notice to the SRO if their capital falls below the minimum level.

⁵⁷ See Incomplete Regulation of the Retail Interface, Chapter 3.

- Performance reporting and presentation⁵⁸,
- Disclosure of conduct and experience,
- Disclosure of services and fees, prices and commissions,
- Disclosure of conflicts, and
- Fair dealing.
- Supervision.

Activities of the SRO would include:

- Authorizing individuals and firms to enter the industry;
- Writing rules that govern behavior of intermediary firms, their employees and associates;
- Examining intermediaries and their associates for regulatory compliance and disciplining those who fail to comply;
- Supporting intermediary firms in their compliance activities; and
- Operating an intermediaries' dispute resolution forum.

Use of technology: To manage the records and activities of the many thousands of firms and individuals who distribute financial products and hold themselves out as offering or providing investment advice, the SRO must be built around technology. The SRO should be responsible for building, maintaining and operating technology systems for itself and for sharing that information with SEBI and other financial market regulators. The technology systems of this SRO are presented in Text Box 5.3.

Education: The SRO, in coordination with NISM, would work to raise standards of market professionals through the development of

⁵⁸ The international standard is the CFA Institute's Global Investment Performance Standards (GIPS).

criteria referenced examinations and continuing professional education requirements.

The SRO could implement regulation of discrete market segments in phases. Implementation could be prioritized on the basis of the potential size, associated risk to investors and the market and ease of implementation of the market segment. One possible phasing plan might start with the currently unregulated entities: mutual fund distribution firms and their sales employees; financial planners and their employees; and then add retail sales employees of exchange firms.

5. Regulatory structure should mirror market structure

The integration of the financial services marketplace presents a challenge to India's regulators. The current regulatory structure applicable to advising and/or distributing securities and other financial products to the retail investor includes the Reserve Bank of India (RBI), the Insurance Regulatory and Development Authority (IRDA), the Pension Fund Regulatory and Development Authority (PFRDA), SEBI and the MoF⁵⁹. A hybrid structure under which the front-line regulator would regulate intermediaries and advice across all retail financial products under the authority of a Board of Management (BOM) composed of representatives of all financial services regulators would be preferable. The BOM would provide broad guidance on the tasks of the self-regulatory organization.

A Memorandum of Understanding (MOU) among current regulators could be utilized to maintain continuity and smooth the transition

⁵⁹ The HPEC report discussed later in this chapter has rekindled the debate on the creation of a single super financial services regulator. Such a significant change may take time. An integrated retail front-line regulator however should be an immediate priority. The MOU approach that we suggest can be implemented in the short term.

Text Box 5.3: Technology Systems of the SRO for Retail Intermediaries

A Central Registration Depository database to maintain records for SEBI, SRO and NISM of:

- Persons qualified by certification and “grandfathering”,
- Continuing education requirements and their completion by individuals,
- Individual registration data including:
 - Job and location history,
 - Education,
 - Conduct history including incident reviews in process and completed, including explanatory information,
 - Customer complaints,
 - Information on registered firms (ownership, locations, directors and key officers), and
 - Registered firms’ budget, written supervisory procedures and business plans.

A Report Database to track registered firms that:

- Accepts electronic reports of operations and financial status submitted by each firm,
- Analyses information to produce exception reports, and
- Receives notices such as early warning notices.

A Regulatory Database to:

- Maintain the history of examinations,
- Establish a risk rating to direct examinations, and
- Include comments from past examinations, observations.

to a new regulatory structure. The MOU would define the responsibilities and roles of the regulators with respect to the supervision of retail investment advice and distribution of the various products purchased and sold in the integrated retail marketplace. All financial service regulators would need to agree on functional supervision. A single oversight regulator should supervise the front line regulator. As explained above, SEBI would be the appropriate oversight regulator.

It is possible that an agreement between all financial services regulators would take time. The need to start regulating the retail intermediaries is urgent. The process can begin with the securities market and be extended later to include other products.

6. Front-Line Regulatory Solution for Cross-Market Trading

□ Completing the Surveillance Infrastructure

Historically, Indian exchange markets have been regulated through front-line self-regulators, the stock exchanges. With cross listing and members in common the need for strengthening cross-market surveillance and enforcement efforts is self-evident. While the IMSS provides SEBI a tool to analyze transactions across exchanges, SEBI still lacks a complete integrated view of all the firms and individuals operating across these exchanges. Additionally, as discussed in Chapter 3, India’s surveillance infrastructure

for the exchange markets is incomplete and can be only partially effective until it includes:

- **A database that maintains** current integrated information on all exchange firms (including affiliates) and individuals, and
- **Uniform prudential requirements** that require frequent regular reporting of intermediary firms' financial and operating situation.

These two information sources, available and analyzed electronically along with transaction information and analyses from the IMSS, alert the regulator to possible market misconduct and to firms and individuals that may pose a risk to the market and investors and that would help to prioritize inspections and examinations.

□ **Integrating member information across exchange markets**

Efficient market regulation and enforcement require a complete information database on all intermediary firms and individuals operating in the market. This SRO would build a database for the currently regulated firms and individuals in the exchange markets. It would integrate, update and expand currently available information with the two major exchanges. This integrated information would include information on affiliates and related entities and individuals.

□ **Implementing uniform prudential requirements and periodic financial and operational reporting**

Prudential or financial adequacy regulations protect public customers from loss in the event of their intermediaries' insolvencies. They foster confidence in the financial markets by assuring that the regulator receives early warning of an impending lack of capital or liquidity of an intermediary and protect its clients by preventing withdrawal of any assets by the intermediary, its lenders or

control persons. For India's investor and market protection policies to be effective; to complete its regulatory structure; and to raise the confidence of investors, a comprehensive set of financial adequacy regulations must be implemented.

Consistent with the International Organization of Securities Commissions (IOSCO) principles⁶⁰, financial adequacy regulations should focus on investor safety. They should define capital adequacy; and require liquidity to meet a firm's obligations and a cushion to survive the many risks of the financial markets. Together with financial and operational reporting regulations, effective financial adequacy standards regularly would provide regulators critical current market information: which firms are active; inactive; or too highly leveraged. They also would afford a firm better internal controls and safety, enhancing its awareness and ability to determine its own investments; pace of expansion or contraction; and business activities. Frequent compulsory firm-by-firm electronic reports can easily be reviewed for discrepancies electronically and examinations and enforcement can focus on the statistical outliers.

One fundamental standard that these requirements should implement relates to "Liquid Net Capital." This standard requires that a firm, at all times, have sufficient liquid assets, adjusted by specified valuation reserves, to meet its financial obligations. Its capital must be adequate to enable the firm to service clients while encountering market risks, liquidity risks, credit risks, operational risks, legal risks and systemic risks. "Liquid Net Capital" levels should be used to manage market risk, varying with the extent of the risk. Financial adequacy

⁶⁰ "Principle 22: There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake," Objectives and Principles of Securities Regulation, IOSCO, May 2003

standards should be designed to assure that an adequate cushion exists, one that allows a firm to absorb some losses, particularly in the event of adverse market movements, and to achieve an environment in which a firm could wind down its business over a relatively short period without loss to its clients or those of other firms and without disrupting the orderly functioning of the financial markets. Ultimately, financial adequacy standards need to ensure the financial integrity of firms' through prescribed standards of financial responsibility and reporting. Adequate supervision of ongoing financial adequacy standards will increase investor protection and market stability.⁶¹

7. Create an SRO for regulating intermarket trading

India's market is regulated through the exchanges. India lacks a cross-market regulatory organization. Without effective surveillance of intermarket transactions and effective prudential supervision of all securities intermediaries, Indian markets increasingly are prone to risk. As explained above, SEBI is constrained in its ability to act as a front-line regulator. The better strategy is to establish an industry promoted front-line regulator responsible for conducting surveillance and enforcement across exchanges. Such a regulator would:

- Facilitate intermarket surveillance because it would be responsible for all regulatory data from all markets.
- Substantially improve surveillance and enforcement because it would have a universal view and access to complete information about every

registered exchange firm and its affiliates.⁶²

- Partly address the concern of unequal quality and effort of regulation across different markets.
- Be a more economical and efficient means of regulating the marketplace, concentrating the regulatory effort in one organization, eliminating duplication and overlap of multiple regulators and exchange self-regulatory bodies and reducing the burden of compliance on exchange firms.⁶³

Because India's two leading exchanges, the NSE and the BSE, are demutualized, a re-examination of the regulatory structure is required to minimize or resolve conflicts of interest relating to exchange ownership and operations. Internationally, regulators and exchanges have coped by, among others, exchanges outsourcing their regulatory functions to other regulators or by separating the market regulator from the market operator. (See Text Box 5.4)

As discussed above, these exchanges currently conduct their own surveillance and enforcement; provide reports to SEBI; and cooperate with SEBI in investigating suspicious transactions across the exchanges. However, as is also noted above, such

⁶¹ Please see *"Risk Management and Control Guidance for Securities firms and their Supervisors"* IOSCO Technical Report and *"Principles relating to Market Intermediaries"*, IOSCO.

⁶² Its view will extend beyond exchanges and depositories to all transactions in securities on and off exchanges and also to sales conduct.

⁶³ At a November 17, 2005, Congressional Hearing exploring SRO reform, Robert Glauber, CEO and Chairman of the NASD asserted that having one regulation fee instead of two would save the industry about US\$50 million a year. In addition, by contending with one examination staff and one enforcement staff, Glauber testified that firms would lower their compliance costs by another \$50 million a year." (Excerpted from "Everything's Coming Up Hybrid," Ivy Schmerken, Wall Street & Technology, January 6, 2006).

surveillance is incomplete because of the lack of access to cross-market data and analysis. SEBI might encourage the NSE and BSE to divest or merge part or all of their surveillance functions into a separate body, an inter-exchange regulator ⁶⁴, with an independent governance structure and to seek SEBI recognition as an SRO. Such recognition would be necessary to enable the Inter-Exchange Regulatory Organization (IExRO) to access required transaction and member information from exchanges, banks and depositories. This organization would gain the strength and stature required to be effective only if it and its functions were authorized legislatively or by SEBI and if it is given broader scope and functions.

This change would leave the exchanges free to compete for issuers and transactions while strengthening regulation of the markets.

The IExRO, from a structural and regulatory perspective, would be very similar to the front-line SRO for intermediaries and would operate on the same principles. It would be built around similar tech-centric concepts and operations developed to enable adequate supervision, but would focus its responsibilities on intermarket surveillance and enforcement. It would require:

- a central registration depository that integrates information on exchange firms and their affiliates;
- a system to accept and analyse financial and operation reports;
- a system to digitize inquiries and responses; and

⁶⁴ The organization would be “self regulating” only in the sense that it would be promoted by industry organizations and financed by the entities that it will regulate. It is not envisaged to be a “membership” body, but an independent professional regulator.

- regulatory system to maintain compliance and inspection information.

Like the retail SRO, the IExRO should be free to create its own hiring and compensation policies to enable it to hire and retain talented market professionals. Form more details on the IExRO see Text Box 5.5. The IExRO should be able to persuade SEBI to share its intermarket surveillance (IMSS) technology to enable it to “hit the ground running.”

Following the creation of the IExRO, regulatory functions for the exchange markets, would be allocated as follows:

- Exchanges would continue to manage settlement risk, trading systems and operations;
- Exchanges could, if they choose, continue to conduct surveillance to enforce their own market rules; and
- SEBI would continue its primary regulatory responsibility, and would also be responsible for oversight of the IExRO.

8. Long-Term Potential Adjustments in the Front-Line Regulatory Structure

Establishing a private sector front-line inter-exchange regulator (IExRO), separate from the front-line regulator for retail intermediaries, is to some extent duplicative and, therefore in the long-run probably more expensive. However, given the existing market and surveillance structures, it is a more realistic approach.

The IExRO can be established faster than the front-line regulator for intermediaries because the foundations for IExRO already exist at the NSE and BSE, while the retail regulator will have to start from scratch. Secondly, the

Text Box 5.4: Exchange Demutualization and Regulatory Implications

Historically, exchanges were market utilities that enabled trading of securities. As the role and importance of the exchanges grew, this concept gave way to exchanges as businesses. Exchanges competed for order flow, because order flow made money. Because investor confidence was important for order flow, exchanges developed as self-regulators, overseen by regulators. With the technological changes of the 1990s came the arrival of Electronic Communication Networks (ECNs) — electronic trading systems that automatically execute matching buy and sell orders. Through this transition, exchange business models have undergone a dramatic shift. Increased competition, the need to make increasingly large investments in new technologies and operations, and the consequent need to raise capital have required more flexible governance structures.

These imperatives have led to a spate of exchange demutualizations, starting in 1993 when the Stockholm Exchange demutualized, and extending to the recent demutualization of the NYSE.

Conflicts of Interest

A major regulatory concern is that for-profit exchanges will attempt to maximize their profits and shareholder value at the expense of reduced or less effective regulation and supervision.

The conflict of interest between the interests of members and investors has been replaced by a conflict of interest between the interests of shareholders and investors, which in fact may be, as most regulators fear, more aggravating.

IOSCO considered the following issues in its “Issues Paper on Exchange Demutualization” (IOSCO, June 2001):

“...the more commonly expressed concern is that in a demutualized exchange, the drive for profit increases both the scope and the intensity of the conflicts. In a not-for-profit environment, the focus is on generating sufficient fees to meet the budget for expenses, capital investments and other outlays. In a for-profit environment, the revenues must meet the budget plus produce an acceptable rate of return to investors.

The revenue and outlay decisions are driven by the expected effect on the bottom line of the financial statement. While both parts of the cost/benefit equation are fairly straightforward in the commercial operations of the exchange, only the cash outlays on regulatory functions are clear. The benefits of good regulation are harder to quantify and therefore may not be given full weight. A for-profit self-regulatory organization therefore may be unwilling to commit the resources that vigorous self-enforcement would require. Due to increased pressure to generate investment returns for shareholders, a for-profit exchange may be less likely to take enforcement action against customers or users who are a direct source of income for the exchange. By similar reasoning, a for-profit exchange may be less likely to suspend trading in the more liquid products listed on its markets where this may impact adversely on transaction fees such trading would otherwise generate.

The conflicts inherent in an exchange regulating its competitors, while not new, become more apparent where the exchange is also a for-profit enterprise”

Competition and changing market shares of exchanges

The increasing competition of exchanges and consequent changes in their market shares, as well as trading in multiple markets, have led to regulators' concern about the effectiveness of cross-market surveillance.

Increased competition, while having spurred innovation in trading systems and reduced trading costs, has also increased concerns about potential gaps in the surveillance of intermarket trading. There is also a fear that loss of market share may leave fewer revenues to support an exchange SRO's regulatory functions^a.

“Some have predicted these pressures will result in a "race to the bottom" in exchanges' regulatory standards. For example, exchanges will underfund regulation to free up the resources for other purposes, minimize the value of a regulatory culture, fine and discipline traders as a means to collect revenue or to punish their competitors, raise listing company, trading and market data fees to maximize business, and lower listing standards and surveillance parameters in order to generate or maintain revenue and encourage repeat business.”^b

Regulatory responses

Various regulatory model changes have evolved in light of the above issues.

Some exchanges have outsourced their regulatory functions to other regulators. For instance, the Canadian Market Regulation Services (RS), promoted by TSX and Investment Dealers Association (IDA), regulates securities trading and market-related activities of four Canadian equity marketplaces.^c

Other exchanges have established a separate entity to carry out regulatory functions to resolve the conflicts of interest. Such exchanges include the Toronto Stock Exchange (TSE), which promoted RS. In some cases, such a separation has been dictated by the regulators, like that in the US between the NASD-R and the NASDAQ. The Australian Stock Exchange (ASX) established the ASX Supervisory Review Pty Limited (ASXSR), a wholly owned subsidiary, operating independently of the ASX Group's board and management and tasked with assessing whether the ASX Group adequately complies with its obligations as a market and clearinghouse operator, is conducting its supervisory activities ethically and responsibly, funding them adequately, and maintaining appropriate controls concerning employee and commercial conflicts of interest. In 2006, ASX separated its supervisory functions into a separate subsidiary with a separate board, ASX Market Supervision (ASXMS) and in late 2006 ASXSR ceased to exist.

^a “New Challenges in Regulating Financial Markets,” SEC Commissioner Roel Campos, remarks at NYU Stern, March 24, 2006.

^b “Regulatory Role of Exchanges and International Implications of Demutualization,” speech by SEC Commissioner Roel Campos, March 10, 2006.

^c In Canada, RS was established as a joint initiative of TSX Group (Toronto Stock Exchange, Group) and Investment Dealers Association (IDA). RS amalgamated the in-house surveillance, trade desk compliance, investigation, and enforcement functions of the Toronto Stock Exchange (TSX) and TSX Venture Exchange to produce a new single, neutral entity to monitor and enforce trading rules without preference to one marketplace over another. It now also regulates Alternative Trading Systems such as Canadian Trading and Quotation System (CNQ), including its "Pure Trading" facility; Bloomberg Tradebook Canada Company; Liquidnet Canada Inc.; Perimeter Markets Inc. (BlockBook™); and TriAct Canada Marketplace (MATCH Now) Fifty percent of RS's Board is made up of Independent Directors (www.rs.ca).

Text Box 5.5: The Inter-Exchange Regulatory Organization (IExRO)

The IExRO would be:

- Organized as a separate company;
- Promoted by the NSE and BSE;
- A public body with an independent governance structure, including a Board of Directors with a majority of its members drawn from the public, and independent of the exchanges;
- Recognized by SEBI as an independent SRO functioning under SEBI oversight;
- Able to access to all required information such as that from depositories and banks pursuant to its SEBI mandate;
- Financed initially by the exchanges and by fees paid annually by the entities regulated under a budget approved annually by SEBI to ensure that it receives adequate support from the regulated entities;
- Contracted by each of the exchanges to provide regulatory services. The contract would cover issues such as:
 - The term of contract (a significant duration such as 8 or 10 years);
 - Services to be provided, which may include:
 - Surveillance, examinations and investigations;
 - Conduct of formal disciplinary processes;
 - Dispute resolution;
 - Confidentiality of certain activities;
 - Fees to support the services and necessary administrative costs;
 - Sharing of resources such as premises or technology;
 - Establishment of committees to oversee certain functions such as operations and product development, etc.;
 - Records to be created and maintained;
 - Reporting requirements; and
 - Other issues such as:
 - Taxes and assessments;
 - Insurance to be carried;
 - Amendments to the contract;
 - Mediation and/or arbitration of disputes;
 - Termination clauses; and
 - Financial weakness or insolvency;

exchanges may have limited interest in extending their regulatory reach into areas of retail distribution of financial products. A unified approach from the beginning may lower the emphasis on retail intermediary regulation.⁶⁵

The recommendation of developing front-line self regulation via the two proposed SROs is guided by the urgency of the need for regulation; by the practicality and convenience of utilizing available resources; and ultimately by the longer-term needs of the evolving market for a more efficient less costly and more adaptable regulator. Starting the process and simplifying the approach are the overriding concerns.

⁶⁵ It would however be cost effective and efficient for both SROs to cooperate closely while building their infrastructure and in their operations.

Over time, India should move toward a single private sector front-line regulator. After demonstrating the benefits of self-regulation, and after gaining significant operational experience, the two SROs should consider a merger. The merger of the two – by then highly functioning - SROs would also likely be compelled by the burgeoning markets, the economies of scale and the operational and regulatory efficiencies of a single combined SRO.

Enhance Customer/Investor Protections

In advanced securities markets, retail investors are assured that for all securities, not only those purchased on an exchange: (a) the financial service providers they deal with are properly regulated; (b) an effective mechanism for them to resolve problems with service providers exists; and (c) a financial “safety net” is in place as a stand-in for service providers who cannot or will not meet their responsibilities.

1. Establish an Ombudsman Process and a Securities Investors’ Protection Fund

Recommendations for completing regulation of the securities market described above), are a strong foundation. Others that directly empower and protect investors are also a vital part of a comprehensive regulatory program. Two processes that address investor concerns relating to redress of grievances and customer protection are recommended⁶⁶:

- **An Ombudsman Service**, that would assist investors in resolving their complaints about retail market participants; and

- **An Investor Protection Fund**, that would be available where registered market participants have failed or disappeared.

□ Establish a Securities Investors’ Ombudsman Service

A Securities Investors’ Ombudsman Service (SIOS), within the retail SRO should be established. All SRO registered market participants should be required to participate in the Ombudsman Services Program and to prominently display their participation in the process.

The SIOS should have the following functions:

- It would serve as the “go-to” venue for securities investors who cannot resolve their grievances directly with market participants registered with the retail SRO;
- It would receive complaints from investors and begin the grievance resolution process;
- It would compel market participants to engage in the grievance resolution process;
- It would be able, on its own discretion, to refer facts to SRO’s enforcement wing for regulatory investigation at any time appropriate (i.e., the regulatory process is separate from the grievance resolution process);
- If the parties agree to resolve the grievance, the matter would be final and could not be appealed;
- If an agreement were not reached, the Ombudsman could enter a decision or award, including compensation or specific performance by the market participant;

⁶⁶ The structures are applicable only to the regulated activities of registered firms and registered individuals.

- The complainant would have the option of accepting or rejecting the decision. If accepted, the decision would be final and enforceable;
- If accepted, SIOS would direct the participants to comply with the Ombudsman's decision;
- If dissatisfied, the complainant could appeal the decision or go to arbitration/ litigation;
- SIOS could award assets from the Securities Investors Protection Fund (discussed below) if a market participant has failed; and
- SIOS, SRO and SEBI will be able to study trends identified in the grievance redressal process that would enable SEBI and the SRO to develop regulatory policy or investigative initiatives.

□ **Establish a Securities Investors' Protection Fund**

Establishment of a Securities Investors Protection Fund (SIPF) either as directly governed and managed by SEBI or operated as an independent agency subject to SEBI oversight, is recommended. The source of the SIPF's initial corpus would be the Government or SEBI. It would be augmented by annual charges collected from market participants.⁶⁷ The SIPF could also take additional insurance cover. All market participants registered by the Retail SRO should be required to belong and pay assessments to the Fund and to prominently display their participation in SIPF through their signages, correspondence, statements, etc.

⁶⁷ Established as a separate body, the SIPF would provide investor protection cover for the failure of participants registered with the retail SRO. Failures of exchange registered intermediaries are currently covered by Exchange Investor Protection Funds. Depending on the size of its corpus, if so desired, the SIPF can further augment this coverage.

SIPF functions would include:

- Insuring that investors retrieve their cash and securities if a market participant fails. It would apply to transactions throughout the entire securities market.
- Restoring clients to the position they would have been in absent the market participant's failure.
- Establishing maximum recovery limits that would prescribe the amount clients may recover for each account held at a failed market participant.
- Hiring or appointing SIPF Trustees.
- Managing the liquidation of failed market participants with its authority to freeze, take possession of and liquidate assets.
- Paying out cash and securities owed to investors that were held or controlled by failed market participants, subject to any SIPF established recovery limits.
- Paying any amounts awarded by a SIOS Ombudsman from the participant's collected assets first and then from the SIPF Fund.

Both SIOS and SIPF would cover only fraudulent or negligent activities and financial failures of registered market participants. Coverage would be limited to issues that result from sales by or operations of a registered firm or individual. Losses caused by changes in market value or by a client's misjudgment would not be covered nor would an issuer's non-payment of dues or failure to issue securities be subject to dispute resolution by the SRO or covered by SIPF.

The Ombudsman and Protection Fund process would not replace the regulatory process managed by SEBI. The processes of assuring prompt, efficient resolution of

grievances and of assuring client asset protection can and should be operated separately.

2. Strengthen Investor/ Customer Protections

Exchanges have provided payments to investors from their Investor Protection Funds for incomplete trades. They have also been successful in liquidating brokers by freezing and acquiring their deposits with the exchange and liquidating their membership or trading cards. Additional procedures are necessary to improve customer protections and redress.

Provide bankruptcy and client priorities.

Legislative changes are required for SIPF to function within the bankruptcy acts and to establish client priority to the funds of a failed firm. The regulators' (or SIPF's) ability to participate in the liquidation process is critical to its ability to regulate the market and to provide more effective customer redress.

Standardize priorities for liquidating intermediaries.

The current processes for liquidating an intermediary vary depending upon how the firm is structured. The Companies Act establishes the priority of payment for liquidating corporations. Different priorities apply to partnerships or sole proprietorships that must be liquidated under another Act. Fair and equal treatment of investors, regardless of the business structure of their intermediaries, requires that this legislative inconsistency be corrected.

Provide investors a priority to reach assets in an intermediaries' trust account. Neither the SEBI Act nor the Companies Act specifically provides investors a priority to reach assets in a broker's trust account. SEBI's authority, when liquidation of a broker is

required, is limited to seizing the records.⁶⁸ Legislation that spells out priorities would be superior to the current uncertain and time consuming processes. SEBI needs, but lacks, specific authority to freeze or seize bank accounts or other assets in such cases.

3. Enhance Protection for Mutual Fund Investors

Mutual Funds as seen in earlier chapters are fast becoming a major investment vehicle for Indian investors. It is therefore imperative that mutual funds regulation is strong and resilient enough to manage the explosive growth that the industry is expected to witness in the next few years.

Asian Development Bank (ADB) consultants Cadogan Financial in association with A F Ferguson & Co. presented a report on "Reform of Mutual Funds in India" in March 2004 (ADB Report). Its recommendations on a variety of mutual fund issues are still valid. Significant issues related to improving investor protection are critical and should be implemented soon. These are highlighted below.

□ Governance structure of Mutual Funds: Introduce Professional Corporate Trustees

Current mutual fund structure in India requires a Sponsor who incorporates the Asset Management Company (AMC) and appoints the Trustees. The Trustees are the investors' representatives charged with ensuring that the activities of the AMC are in accordance with applicable regulations and protect investor interests.

SEBI Mutual Fund Regulations place onerous responsibilities on the trustees. These

⁶⁸ On occasion, it has argued successfully that trust assets belong to investors, not the intermediary.

include⁶⁹: Appointing AMC directors (but not the Chief Executive Officer of the AMC, which seems irrational since that person must be the most powerful); Monitoring the competence, capacity and compliance of the asset management company, including its preparation of compliance manuals and procedures for internal controls and audit and its maintenance of the required amount of capital; Monitoring compliant usage of brokers by the asset management company and that the AMC does not unduly favour associates in transactions or damage interests of fund investors in so doing; Ensuring that AMCs do not prejudice the interests of members of any one scheme within a mutual fund vis a vis members of another scheme of the same fund; Informing SEBI of violations of regulation; Holding assets of the fund in trust; Ensuring that transactions in fund assets are in accordance with the trust deed; Calculating income to be paid to fund investors; Monitoring dealing in securities by key personnel of the AMC; Reviewing all transactions between mutual funds, AMCs and their associates; Reviewing investor complaints received and how these have been dealt with; Reporting to SEBI half yearly on mutual fund activities, stating that no instances of self dealing or front running have arisen and certifying that each scheme has been independently operated by the AMC and that investor interests have been protected; Ensuring all contractors to the fund have appropriate regulatory status and monitoring performance of contracts; Reviewing AMC performance; Obtaining internal audits; Assessing the reasonableness of fees paid to contractors; and Varying the AMC contract.

A compliance officer generally employed by the AMC aids the trustees in their tasks. The Trustees therefore completely depend on the

AMC for information that they need to complete their designed tasks.

Thus trustees are generally poorly remunerated, do not have the knowledge, time, motivation or commitment, nor do they have the information to meet the requirements that the regulation imposes on them.

The ADB report states that, "...while SEBI approves the AMC, receives reports from it and orders inspection of it, and disciplines it, that much oversight of the AMC's compliance with mutual fund regulation has, in effect, been delegated by SEBI to trustees who we think lack the capacity to effectively fulfill this role."

The task of "trusteeship" should be performed by expert professionals. Efforts should be made to introduce Professional Corporate Trustees (PCT) into the Indian mutual fund structure.

The PCT will be a separate registered entity with its own authorization procedures and rulebook and is therefore also subject to regulatory supervision, inspections and enforcement. It would be in a position to provide expert trusteeship services to several AMCs, thus achieving economies of scale. A PCT can be required to have a higher capital than AMCs. It would have internal systems, compliance controls and procedures that parallel the AMC systems and therefore a much stronger and timely access to critical fund information than any individual trustee could have. The PCT would be in a position to have professional staff with the required competence and subject to internal controls and procedures. The PCT would review the procedures, systems and controls of any AMC that it is considering providing trustee services to and would not accept the risk of providing services to those whose systems are

⁶⁹ ADB Report, p.127

likely to remain inadequate for fear of risk to its own reputation⁷⁰.

SEBI would also have to expand its regulatory capacity to be able to register and regulate PCTs and to enhance mutual fund regulation especially in the area of AMC and PCT inspections. However, this may be a lesser burden than a broader direct supervision of AMCs.

□ Regulate Distribution

Mutual fund distributors are not registered and regulated. This subject has been discussed in detail above in Chapters 3 and 4 in the broader context of unregulated retail distribution.

“The distributor or financial adviser lies at the heart of most of the regulatory problems relating to investment funds and similar packaged products in developed markets, for it is here that poor quality advice driven by ignorance, incompetence or the desire to earn the highest commission leads to a customer buying a product that does not fit his need or having his money stolen or otherwise being defrauded.”⁷¹

Creating a front-line regulatory organization to address the issue of regulation of retail intermediaries distributing securities and other financial products; and providing investment advice and financial planning services would address the issues related to mutual fund distribution.

4. Enable more effective private rights of action to enforce the securities laws

Expanded private rights of action and class actions overseen by easily accessible and

quickly responsive courts are needed to protect investors and enforce the securities laws. In effect, Indian investors lack the principal and most effective means of obtaining redress for losses suffered as a result of violations of the securities laws: the ability to bring a meaningful private civil action or a class action for violations of India’s securities laws.

Such actions, through their in terrorem effect and the “heads up” tips they give regulators provide an enormous boost to self-discipline and the enforcement of the securities laws in the United States.⁷² Although at first glance it would appear that Indian law provides opportunities for such relief, they are in fact illusory because of limitations on the scope of class actions; uncertainties regarding investors’ rights to bring private actions to enforce the securities laws and be awarded damages; and interminable delays in legal proceedings.

Under a modified legal regime that would make it easier to bring class actions for violations of the securities laws, market forces (i.e., more private sector law suits quickly and efficiently disposed of through the courts or another acceptable forum, “a rocket

⁷² The U.S. Supreme Court held in J.I. Case Co. v. Borak, 377 U.S.426, 84 S.Ct.1555 (1964):

“Private enforcement of the proxy rules provides a necessary supplement to Commission action. As in anti-trust treble damage litigation, the possibility of civil damages or injunctive relief serves as a most effective weapon in the enforcement of the proxy requirements.

*We therefore believe that under the circumstances here it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the Congressional purpose. * * **

For a similar U.S. decision by a federal District Court relating to insider trading, see, Kardon v. National Gypsum Co., 69 F. Supp. 512, 513-514, (E.D. Pa., 1946) .

⁷⁰ ADB Report, p. 130.

⁷¹ ADB Report, p. 223

docket⁷³), could provide an effective avenue for shareholder redress; for disciplining securities market professionals and insiders, and for assisting SEBI in enforcing the securities laws. For India to continue its transformation to a market economy, fully implementing such a change in the judicial and legal environments could usher in a new era of investor protection, observance of the securities laws and self-discipline among market professionals.

Improve Knowledge Standards Across the Market

1. Improve knowledge standards of market participants

For the operators of the Indian securities industry to become truly professional the competency levels of all intermediaries must be upgraded. Mandatory certification and continuing education (CE) requirements can help significantly to achieve this goal. Priority should be given to training, testing and certifying those intermediaries who interact with the retail investors. Because retail intermediaries have the most immediate impact on how retail investors experience the securities market, increasing their knowledge and professionalism becomes the highest priority.

In its 2005 Budget Message, the GoI announced that it would establish a National Institute of Securities Markets (NISM), as an educational institution⁷⁴ to cater to the needs

of securities market education, continuing education and research.

SEBI, through its recent regulation, "Certification of Associated Persons in the Securities Markets, Regulations, 2007," has mandated certification requirements for market intermediaries. It is a major step toward ensuring that persons joining the securities industry have a defined minimum level of knowledge. NISM is the implementing agency for this market-wide program and should be the sole agency tasked with ensuring minimum standards across the securities markets. It should ensure that only those who meet the minimum requirements should be work in the securities industry.

NISM certification requirements will boost the training and education of industry participants. As markets adjust to the new requirements, training programs and institutes that specialize in training prospective entrants will develop. NISM should initiate and encourage this development by working with training institutions and industry associations to develop relevant and high quality training material, guidance notes and sample examinations; and should conduct training workshops for trainers to ensure quality control and consistency throughout the industry.

India's efforts to develop an international financial centre also require the availability of capable human resources. The High Powered Expert Committee on Making Mumbai an International Financial Centre established by the MoF (HPEC) in its report recommends increasing the output of MBAs majoring in Finance and Quantitative Finance and the creation of specialized post graduate programs such as an M. Sc. in Finance. It

⁷³ The U.S. District Court for the Eastern District of Virginia has the well-deserved reputation for adjudicating all cases -- from the most basic to the most complex -- with unparalleled speed and efficiency. It is known as the "Rocket Docket."

⁷⁴ NISM is comprised of six schools: the School for Certification of Intermediaries (SCI); the School of Regulatory Studies and Supervision (SRSS); the School for Corporate Governance (SCG); the School for Investor Education and

Financial Literacy (SIEFL); the School for Securities Education (SSE); and the School for Securities Information and Research (SSIR).

suggests that such a program be pioneered at an academic centre of excellence near Mumbai. NISM's School of Securities Education appears well positioned to play such a pioneering role.

2. Improve Financial Literacy

Achieving a broad level of financial literacy is important to India. For individuals and families, the ability to apply financial literacy skills can make a difference in the quality of their lives. A more financially literate population should be better equipped to make financial decisions. Financial literacy skills include numeric and reading skills: the ability to read, analyze, manage, and communicate about the personal financial conditions that materially affect an individual's well being. Financial Literacy focuses on competency. It includes the ability to:

- Discern financial choices;
- Discuss money and financial issues without (or despite) discomfort;
- Plan for the future; and
- Respond competently to life events that affect everyday financial decisions, including events in the general economy.”⁷⁵

Regulatory organizations in other countries have taken upon themselves the task of improving financial skills of their populations. In the UK, the Financial Services Authority (FSA) leads the “National Strategy for Financial Capability,” In the US, the Congress established the “Financial Literacy and Education Commission” to coordinate and promote financial education efforts and in Australia the Financial Literacy Foundation was established for this purpose.

⁷⁵ US based National Endowment for Financial Education.

SEBI, the Ministry of Company affairs, the Government of India and many private organizations such as the stock exchanges have taken initial steps to promote financial literacy. SEBI's efforts have focused on securities market awareness. It has conducted investor information workshops, seminars and training programs, published investor education materials distributed via the internet and brochures that have been disseminated throughout India in several local languages.

In India, while attempts at promoting investor education⁷⁶ are being made, there is a distinct need for an intensive, coordinated and continuous effort at promoting financial education. India needs a consistent and focused national strategy, including an ongoing process and continuous effort to develop specialized skills in adult education and financial markets.

NISM's School for Investor Education and Financial Literacy is well positioned to lead the development of India's financial education strategy and to spearhead and coordinate its implementation.

Additionally, just as specialized agencies such as the Basic Skills Agency and the Personal Finance Education Group (PFEG) of the UK and the National Council on Economic Education (NCEE), Jump\$tart coalition and National Endowment for Financial Education (NEFE) of the US are playing a critical role in developing and disseminating financial literacy education in those countries, India, through NISM, can develop specialized skills to fill this gap. It should develop educational material that meets the needs of various sections of the population and coordinate its delivery to those who need it when they need it, in a variety of

⁷⁶ SEBI launched its “Securities Markets Awareness Campaign” in 2002. Under this initiative SEBI has developed investor brochures, an investor website and conducted numerous workshops across India.

innovative ways. As the programs NISM has been designed to promote, progress, they should provide needed dimensions to the Indian securities market and the milieu in which it functions.

Strengthen Oversight of the Accounting and Auditing Profession

1. The Potential Implications of Complete Convergence

Full observance of IFRS by all public interest entities can have much broader implications for India's securities market than an individual company's voluntary implementation. As of mid 2007, only a handful of the thousands of individual issuers of listed securities had reconciled their Indian financial statements with US GAAP or IFRS. Similarly, to date the ICAI and/or SEBI (in its exchange Listing Agreement requirements) have introduced only some accounting standards that are closely aligned with international standards. Full convergence for periods commencing on or after April 1, 2011, should bring observance of all international standards by all issuers of publicly traded securities and all other public interest entities. Moreover, the U.S. SEC's proposal July 27, 2007, to allow US issuers to choose between IFRS or US GAAP for the preparation and presentation of their financial statements means that, if and when, the SEC's proposal is implemented, the convergence of India's accounting standards with IFRS and US standards will be more complete, if not total, and should diminish any remaining accounting barriers to international markets.

Complete convergence presents advantages of scale nationally and internationally and enormous opportunities for economy-wide growth. Nationally recognized international accounting standards will involve all

regulators, accountants, analysts, management teams, etc. and require them to focus on, master and implement the same standards. A united effort should inspire them to make the standards work. Harvard Professors Miller and Narayanan⁷⁷ cite the U.S. SEC as an example of how oversight by a single regulator who is actively involved "greatly increases the comparability of implementation across countries," and makes country-level adoption "economically more efficient... and accounting more credible to outsiders..." Internationally, the visibility of international accounting standards and the realization by outsiders that understanding India's accounting will be much less of a barrier, makes them more likely to invest in a company. Country-wide adoption will give the ICAI and India, as a wide user of the standards, a better opportunity to influence, or perhaps play a leading role in shaping, the standards setting process. It could also give further impetus to global outsourcing of accounting and auditing work to Indian accounting firms.

2. Establish a Financial Review Board and Provide Means of Enforcing Compensation for Losses Due to Audit Failures

The transition to IFRS will require a huge educational effort, not just for the profession, but also for owners, managers, analysts and investors. For accountants and auditors it is akin to having to become proficient in a new language; then being tested in and meeting worldwide professional standards. For owners of closely held listed companies there will be many adjustments and opportunities. For the transition to be effective India must

⁷⁷ Cynthia Churchwell, Harvard Business School, Working Knowledge for Business Leaders, "Financial Reporting Goes Global," Q.& A. with Gregory S. Miller and V. G. Narayan, January 23, 2006.

also develop a proper regulatory framework for the effectiveness of high quality accounting and auditing standards that is recognizable and respected by the international investors and will be trustworthy in the eyes of domestic retail investors. India differs in significant ways from many of the economically developed common law countries that are sources for IAS and IFRS. The economic, legal and political institutions of those countries offer a framework for the effectiveness of high quality accounting standards: resource allocation determined by free markets, not the state; public markets rather than banks as major sources of financing; corporate governance focused on shareholders; and clear separation of ownership and management.

Public financial reporting and disclosure and reliable independent auditing of financial information are essential to such a framework. For them to be effective, the regulatory framework must contain working mechanisms for holding accountants and auditors accountable for the quality of their work.⁷⁸ Two complementary, but fundamental, reforms are recommended to make accounting and auditing standards effective and accountants more accountable.

⁷⁸ In 2002, the Department of Company Affairs established the High Level, Naresh Chandra Committee (NCC) to suggest, analyze and recommend changes in the statutory auditor–company relationship; the rotation of statutory audit firms or partners; the procedure for the appointment of audit partners and the determination of audit fees, the independence of audit functions; a transparent system of scrutiny of audited accounts; the advantages and the need for a regulator similar to the Public Company Accounting Oversight Board prescribed under the Sarbanes-Oxley Act; and the role of independent directors. Some favored an oversight board, but resistance from the accounting profession resulted in alternate recommendations to strengthen the accounting and auditing profession.

Shareholders must be able to enforce compensation for losses caused by financial fraud by managers and audit failures through private litigation and class action suits.⁷⁹ The importance of effective shareholder access to India’s legal system and the ability to gain meaningful redress is fundamental to the success of India’s accounting reforms. “Mere adoption of superior accounting and disclosure standards will not raise the quality of Indian financial reporting. Creating a complementary institutional framework that, among others, facilitates cost effective private litigation by shareholders is critical.” R. Narayanswami, *The Chartered Accountant*, “Globalisation and Indian Accounting Standards,” January 2006, at p. 974.

Oversight of India’s accounting profession must be strengthened by establishment of a Financial Review Board. India’s movement to IFRS and full convergence require strong continuing oversight. ICAI, India’s professional accounting body has embraced IFRS, but without independent oversight. Despite the allegations of financial impropriety, few, have been subject to disciplinary measures or have been required to compensate victims of financial fraud.

Among the mechanisms for maintaining high quality audits which could be required and monitored by a Financial Review Board are: adopting and observing International Audit Standards; effective corporate audit committees; internal audit firm quality controls; and regular, rigorous peer reviews; auditor rotation; greater audit firm transparency which allows better informed

⁷⁹ The need for private rights of action and civil liability for violations of the securities laws to protect investors is discussed above in a broader context. The need to include the accounting and auditing professions within its reach is discussed here to emphasize its prophylactic effects and importance to the implementation of international accounting and auditing standards.

competition and fosters performance evaluation by professional bodies, shareholders and regulators; and shareholder empowerment through voting, inspection of auditors. These kinds of mechanisms must be rigorously enforced. This has not yet been done satisfactorily whether by the ICAI, clients, investors or regulatory bodies. A comprehensive program is needed to strengthen the reliability and credibility of audits and the accountability of the accounting profession.

The Chartered Accountants (Amendment) Act, 2006 establishes a Disciplinary Directorate headed by an officer of the ICAI designated as Director (Discipline), a Board of Discipline and an Appellate Authority. It also establishes a Quality Review Board that has advisory powers but lacks the ability to enforce its recommendations.⁸⁰ Although these measures recognize the need for increased professional accountability and enhance the structure of the ICAI as a professional body, they are still untested and, as conceived, do not contemplate the comprehensive protections that independent oversight of the profession would provide in achieving the objectives outlined above. For publicly listed companies making the transition to International Accounting Standards, an independent Financial Review Board comprised of affected regulators and eminent members of the financial, commercial and legal communities, and staffed by professional accounting experts would be better able to assure the adoption, maintenance, monitoring and enforcement of

international accounting and auditing standards.

Develop the Architecture and Legal Framework of the Corporate Bond Market

To develop the corporate debt market, issuers, investors and intermediaries must be convinced of the clear economic benefits to each of a well-functioning corporate bond market: better costs; lower risk; or better market performance than the status quo; and an enabling environment must be established. As is explained more fully below, the same kind of shift in regulatory approach and market infrastructure that has succeeded in the market for equities is needed to develop the corporate debt market. Moreover, because the elements of the debt market are interdependent, they must be developed together.

1. The Keys to Development of India's Corporate Bond Market

The World Bank analyzed the Indian Corporate Bond Market and in its report (WB Report)⁸¹ put forward very pertinent recommendations. The principal recommendations of the WB Report are presented below.

The types of changes identified by the WB Report to transform the corporate bond market include: regulatory reforms that allow market forces to function; cooperation among regulators; building an appropriate market infrastructure that maximizes technology, and increases information and transparency. The WB Report's recommended reforms focus on facilitating speedy and cost-effective primary issuance without compromising transparency and

⁸⁰ The amendments add a new section 28A-D that establishes a Quality Review Board. Section 28B, "Functions of the Board," enable it to: "review the quality of services;" "make recommendations" regarding those services"; and "guide members" of the ICAI to improve the quality of services and adherence to the various statutory and other regulatory requirements.

⁸¹ World Bank, *Developing India's Corporate Bond Market*, December 2006.

disclosure; elongating maturities of corporate bond issuances; and improving liquidity in secondary markets.

One critical theme of the WB Report is how to restructure the corporate debt markets' primary and secondary microstructure: issuance methods; trading mechanisms; dissemination of transaction information and the role of intermediaries.⁸² The WB Report's proposed reforms focus on improving liquidity and providing information on transactions to improve bond market pricing. To improve liquidity it called for the following market infrastructure reforms: trading platforms that promote efficient price discovery; efficient clearing and settlement mechanisms; and adequate credit information.

Because the narrow range of debt instruments also detracted from the market's liquidity, the WB Report called for the RBI to adopt guidelines that would enable the creation of needed credit derivatives and of a suitable money market index for the interest rate swap market to enable development of hedging tools (now being developed). Because the lack of information on bond market transactions⁸³ limited active trading and pricing in the debt market, to enhance price discovery it called for more information on the amount of debt outstanding on any given date and data on bond issues: size; coupon; latest credit rating; underlying corporate performance; information on secondary trading; and default histories of companies.⁸⁴

A second critical theme of the WB Report is the need for increased cooperation and coordination among regulators. Three strong

⁸² Ibid.

⁸³ Ibid.

⁸⁴ Ibid.

well-respected Governmental bodies: the RBI, the MoF and SEBI, have significant, but ill-defined supervisory responsibilities in the corporate debt market. Despite the strength of each, their differing focuses and poor coordination weaken the market's regulatory structure and undermine its development. Substantial cooperation among the three is the underlying premise of the recommended reforms. Those reforms would clarify administrative responsibilities and improve coordination among the various oversight authorities; facilitate aggregation and disclosure of information about transactions; modernize laws on creditors rights, bankruptcy and corporate governance to enable speedy and efficient enforcement of laws relating to default proceedings and create a Bankruptcy Code and institutional mechanisms to deal with business failure in a way that is fair to bondholders.⁸⁵

2. Recommendations for Development of the Corporate Bond Market

The WB Report provides a detailed set of recommendations that would develop a growing and diverse set of issuers by streamlining procedures and reducing costs of issuance; encourage local institutional investors: banks, pensions fund managers, and insurers, to participate in the corporate debt market by making investment policies and regulatory guidelines sufficiently flexible for these entities to choose an appropriate risk-return profile within fiduciary restraints; and strengthen the legal and regulatory framework by clarifying oversight responsibilities among the various regulatory agencies and modernizing laws governing creditors' rights and corporate governance.

⁸⁵ Ibid.

These reforms cluster around the comprehensiveness of, and access to, issues and issuers; the efficiency and reliability of the market infrastructure; the range of products available; and the homogeneity of the corporate bond securities. They are spelled out in Table 5.2, a condensed adaptation of Table 1 of the WB Report, Summary of Recommended Regulatory and Market Reform Measures, that also identifies the agency or agencies responsible for reform.⁸⁶

3. Progress in Implementing Recommendations for Development of the Corporate Bond Market

As indicated above, implementation of the WB Report's recommendations started early in 2007 when the GoI placed primary market issuance and secondary markets, including OTC and exchange trading and settlement under SEBI's jurisdiction; gave responsibility for repo/reverse repo transactions in corporate debt to the RBI; and required all trades to be reported through the exchanges where they are traded or to reporting platforms. Both the NSE and the BSE have started using their existing infrastructures for corporate bond trading. FIMMDA has also made operational a

reporting platform for over-the-counter (OTC) trades in corporate bonds and a consolidated ticker service for reporting all such trades. Both exchanges are expected to provide an anonymous order matching system for trading of bonds in the near future. With the introduction of the order matching system, clearing and settlement facilities would be provided by the BSE and NSE with a multilateral netting facility for trades executed on the platform.

SEBI has also begun drafting regulations for "Public Offer and Listing of Securitised Debt Instruments." SEBI's proposed regulations for Issuance (Continuous Disclosure) Regulations and (Issuance of debt capital) should simplify the debt issuance process and thereby encourage more corporations to issue bonds. Efforts to introduce repos in corporate bonds also have begun.⁸⁷ Priorities among many still pending recommendations are amending the Companies Act to reduce the disclosure requirements for already listed issues and reducing and rationalizing high and varied stamp duties across states and instruments.

Developing a vibrant corporate bond market should be a priority for Indian policy establishment.

4. Benefits of Bond Market Regulation

An appropriate regulatory structure for the corporate debt market would encourage the market's development by eliminating the Government of India's restrictive regulatory and investment guidelines that require banks, insurance companies, and pension and provident funds to invest a large portion of their funds in government securities. Such a

⁸⁶ The WB Report followed the "Report of High Level Expert Committee on Corporate Bonds and Securitisation," headed by Dr. R.H. Patil, submitted in July 2005, which recommended enhancing the issuer as well as investor base; simplifying listing and disclosure norms, rationalization of stamp duty and withholding taxes; consolidation of debt; statutory listing of private placements; creation of market-makers; improving trading systems through introduction of an electronic order matching system; efficient clearing and settlement systems; a comprehensive reporting mechanism; developing market conventions and self-regulation; and development of the securitised debt market.

⁸⁷ An important recommendation of the Patil Committee was to widen the "repo" market to include corporate bonds.

Table 5.2: A Condensed Adaptation of Table 1 of the World Bank Report, Developing India's Corporate Bond Market

Reform Measure	Responsible Agency
Regulatory reforms affecting issuers	
* Streamline procedures for public issuance of debt through streamlined disclosures. Extend shelf registration for all types of corporate borrowing to allow filing a consolidated document for several offerings.	SEBI and DCA
Strengthen the debenture trustee system by protecting against default in timely interest payments by the company	SEBI
Rationalize the stamp duty among different classes of investors and states	MoF, State govts, RBI
Regulatory reforms affecting investors	
* Relax and amend regulations permitting pension and provident funds to invest in corporate debt	MoF, Income Tax Dept., MoL, Employee Provident Fund Orgs.
* Modify insurance co. investment guidelines to allow investment in less than AA rated instruments with adequate safeguards to protect soundness	IRDA
* Relax regulatory caps on bank investment in unlisted corporate bonds (now 10% of total non-SLR investments) and minimum rating requirement needed to invest in corporate bonds (minimum investment grade, AA and above)	RBI, MoF
Provide capital for the interest rate risk in the entire balance sheet , not just mark-to-market portion of the book. Ensure that bonds and loans receive similar treatment from perspective of interest rate risk	RBI, MoF
Remove artificial distinction between investments and advances. Guidelines and rules should be similar for a given credit, whether a loan or a bond	RBI, MoF
Raise the ceiling on corporate bonds for FIIs Start by relaxing cap on longer-term investment in corporate bond markets (over 3 Years)	RBI, MoF, SEBI
Professionalize fund management to ensure access by pension and provident funds and insurance cos. to professional management. Put in place adequate risk management systems to preserve these investors' soundness	SEBI, IRDA, Employee Provident Fund Orgs.
Reforms of the legal and regulatory framework	
Improve existing regulatory practices. Put regulation of corporate debt market under a single regulator	High Level Comm. On Capital Markets, MoF, RBI, SEBI
Enforce amended bankruptcy laws that: clearly define creditors' rights and investors' responsibilities; promote adequate corporate governance; and timely and adequate public disclosure of financial information	DCA, MoF, RBI, SEBI
Market Microstructure Reforms	
Improve comprehensiveness of, and access to, corporate credit and trade information	SEBI, DCA, secondarily credit rating agencies, exchanges, CCIL, MoF
Improve trading and settlement systems to provide greater liquidity, efficient price discovery, and an exit route for debt investments in infrastructure	SEBI, RBI, exchanges, CCIL, MoF
Develop new product structures (e.g., credit enhancement, bond insurance) and hedging mechanisms	SEBI, RBI, exchanges, CCIL, MoF, ind. Asns. FIMDA, AMFI, PDA
Permit short selling in govt securities to help refine the corporate bond pricing mechanism, and help investors hedge risks effectively	RBI, MoF
Remove differential tax treatment between different classes of corporate bonds	MoF, Central Board of Direct Taxes

regulatory structure would also permit greater flexibility to invest in nongovernmental private sector corporations, particularly those that are lower rated, thus opening new sources of capital to the market and increasing its diversity. Foreign investment in the lower rated, higher risk bonds would be encouraged. Instead of preventing foreign institutional investors from investing in bonds across the credit spectrum through investment caps on their debt investments, an appropriate regulatory structure would follow the approach taken in more mature international markets. This approach would give pension funds and insurance companies greater flexibility in managing their portfolios, and not require explicit ceilings on the debt securities that they may hold.

An appropriate regulatory structure also would encourage more innovative bonds and derivatives that would help protect against interest rate and credit risks. Appropriate regulations would allow lower rated corporations and infrastructure sponsors to tap investments from institutional investors.

5. Beyond Bonds: An International Financial Center in India

The HPEC report makes far reaching recommendations to develop India's ability to develop an international financial center. Some of its salient recommendations on the market and regulatory structure are discussed below.

The HPEC report identified the debt, currency and derivatives markets as the most critical market components missing in India. Six specific deficiencies noted by the report are the absence of:

- a liquid and efficient sovereign bond markets with an arbitrage free INR yield curve,
- a wide range of essential derivatives on INR interest rates,
- a liquid spot market for INR, dominated corporate bonds,
- credit derivatives on credit spreads or credit events,
- a liquid currency market, and
- a full range of currency derivatives.

The report recommended a new single omnibus legislation that will bring together under its umbrella all aspects of financial services: securities trading, banking, derivatives, insurance and commodity finance. It also recommended a principle based regulatory approach as opposed to a rule based approach. It also recommended that the regulatory architecture be reformed to ensure that regulation of all organized financial trading (currencies, bonds, commodity derivatives) be placed under SEBI's jurisdiction. It recommended that the wholesale markets be governed by a less restrictive regulatory regime as compared to the retail markets where investor protection should be the paramount consideration. It also recommended that periodic independent regulatory impact assessments of the financial regulatory regime be conducted to ascertain the efficiency and cost effectiveness of regulation in meeting its objectives.

Although this report does not have a mandate to evaluate or comment in detail on the proposals contained in the HPEC report, broad agreement with the HPEC's recommendations, specifically those related to market structure, can be expressed. India must develop the missing Bonds-Currency – Derivatives (BCD) markets. The HPEC's contention that regulation in silos has inhibited the competitive strength and innovative ability of India's financial services industry coincides with the observations and recommendations contained in this report and with the need to integrate regulation of the financial markets.

This report takes the position that India's market regulators have limited capacity to regulate the potentially vast Indian market that is rapidly becoming more technology intensive and developing more intricate product and market structures. It therefore has recommended that the financial services industry should play a major role in regulating itself by employing a governance structure that reduces the conflicts of interest inherent in self-regulation under close oversight of regulators. It takes the position that the India's financial services industry should play a more prominent role in building the market regulatory infrastructure that is essential for its growth.

Conclusion

This report has traced the transformation of the Indian Securities Market from 1992 through mid-2007 and described its principal engines of growth. It is a remarkable story in which India can take great pride. It has developed a respected market regulator and an enabling legal and regulatory framework; a state of the art market infrastructure; thriving derivatives and mutual fund markets; and improved disclosure and transparency. India's market has found a respected place in the global market. These achievements are a strong foundation, but are only a start. India must continue to strengthen and transform its market to compete, not only with mature markets, but also with other newer equally dynamic markets as well.

By building on its foundation and applying the lessons and techniques that have already succeeded, India can seize the opportunity to continue the transformation of its securities market on a global scale: to add new dimensions that will allow it to better allocate resources; strengthen its economy and infrastructure; and broaden participation of the Indian public, both directly as retail investors and indirectly through institutions such as mutual funds, banks, pension and provident funds and insurance companies.

This report sets forth tested strategies and detailed recommendations for strengthening India's securities market. As they succeed, ***"Today's investors will not recognize tomorrow's markets."***

