Stock Market*

- **K.S. Chalapati Rao**

With the backing of the World Bank group, many developing countries started giving prominence to stock markets for financing enterprises and allocation of savings. In India too, the process started in the early 'eighties. In the wake of increased pace of economic liberalisation initiated in 1991, the *Capital Issues Control Act, 1947*, which till then regulated the issue and pricing of new capital, was done away with and even greater emphasis was placed on the stock market. As a part of the measures to develop the stock market and liberalisation of the external sector, foreign institutional investors were invited to trade directly on the Indian stock exchanges. The main expectations were that the market would help corporates raise resources directly from investors, help attract foreign portfolio capital and facilitate the process of privatisation. The entry of foreign portfolio/institutional investors (FIIs) was expected to broaden the base of the market and also help in the market's development by forcing developing country governments to follow consistent and market friendly policies. Through their expert analysis and research, FIIs were expected to help in better price discovery. Since 1991, a number of measures at improving share trading and delivery mechanisms and investor protection ranging from more periodic disclosures, takeover regulations, insider trading rules, corporate governance code, etc. have been introduced by the Securities and Exchange Board of India (SEBI), the market regulator.

Rude Awakening

Even for those who have been closely following the many setbacks and scams that surfaced ever since the liberalisation process was accelerated in 1991, the revelations following the market's crash in early March 2001 came as a rude shock. With each successive disclosure of market manipulation, the market lost heavily. From 4271 on March 1, 2001, the Bombay Stock Exchange Sensex nose-dived to 3184 by April 12 2001 *i.e.*, by about one-third. Thereafter, the index recovered to hover around 3400-3500. The government, having presented a business-friendly Budget, was probably expecting the stock market to again climb the heights which it reached in early 2000. The most important cause for the sharp decline following the Budget 2001-02 is the bear hammering to take advantage of big bull Ketan Parekh's troubles. A combination of factors are stated to be responsible for these problems namely, fall of technology stocks in Nasdaq, arrest of Bharat Shah, Tehelka exposures, profit warnings from Infosys, etc. Mr. Parekh, who started riding the technology stocks

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wave of Nasdaq, has come to specialise in these stocks some of which have earned the sobriquet of K-10. In the process of unravelling the scam, the muck that has been there and many were aware of but preferred to be silent for reasons best known to themselves, is coming out into the open. Allegations of insider trading, price manipulation, nexus between brokers and promoters, defrauding and diversion of bank funds, possible links with mafia, misuse of the FII route, etc. started pouring in. The proposed merger of Global Trust Bank and UTI Bank has been called-off. Role of cooperative banks has come under sharp focus. Role of the regulators has come under a cloud. The scam also claimed a few lives that were buried in the avalanche of falling tech stocks.

Interestingly, *Economic Survey 2000-01*, released only a few days earlier to the market cave-in, did not indicate any major problem in the secondary market except for an increase in volatility over the previous year. The *Survey* explained:

> The current financial year witnessed considerable increase in stock market volatility vis-à-vis the previous financial year. The increase in volatility noticed in the Indian capital market in the current financial has been observed in the capital markets abroad. Volatility has been an international phenomenon, particularly due to increased influence of the new economy stocks in the markets.

Thanks to the scam, the press has started highlighting the darker side of the stock market. The government, SEBI, Reserve Bank of India (RBI), the financial press and a host of analysts are active to identify the culprits. With the findings of SEBI trickling in, more and more skeletons are tumbling out of the Indian stock market's cupboard. A flurry of decisions were taken in rapid succession. Some brokers have been suspended from trading, some broker members, including the President of BSE, were removed from stock exchange boards, steps were initiated to demutualise stock exchange boards and short-selling has been banned. Various forms of *badla* would come to an end on July 2, 2001. The much-delayed introduction of uniform trading cycles in the exchanges would soon become a reality hitting arbitrage hunters. Frantic efforts have been initiated to draft an investor protection law. Action was taken in the long pending case of share price manipulation by BPL, Videocon and Sterlite by permanently banning Harshad Mehta from associating himself with the stock market and imposing restriction on raising capital from the market of various durations on the three companies. The punishment for the promoters and directors of these companies is, however, yet to be delivered. A Joint Parliamentary Committee (JPC) has been constituted to go into the scam. Indications are that SEBI, which has been asking for more powers, may get some soon.

Even though these developments are important by themselves, a close look at some of the characteristics and happenings is necessary to understand the state of the Indian stock market better.

Concentration in Trading and Volatility

Undue and wide movements in share prices help neither the ordinary investor nor the entrepreneur to take informed decisions. The volatility of the Indian stock market is being explained by the government as a part of international phenomenon. No doubt, in an open system huge funds can flow in out with much ease. Also, when important constituents of the market are listed on international stock markets prices in those markets are more likely to get reflected in local markets. FIIs are known to churn their portfolios frequently. There can be no escape from a degree of volatility.

More importantly, however, in the Indian case, it is the heavy concentration in trading in a few sectors and scrips and the consequential heavy weights attached to such sectors, disproportionate to their relative importance for the economy, appear to have a major influence on volatility. The concentration in trading has been increasing over the past few years. The phenomenon of Ketan Parekh is not new and has indeed contributed to its worsening. What is probably not known is the dominant part played by stocks popularly known as K-10 in trading volumes and values.

Table – 1

Month-wise Shares of K-10* Scrips in Total Trading Volume and Values of BSE during 2000-01#

(Percentage Shares)

Month	*Number of Trades*	*Number of Shares Traded*	*Net Turnover*
(1)	(2)	(3)	(4)
April 2000	23.29	13.71	43.33
May 2000	40.48	31.53	57.71
June 2000	42.10	33.46	63.65
July 2000	39.18	33.60	58.46
August 2000	46.84	51.49	66.36
September 2000	46.73	48.29	66.33
October 2000	49.20	52.68	65.60
November 2000	40.67	40.75	62.08
December 2000	35.69	36.66	57.03
January 2001	36.73	38.77	55.17
February 2001	30.21	28.80	46.76
March 2001	35.83	36.99	41.23
Total	***39.08***	***37.59***	***58.20***

* As per a popular Indian financial web site Indiainfoline.com, the scrips are: Aftek Infosys; DSQ Software; Digital Equipment; Global Telesystems; Himachal Futuristic (HFCL); Pentamedia Graphics; Satyam Computers; Silverline Industries; Software Solution Integrated (SSI); and Zee Telefilms. However, Global Trust Bank, Lupin Labs, Mascon Global Ranbaxy and Padmini Polymers are also reported to in Parekh's sphere.

Excluding trading in debt securities.

From Table-1 it can be seen that during 2000-01, K-10 stocks were accounting for nearly two-thirds of the trading volumes and half of the trades and number of trades in some months. In the over all, they had fairly high shares of nearly sixty and forty per cent respectively of trading turnover and number of trades. If one adds to this set, the other companies in which KP is reported to have had an interest, the figures may turn out even more prominent. It is not to suggest that Mr. Parekh was responsible for the entire trading in these stocks. The evidence does, however, suggest the perception of market players regarding Mr. Parekh's abilities at moving the market in these scrips. Such high shares should have caused concern for any one and especially for the regulators who were to "promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto". The explanation that in response to SEBI's queries, the stock exchanges did not report any irregularities does not sound convincing. The high concentration had its reflection in the poor liquidity of thousands of scrips. While a couple of thousand BSE-listed companies were not traded at all during the year, in nearly half of the companies traded, the average number of trades per day was just one! So much for the liquidity offered by the stock market for investors.

Incidentally, the recovery of BSE Sensex started some time in the middle of October 2000 from about 3600 and its near sustained rise till the middle of February 2001 to exceed 4400 can be attributed, apart from other factors, to the increased exposure of banks to stock market and the so-called FII investments. The market had since fallen back and once again started hovering in the region of 3500-3600. Later developments clearly show that banks' advances to the stock market operators played no mean role in the scam.

Whatever that is good for and workable in US need not necessarily be beneficial to or feasible in developing countries. Why should banks advance substantial amounts of money to stock market operators? When money chases money, more often the result is creation of a bubble. And bubbles are bound to burst. Should one let stock markets hurt the banking system which has a much larger and proven role in the financial system?

Primary Market

A test of a stock market's utility is in its ability to mobilize resources for investment. It is an established fact that after the fiasco of mid-'nineties, the primary market has been performing poorly. During 2000-01, though the number of issues increased from 93 to 151, the amounts involved came down to Rs. 6,100 crores from Rs. 7,800 crores. In terms of sectoral composition, the situation turned out to be even worse (See Table-2). Banking and finance as also the ICE (Information, Communication and Entertainment) sectors claimed the lion's share of the relatively small amounts raised from the market. While in the previous year, the other sectors claimed about 15 per cent share in resource mobilization, in 2000-01 their share fell drastically to just about 5 per cent. In sharp contrast, as per data from other sources, most of the funds raised by corporates domestically were through private placements: 80 per cent as against 70 per cent in the previous year. Interestingly, out of the total mobilization, almost 40 per cent was from overseas floatations. Also, net inflows to mutual fund (MF) schemes fell to less than half of what they were in the previous year: Rs. 9,128 crores against Rs. 18,545 crores. Obviously, the market has been sidestepped by the corporates for their financing needs. The presence of FIIs did not make any difference either.

Table-2
Major Sectors which Attracted Investment from the Primary Market

	1999-00			2000-01		
	No. of Issues	Amount (Rs. crore)	% Share in Total Amount	No. of Issues	Amount (Rs. crore)	% Share in Total Amount
A: Banking & Finance						
Banking/Financial Institutions	15	4,038	51.66	13	3,139	51.40
Finance	3	124	1.59	10	439	7.19
Sub-Total	***18***	***4,162***	***53.25***	***23***	***3,578***	***58.59***
B: Information, Communication & Entertainment (ICE)						
Telecom.	1	75	0.96	2	922	15.10
Info Tech	36	1,547	19.79	89	803	13.15
Entertainment	2	128	1.64	13	457	7.48
Sub-Total	***39***	***1,750***	***22.39***	***104***	***2,182***	***35.73***
C: Others	36	1,904	24.36	24	347	5.68
Total	**93**	**7,816**	**100.00**	**151**	**6,107**	**100.00**
Share of A & B in Total	***61.29***	***75.64***		***84.11***	***94.32***	

Based on *SEBI Bulletin*, March 2001.

Takeovers

The third important function of the stock market is monitoring of company managements through takeover threats. Contested takeovers are perceived as an indication of the monitoring role the stock market is expected to perform since the poor performance of a company as reflected in low share prices would induce those confident of performing better using the assets of the company to dislodge the incumbent managements. In this regard, the attempted takeovers and mergers of listed companies during the year clearly reflect a pattern of mutual arrangements rather than contests. The contests are restricted to very few companies namely, Bombay Dyeing, Gesco Corp of GE Shipping group and VST Industries. Feeble attempts have been made in case of Ballarpur Industries and Jaiprakash Industries and more recently in DCM Shriram Consolidated. While the war of open offers between Damanis and ITC over VST is still continuing, in none of the cases there was a change in management. Interestingly, some of the prospective acquirers were from the stock broking community. Thus even in the few where there was an element of contest, the nature of prospective acquirers and the manner in which the attempts have ended, assuming that the acquirers were acting on their own, suggest an element of blackmail and asset stripping being the motives. This can hardly be described as a reflection of the market's monitoring role.

There is definitely a dilemma. Should the Indian companies be made easy takeover targets in the light of enhanced freedom to foreign capital? Or, should one let the stock market perform its role of monitoring the managements? At present, the former seem to be dominating. Through creeping acquisition of shares, private promoters are enabled to enhance their shares and secure control over the companies. Also, with public offer as low as 10 per cent in some sectors and large projects, the contested takeovers are going to be few and far in between. Indeed, norms for creeping acquisition have been further liberalised with the limit raised from 2 to 5 per cent. Given the support extended for the existing managements, especially by leading industry associations and business houses and the reported recommendations of SEBI's takeover panel which suggested relaxation of creeping acquisition limits till December 2003 to achieve majority stake, it is clear that the existing promoters would continue to have the sympathy and support of the policy makers.

As a sideshow of acquiring stakes by the promoters, a new trend has emerged in case of MNCs listed on Indian stock exchanges. When share buyback and buy-out were mooted in the *Companies Act*, it was anticipated that a good number of MNCs would seek delisting. Of late, a few listed MNCs are subject to open offers by their foreign parent companies and buyback of shares. The ones reported in the past few months are: Cabot India, Centak Chemicals, Hitech Drilling Services, Hoganas India, Knoll Pharmaceuticals, MICO, Sandvik Asia, International Best Foods, Philips India, Punjab Anand Lamp Industries, Castrol India, Coates Viyella, Carrier Aircon, Otis Elevator and Schenectady-Beck India. Some of these are attempts at acquiring full ownership and control by the foreign parents and the companies would be delisted as a consequence. It does appear that MNCs are taking advantage of the sudden fall in share prices to hike their shares or to take full control of their Indian subsidiaries and affiliates. Whether the reserves of Indian companies are utilised for this purpose or fresh capital is brought in, the obvious beneficiaries are the foreign parents. It does appear that the Indian stock market would progressively lose a good number of foreign-controlled companies with strong fundamentals through delisting.

Foreign Institutional Investors (FIIs)

In spite of the heavy emphasis placed on FII investments, and the many apprehensions about foreign portfolio investments, one is not aware of any official study of the operations of FIIs. What is the number of FIIs, their categorisation according to pension funds, mutual funds, investment trusts, asset management companies, etc., their inter-linkages and association with domestic mutual funds, the sub-accounts whom they represent, the active ones, what and how many companies they invest in, what are their turnover ratios, at any point of time what are the repatriations and on what account, etc. are all unknown. SEBI just offers a list of registered FIIs, the total daily purchases and sales on their account aggregated monthly and annually. On its part, Economic Survey also does not throw much light on the activities of FIIs as it relies on SEBI. RBI puts out a list of companies in which FII limits are reached or can be reached. In spite of their heavy influence on the stock market, the approach seems to be just to count the dollars that have come in and those that have been repatriated.

Last year there was a hue and cry when steps were initiated to plug the Mauritius route for tax evasion. The Government promptly retraced the steps. Thanks to the scam, this time around, however, one is able to get some insights into what goes generally as FII investments. SEBI's investigations pointed out the role of Credit Suisse First Boston (CSFB) and JM Morgan Stanley and First Global (a deemed FII) in the scam and bear hammering. The possibility of money being siphoned out of the country by Overseas Corporate Bodies (OCBs) and FIIs has also surfaced.

> … the pattern of investments and trading transactions, the timings, the inter-connections all point towards prima facie misuse of OCB and FII sub-accounts route including market manipulation in the form of circular trading, parking of shares, structured transactions and concentration of holdings.

SEBI further indicated the possible misuse of investment and automatic repatriation facility in the Indian market given to FIIs through the system of participatory notes (PNs). Under this system an entity, which intends to purchase equity shares in India, approaches the subsidiary of a pension fund incorporated abroad and registered as an FII in India. This facility is used by those who are not eligible for registration as an FII or those who wish to hide their identity possibly for indulging in malpractices. The possible extent of siphoning-off of funds can be seen from the following extract based on the SEBI investigations.

> The total repatriation made by European Investment, Far East Investment, Wakefield Holding, Brentfield Holding and Kensington Investments in the last one-and-a-half years is Rs 3,677 crore whereas they brought only Rs 777 crore in the country. The total paid up capital of all the five OCBs put together is Rs 7,52,940 only.

Interestingly, SEBI has so far granted 'Deemed FII' status to four domestic entities namely, Anand Rathi Securities Pvt Ltd, First Global Stock Broking Pvt Ltd., Munoth Financial Service Ltd. and Reliance Capital Asset Management Ltd. Incidentally, the first two have been suspended in the wake of the scam. The ostensible purpose of granting deemed FII status was to give the Indian fund managers level playing field to manage foreign funds raised abroad by authorised entities and funds. Obviously, much more needs to be unearthed of FII transactions and their role in periodic market swings.

Insider Trading

SEBI had formulated regulations to prevent insider trading as far back as 1992. It is only now when allegations of insider trading are coming in thick and fast, it looked at them once again and decided on issuing a code of internal procedures and conduct with the objective of minimising the use of this practice by persons having access to price sensitive information.

Some of the reported allegations of insider trading are related to mergers and buy-outs by foreign parent companies. The cases in point are: Bank of Madura-ICICI Bank merger, GTB-UTI Bank merger and buyouts of Hitech Drilling, OTIS and Carrier Aircon. The real problem, however, is that price sensitive announcements including quarterly operational results are released periodically. In the context of acknowledged broker-promoter nexus, it is anybody's guess, how promoters and key officials must be enriching themselves or minimising losses at the cost of ordinary investors. With the huge network of companies, at times running into a few hundreds, with which brokers and promoters operate and with information about the corporate sector being so unorganised and in the absence of a reliable database on promoters, directors, brokers and other market intermediaries, their close relatives, the firms and companies in which they are interested, it is debatable to what extent the new code would help minimise insider trading. The long drawn investigation of 'vanishing companies' is a clear pointer to the state of affairs. The poor efficacy of the concept of Companies under the Same Management and the limitation of MRTP Act in covering all companies of a house are clear pointers to the problems in implementation. Indeed, it took quite sometime for SEBI to discover all the brokerages of Mr. Parekh. SEBI was also ridiculed for seeking information on Depository Participants to unearth linkages with Mr. Parekh. It was suggested that SEBI should have looked into its own records before calling for information. Does this indicate that much of the information collected remains to files, computer or otherwise?

What does the future hold?

In important areas such as resource mobilisation, liquidity, regulation of price manipulations, insider trading and foreign portfolio investments, the experience has not been reassuring. The scam had no doubt forced the authorities to introduce long pending reforms. But, it had also clearly shown their apathy to being proactive. One would not be wrong to expect that but for the serious crisis which upset the calculations of the government, the frauds may not have been exposed at all. The fact that so much could come out within a short time and with no additional powers for the regulator is an indication of the lack of will on part of the authorities involved. More importantly, the regulators are now being accused of under-investigating the role of bears. Many changes are in the offing. However, since the official machinery and the media have shown a clear inclination for giving run-of-the-mill explanations for the day-to-day developments and not venturing to disturb the feel-good-factor, one cannot be too optimistic about recurrence of scams and even routine frauds on investors remaining unnoticed and ignored.

Apart from these facts, it does appear that the Indian stock market will have to function under a number of limitations.

- No new major foreign company is likely to get listed in India. A number of existing foreign affiliates and subsidiaries are likely to exit from the stock market. In the context of growing importance of FDI in Indian economy many important companies and sectors will thus remain outside the stock market. This would be a major factor that distinguishes developed country markets and the developing ones.
- Large Indian companies are raising resources from abroad. Some of them may even list exclusively abroad. Already, the share of foreign portfolio investors has technically reached 49 per cent. The ordinary Indian investor will thus be sharing lesser and lesser portion of the benefits of Indian enterprise.
- The demand may then be to allow Indians to invest abroad. To some extent, this has been already conceded as Mutual Funds can invest abroad within specified limits. A complementary issue, however, is whether a capital scarce economy should let its savings flow out while it seeks foreign capital to supplement its own savings.
- Some PSUs may get listed. But definitely not all. The uncertain nature of the market was one of the reasons responsible for the government choosing the strategic partner route for privatisation. Those getting into the fold of MNCs are unlikely to get listed.
- Even small and medium companies would not find it attractive to tap the equity market because of (i) stringent entry and continuing restrictions and (ii) the investors becoming wary of new promoters. Such companies would continue to dependent upon banks and informal channels of financing.
- There is so much of slack that has got accumulated since the mid-'eighties that would be hard to disgorge.
- Active and increasing influence of FIIs, directly and through the MFs under their control, would be a major destabilising factor.
- To the extent volatility of the Indian stock market is related to external factors which do not have any direct relationship with Indian economy, the state of the market would fail to provide correct pointers to the potential of the economy in general and of her companies in particular.
- India's and other developing country stock markets would play a second fiddle to the developed country markets.

Besides, we need to know more about the operation of the stock market. For instance, is the stock market proving to be a self-serving institution? Far from leading to disintermediation, it does support quite a large number of individuals and institutions. What role does it play in distribution? Does it lead to trickle up rather than trickle down? To what extent foreign portfolio investments are beneficial to the economy in general and stock market in particular? Should the investors be forcibly made turn to the stock market by lowering interest rates? Given these and many such questions, the excessive emphasis on the stock markets should be discouraged and policies formulated not with an eye on the Sensex.