PN-ABP-366
82885

USAID/New Delhi

FINANCIAL INSTITUTIONS REFORM AND EXPANSION (FIRE):

Input to Project Identification Document

Final Report

June 8, 1993

Office of Government Services
1801 K Street, N.W.
Washington, DC 20006
Telephone 202 296 0800

Price Waterhouse

June 8, 1993

Jon O'Rourke
USAID/New Delhi
American Embassy
New Delhi, India
110-021

Dear Mr. O'Rourke:

Re: Financial Sector Development Project
Contract No. PDC-2206-Z-00-8191-00
USAID/New Delhi - Financial Institutions Reform and Expansion Project

Enclosed please find five copies of the Final Report detailing our findings and analysis regarding obstacles and opportunities for the development of India's securities markets. This report is the result of numerous interviews with financial sector participants and extensive exposure to the Indian marketplace.

It has been a pleasure working with you on this assignment. We look forward to further collaboration with the mission.

Sincerely,

J. Richard Breen
Project Director, FSDP

Enclosures

I. INTRODUCTION

A. Background, Objective and Terms of Reference

This project was undertaken to provide support to USAID/India's Financial Institutions Reform and Expansion (FIRE) project. The FIRE project's objective is to support USAID's program goal of improving India's financial and regulatory environment by (a) strengthening the securities market regulations, institutions and systems of India's capital markets and (b) broadening and deepening private investment in India's long-term debt market.

The purpose of the consultancy was to provide background information and analysis to contribute to the preparation of a Project Identification Document and to identify project opportunities for assistance through the FIRE project. The intention was to provide an overall review of the obstacles and opportunities for development of India's securities markets and to identify areas in which a more in depth review would be beneficial. In order to enable the Price Waterhouse team to focus on equity markets, it was determined that other consultants would focus on the debt markets, but that the Price Waterhouse team would report any information they obtained during the course of their interviews regarding the debt market.

Specifically, the tasks were to:

- Identify the primary obstacles to the balanced growth of India's equity market and industry
- Identify the legal and regulatory constraints to orderly development of the market
- Describe and prioritize the inefficiencies in the primary and secondary markets
- Examine the issue of transparency in the debt and equity markets
- Identify the need for new equity and debt market instruments
- Identify key institutions involved in the market and identify possible lead institutions for implementation of the project
- Identify FIRE project consultancy assistance, research assistance and training opportunities for further examination during the design of the project paper

B. Team Composition

The members of the team, who conducted their field work from February 19 - March 11, 1993, were

- John Ruckrich, Securities Industry Operation Specialist
- Jan Aalbregtse, Legal and Regulatory Specialist

C. *Methodology and Contents of Report*

The findings and conclusions in this report are based on interviews conducted with key representatives of industry and government, and a review of background reports and materials. The principal focus of the interviews was on the obstacles facing the industry and possible methods by which USAID could assist in its development. The report contains the following chapters and appendices:

- Chapter II outlines the primary obstacles to development of the market
- Chapter III outlines and prioritizes potential areas of assistance, including consultancy, research and training opportunities. It also includes recommendations for further review in developing the FIRE program.
- Chapter IV suggests methods of delivering assistance, including recommendations of lead institutions for implementation.
- Appendices A, B and C contain a List of Interviewees, the Scope of Work and a Bibliography
- Appendix D contains a summary of interviews regarding the debt market
- Appendix E is a description and prioritization of inefficiencies in the primary and secondary markets
- Appendix F is a compendium and categorization of key institutions
- Appendix G is a grid to assist in sequencing certain USAID actions.

II. PRIMARY OBSTACLES TO DEVELOPMENT OF THE CAPITAL MARKET

The obstacles to development of the Indian capital market are well known, and there is in fact a substantial consensus regarding which problems are most acute. There was overwhelming agreement that the principal problems are due to fragmentation of policy, a weak regulatory system and the outdated settlement system. Problems with the marketplace, especially a lack of automation, and a number of institutional weaknesses were also cited. For discussion purposes, the obstacles are categorized into four categories: fragmentation of policy and a weak regulatory system, an outdated settlement system, problems with the marketplace and institutional deficiencies.

A. *Fragmentation of Policy/Legal and Regulatory Environment*

The GOI has taken many steps to improve the capital markets. Further, committee reports exist in abundance to direct the Government in this process. Nevertheless, the private sector is of the view that there is no directed approach to governmental policy, that there is a lack of knowledge by key policy makers about the market and a resulting lack of a "blueprint" for governmental action to develop the market. It is felt that this lack of direction makes decision-makers subject to lobbying efforts which result in fragmented decisions. A blueprint for governmental action would not only be consistent with a free market, but it is essential in order to create the infrastructure in which a free market can thrive. Required is a well thought out regulatory philosophy designed to create an environment for a fair, competitive, orderly and efficient marketplace.

The principal problems with the legal and regulatory environment that make it difficult to create this infrastructure are:

1. A Fragmentation of Authority over the Markets among SEBI, the MOF, the Department of Company Affairs and the RBI

Although SEBI has been created to oversee the capital markets, significant overlap in authority remains among SEBI, the MOF, the Department of Company Affairs and the RBI. For example, the MOF regulates exchanges and approves SEBI regulations and other actions; the RBI oversees merchant banks that are operated by banks and regulates money market funds whereas SEBI regulates other merchant banks and mutual funds; UTI's market activities are not under the jurisdiction of SEBI; the Department of Company Affairs is involved in disclosure and other corporate matters that affect the securities markets and has authority for prosecution of any actions affecting corporations, including those that would normally be brought by a securities regulatory body. When overlaps in regulatory authority such as these exist, fragmentation in regulation, as well as confusion and bureaucracy, are virtually assured. In India, the fragmentation of authority has resulted in SEBI being less effective than it should be.

2. The Virtual Absence of any Enforcement Efforts

Clearly, a market weakened by securities fraud, deceitful salespersons, misrepresentation, insider trading, price manipulation and financially precarious institutions requires government intervention. Enforcement actions by government regulators can provide a deterrent to these types of practices. Such intervention has not been present in India, resulting in a lack of accountability of institutions in the marketplace.

The absence of enforcement is due in part to the fact that significant powers generally associated with a capital markets supervisory authority have not been delegated to SEBI. For example, SEBI does not have authority over distributions of securities by issuers and does not have the authority to impose civil penalties or participate effectively in the process of instituting criminal actions. However, the Minister of Finance did announce in the budget speech that additional authority would be granted to SEBI.

As is true in most emerging markets, individual Indian investors who are injured by unlawful market practices do not have access to cost-effective remedies. In developed markets, such as the United States, the potential for a lawsuit constitutes at least as great a deterrent to unlawful behavior as any action by regulatory bodies.

3. Lack of an Adequate Legal Framework

The laws governing India's capital markets (principally, the Companies Act, the Securities (Contracts) Regulation Act and the Securities and Exchange Board of India Ordinance) do not provide a comprehensive framework for regulation of the securities markets in accordance with international standards. For example, the SEBI ordinance does not give SEBI power over prospectuses and corporate disclosure, which is a key focus of most securities regulatory bodies. In addition, while proposals are pending to amend the Companies Act, the amendments do not address issues that affect the capital markets. Other laws, especially tax provisions, directly impact capital markets in detrimental ways.

A complete overview of the laws would be helpful. The purpose of the review should be to simplify and streamline the laws, to eliminate barriers to a competitive environment and to allocate jurisdiction properly. A balanced approach is required; the wrong type of regulation can stifle a market, whereas the absence of appropriate regulation can create an environment which is not conducive to investment.

4. A Lack of Transparency Due to Poor Regulation, But Also to Outdated Systems Which Make Regulation More Difficult

A lack of transparency means that persons who deal with a market do not have access to appropriate information to determine the rules of the game, to information about issuers which is necessary to make proper investment decisions and to information to determine whether they are being treated fairly. In India, rules have not been clearly established and rules that do exist have generally not been enforced. Thus, the rules of the game are not apparent.

Corporate disclosure is poor. This term includes prospectus documents that provide information when an issuer makes a public offering as well as annual and periodic reporting and reporting of material events. There is no adequate filing system for such corporate disclosure by public companies and no centralized public reference facility. Due largely to the lack of enforcement, information is exchanged informally, and hence, unfairly.

Price transparency is the problem on which most people have focused in India. The Indian public has no confidence that the brokerage community will transact business at fair prices, due to the inability to audit transactions adequately, as well as the absence of adequate means to obtain redress for unlawful behavior.

Automation is not technically required to correct these problems. An efficient regulatory system can, without automation, assure publication of rules in an orderly fashion, organize corporate data and assure that it is reasonably accurate. It can also provide for an audit trail that can be used to trace violations of "best price" and other rules designed to protect investors in the trading process. This has been done in many countries without automation.
However, automation significantly enhances the ability of regulators and others to accomplish these goals. In India, because of the high trading volumes and the lack of trust in the brokers, automation is essential. This topic is addressed more fully below under "Development of the Marketplace" (Chapter III-C). Automation is not a substitute for regulation and enforcement, and by itself will not achieve the transparency goal. Efficient regulation and enforcement actions by both the regulators and private investors will be required.

5. An Investor Population That is Accustomed to Assured Profits and Government Protection and a Resulting Bureaucratic Governmental Approach to Regulation

The Indian public is accustomed to government protection and to the absence of risk. This attitude has developed largely through the merit-based regulation of the CCI. Merit-based regulation is an anachronistic approach to protecting investors in which a government makes subjective decisions about the safety of investments and/or controls prices. This approach often puts a government in the embarrassing position of approving the investment merits of securities that result in losses to investors and in stifling the ability of a market to work on free market principles to allocate resources.

SEBI's stated policy is to emphasize disclosure, and not to protect investors through merit regulation. Even though SEBI claims not to engage in such restrictive regulation, however, many private sector market participants believe that SEBI is too bureaucratic and is overly concerned with investor protection. Due to the significant change that has occurred in the manner in which shares are offered (e.g., elimination of Government control of pricing) there will need to be a transition period in which investors become accustomed to making investment decisions based on an understanding of the risks involved.

In order for such a transition to effectively occur, investors must receive a reasonable degree of protection from predatory practices and unconscionable acts. Required is a regulatory plan of action that provides for a smooth transition from merit regulation to a disclosure based system. It is also important for SEBI to adopt a system that achieves this goal without creating another bureaucracy.

B. Outdated Settlement System

There was unanimity among interviewees that the settlement systems of today are unacceptable and do not meet international standards. The flaws in today's settlement system are well known, but some discussion is necessary for the less familiar reader. The discussion here shall focus on the settlement procedures identified with the Bombay Stock Exchange inasmuch as they constitute the bulk of the trading and settlement volume in India today.

1. Long Settlement Period

The Bombay Stock Exchange divides the year into 25 fixed settlements of two weeks duration each - Settlement No. 1, Settlement No. 2, and so on. Each settlement period begins on a Friday and ends on a Thursday a fortnight later. Effectively, there are approximately 10 trading days in a settlement period. All purchase or sale transactions entered into during a settlement period are to be settled on the conclusion of the settlement period. This settlement process falls far short of the international standard of T+3.

2. Specified or Forward List Which Extends a Settlement Period That is Already Too Long

The present system in the Bombay and other major exchanges divides listed shares into two groups, viz., specified (or forward list) and non-specified (or cash list). A special privilege given to shares included in the specified list is that transactions in those shares can be carried forward in the form of "badla". In actual practice the bulk (about 75 per cent) of outstanding positions in specified shares at the end of a settlement period get carried forward to the next fortnightly settlement period, thereby delaying settlement and heightening the speculative nature of the transactions.

3. Non-specified or Cash List, Which Creates Excessive Paperwork

In the case of non-specified shares, settlement periods on the BSE are of a two week duration. The other exchanges settle trades for these shares within either one or two weeks. No carry forward is allowed, i.e. all outstanding positions of non-specified shares are required to be settled at the end of the settlement period by actual delivery. While member payments are effected through the clearing house by cheques, the deliveries of securities must be physically made between members on the basis of delivery orders issued by the exchange computer centre. Hence, the paper work is enormous.

4. Pay-out Problems

Settlement by the BSE is between exchange members. Each member must settle with his clients after the pay-out date. The rules of the stock exchanges are not very strict about the time within which payments and deliveries should be made by exchange members to their clients. Complaints from investors about delayed payments by exchange members are fairly common. Complaints of delayed delivery or non-delivery also occur.

5. Delayed Settlement Period with Clients

The actual settlement work till the pay-out day takes 15-20 days from the end of a settlement period, and the final payments/deliveries by brokers to their clients take more time depending on an individual broker's promptness. The gap between a transaction date and the receipt of payment/securities by an investor from his broker/sub-broker could be between 3-6 weeks and, in the case of payments, is often longer. In addition, in order to get the ownership of the securities transferred into their names, the buyers of securities have to lodge them with the issuing companies or with the companies' registrars or transfer agents. This involves considerable time, often months.

6. Problem of Bad Deliveries

Buyers of securities ma experience undue delay and agony due to "bad delivery." Currently 8-10 per cent of the total deliveries are "bad," or invalid. The most frequent reason for "bad delivery" is that the transferor's signature on the transfer form does not match that in the company's records. Another important reason is a one year time limit for a transfer form's validity from the time it is date-stamped by a designated government functionary. Under Indian law, a company may choose to reject a transfer where discreet take-over is suspected, adding to the bad delivery problem. Attempts to correct the problem have not been effective.

7. Paperwork Problem Due to Physical Handling and Movement of Certificates

The present system of deliveries is based on physical handling of securities along with the transfer form, usually for each market lot separately. Payments are by cheques/drafts rather than through electronic transfers. This system involves too much paperwork, delay and high cost because of manual procedures at all stages. The paperwork problem under the existing system has grown to a choking point in the brokers' back offices.

C. *Problems with the Marketplace*

The principal complaint expressed about the marketplace today is a lack of transparency for investor trades, which is a product of the current legal and operational infrastructure. This problem makes the investing public feel vulnerable and taken advantage of by the securities industry. In addition, certain elements of an efficient marketplace are missing in India today. Fundamental infrastructure problems which give rise to and perpetuate these problems are as follows:

1. Method in Which an Investor Must Deal With the Market

Today, an investor has to deal with a broker or a sub-broker. Most individual investors must place security orders through a middleman known as a sub-broker who (as is the case with most middlemen) adds to the cost of the transaction. This additional cost takes the form of a higher purchase or lower sale price than could have been obtained had there been no middleman. This middleman markup or markdown compounds the problem of price transparency.

The sub-broker becomes the intermediary when the broker is not available to the investor directly, which is often the case. The sub-broker seems to be India's answer to having a retail brokerage industry. It also keeps the stock exchange members from being forced to deal directly with much of the investing public. It has been estimated that over 80 per cent of Indian investors were serviced by sub-brokers, who are an unregulated group. The number of sub-brokers in operation has been estimated to be over 100,000. Member-brokers of recognized exchanges numbered only around 5,000, or roughly one for every 170,000 people.

The number of sub-brokers involved in a single buy or sell transaction is not documented but it is known that the number is often greater than one. The more sub-brokers involved, the more the buy or sell price is affected. Price transparency thus becomes increasingly opaque.

2. Lack of Automated Trading Systems and Lack of Interconnected Automated Trading Systems

The absence of automation at, both the individual stock exchanges and in the interconnection of all stock exchanges, prevents the individual order from receiving exposure to the greatest number of buyers and sellers to compete.

The lack of automation of an individual exchange inhibits the rapid dissemination of price information, including bid, ask, and executed prices and the size of each. It also makes it difficult to establish an audit trail that could help re-assure an investor that he achieved a fair price. This is further complicated by the fact that jobbers on exchange floors act as market makers and may act as principals in transactions without disclosure of this fact. The investor then gets a price that is not market driven and has no way to determine whether the price is fair.

To complicate this problem, in India where there are many stock exchanges the investor also may not receive the best price because India's stock exchanges are not electronically linked. Today, an investor places an order through a broker or sub-broker, both of which are linked to a particular stock exchange. If the security to be bought or sold is traded on the exchange the broker and sub-broker are associated with, the trade may be executed on that exchange. If the security is also traded on another exchange, the broker may (but is not required to) call that exchange and execute the order. However, there is no linkage to ensure that a buyer is receiving the best price offered on any exchange. Hence, the entire system is not conducive to achieving the best price for the investor.

3. Indifference on the Part of Major Stock Exchanges to the Need for Reform

The major stock exchanges have found a variety of reasons to delay serious automation projects, improvement in self-regulatory habits, handling of investor grievances, introduction of new instruments or adherence to Group of 30 recommendations. The National Stock Exchange has been proposed to provide a marketplace that does not have these deficiencies, as well as to provide competition to existing exchanges. The Ministry of Finance has placed the National Stock Exchange on a fast track, which has caused great concern among existing exchanges. This concern may provoke exchanges to produce the needed changes.

4. Lack of Ability to Hedge One's Investments

Options and other futures instruments, which provide a means to hedge investments, are not permitted in India. As the Indian capital markets grow in size and its market participants diversify, the need for ways to hedge one's investments will increase. There was unanimity among the interviewees that Indians must have the ability to hedge their investments. The absence of these additional investment vehicles will inhibit the desired growth of India's capital markets. However, they should not be introduced until the NDS is in operation.

5. Lack of Ability to Buy and Sell Debt Instruments in the Marketplace and Inability to Create Additional Instruments

Currently, several factors limit investment options for debt instruments. The interviewees made clear that the absence of a secondary debt market and the lack of ability to create additional instruments limited their ability to utilize debt instruments in financial planning. This absence of a secondary debt market will be addressed by another consultant. However, a summary of interviews regarding the debt market is attached as Appendix D.
The need for additional instruments is discussed under "Development of the Marketplace" (Chapter III-C).

D. *Institutional Deficiencies*

India has developed most of the common institutions that participate in securities markets, including brokerage firms, merchant banks, venture capital firms, credit rating agencies, custodians, mutual funds, stock exchanges and accounting firms. There are a number of institutional deficiencies, however, due to the lack of regulation and the manner in which the market has developed. These include:

1. The Absence of Strong Self-regulatory Organizations

In many markets, market participants are charged with regulating themselves to a great extent through self-regulatory organizations. The presently existing self-regulatory organizations in India (which are comprised primarily of the stock exchanges) are weak, and many organizations that exist in other countries, such as the U.S. National Association of Securities Dealers (NASD), do not exist. Strong self-regulatory organizations can benefit a market significantly, since the persons involved in a market often have superior knowledge and expertise regarding market practices and may be aware of violations. Furthermore, limited resources make it difficult for a government to police a market adequately. Self-regulatory organizations are most effective when (a) most participants in the marketplace have an interest in assuring that others are penalized for unscrupulous behavior so that they can conduct business in a fair environment, (b) the government oversees the self-regulators to ensure they are, in fact, performing their obligations as regulators, and (c) other deterrents to unlawful conduct, such as effective civil remedies, exist. This environment has not been present in India.

2. Outdated Transfer Agents and Registrars

It is well known that transfer agents and registrars constitute a major obstacle in developing the market. Not only are they inefficient; they have also been reported to purposely delay transfers of securities. Further, anti-takeover provisions permit companies to restrict transfers in certain circumstances. If the depository is established as proposed, many of these problems should be resolved. To the extent that a depository does not solve the problems, significant efforts will be required to enhance the effectiveness of these institutions.

3. A Lack of Professional Brokerage Institutions and a Weak Distribution Network

The brokerage industry has a particularly bad reputation in India. This is due largely to the fact that brokers have operated in an environment which is not only unregulated, but has provided easy profits to the brokers through dealings with governmental institutional customers. Competition has not corrected these problems because of the "closed club" nature of the Bombay Stock Exchange, which itself has not been subject to regulation of international standards. Trading on the basis of privileged information has been accepted practice. In addition, the brokerage industry has not adequately developed because corporate members have been excluded from exchanges, and a fixed commission structure has made it disadvantageous for brokers to service retail investors in the secondary markets. Further, tax and bank lending policies have made it difficult for individual brokers to transfer their memberships to corporations, and for corporate brokerage firms to obtain and retain capital.

4. The Absence of Significant Private Sector Institutional Investors

Governmentally owned institutions have been the most significant market participants. These institutions reportedly take substantial positions in the market and act in concert to control it. Clearly, such an environment is not conducive to development of a fair, orderly and efficient market. As a result of the governmental oligopoly, there has been insufficient competition to encourage efficiency or to create pressure for regulation that would foster a fair marketplace. In particular, private mutual funds, pension funds and insurance companies, and especially foreign institutional investors, can have a significant impact on a market.

India is beginning to address the need for private sector mutual funds. Due to prudential investment rules, pension funds cannot participate in the markets other than to invest up to 15% of their assets in public sector financial institutions or public banks. Other assets must be invested in Government of India Bonds, or in corporations that are 100% owned by the Government. The possibilities for participation in the market by private insurance companies should be further investigated. Foreign institutional investors are now permitted in the market, and the budget speech indicated that taxes imposed on FIIs would be reduced to make such investment more attractive.

5. Immaturity of the Capital Markets' Financial Research Function and Institutions Exclusively Dedicated to this Role

The financial research function has not yet developed in India, primarily because the pricing policies of the CCI made research largely irrelevant. A profit was assured when a company made a public offering. Furthermore, inside information has been readily available to major market participants. Accordingly, there has been little need for organizations to conduct analyses. As a result of the change in policies of the CCI, merchant banks and others are beginning to engage in analysis. A need for training in these areas has been indicated.

No network for disseminating information, such as a Standard & Poor's equivalent has yet been developed. As discussed above under "Fragmentation of Policy/Legal and Regulatory Environment," (Chapter II-A) the quality of the information which is disseminated is not very good.

III. ACTION NEEDED TO ADDRESS OBSTACLES; AREAS FOR ASSISTANCE AND ADDITIONAL ANALYSIS REQUIRED

This section of the report addresses the action needed to address the obstacles outlined above and suggests areas in which USAID can direct assistance to development of the equity markets. In a number of areas the need has been identified, but additional research will be required to determine the best method for USAID to assist and whether the GOI will accept assistance in that area. This section is organized into four categories to correspond with the obstacles to development in the market described above: (a) development of the legal and regulatory environment, (b) development of a national clearance and depository system, (c) development of the marketplace, and (d) institutional development. Each section describes the types of research, consultancy and training that could be provided, as well as the additional analysis required.

Although many opportunities exist for USAID assistance, it is recommended that USAID focus most of its attention on development of the legal and regulatory environment and enhancement of the post-trade environment. However, this report identifies certain areas in which assistance could be provided to developing the marketplace and institutions, including development of automated systems and the national market system, futures and options and other instruments, a retail distribution network, mutual funds and the financial research function. A grid to assist in USAID action in these areas is attached as Appendix G.

A. *Development of the Legal and Regulatory Environment*

1. Problems to be addressed; why assistance is required

The problems with the legal and regulatory framework have been described above under "Primary Obstacles to Development of the Capital Market." (Chapter II-A) There is an overwhelming consensus that one of the principal obstacles to development of the securities markets is a fragmentation of policy and lack of adequate regulation. This has been an area in which USAID and multilaterals have provided significant assistance in other emerging markets through the provision of short- and long-term advisors to rationalize jurisdiction, develop streamlined laws and regulations, provide examples of approaches used in other jurisdictions and train regulatory organizations. It is one of the most important areas in which assistance can be provided. Often, if key policy decisions are made to correct legal infrastructure problems and to provide a level playing field, other problems correct themselves through market forces. However, unless a government desires assistance on policy matters, such a course of action is inadvisable. Further, a bureaucratic legal history is difficult to change, and unless there is commitment to do so, work in this area can be frustrating. This section sets forth the most important areas in which assistance could be provided. Further exploration of the GOI's receptiveness to receipt of assistance is required.

2. Action needed to address obstacles; areas for assistance

The most important assistance that could be provided in this area is:

a. Support the development of a "blue ribbon" standing advisory committee to advise the Ministry of Finance; provide secretariat and consulting assistance to support the committee

As discussed above, the private sector noted the lack of a "blueprint" for policy regarding the capital markets. The possibility of establishing a blue ribbon committee to direct this process was discussed with interviewees. Most supported such a committee and felt that, while they had some reservations about establishing yet another committee and about the ability to reach consensus, it was important and should be done.

The committee's initial purpose should be to formulate a blueprint. The idea would not be to establish a governmentally controlled direction, but to create a policy environment in which free enterprise could thrive. Other countries have established such committees, and it is accepted internationally that there is a governmental role in assuring that a country establishes a national market system (including all institutional development that is required to achieve that goal). It is envisioned that the committee would be a standing committee so that direction could be provided on a continual basis to the Ministry following establishment of the blueprint. As this approach has been undertaken in other countries, models from other countries could be provided to assist in designing the committee and USAID assistance to the committee. It should be noted that the IFC is reportedly considering establishing such a superbody to assist the MOF.

Any blue ribbon standing advisory committee should be formed only at the request and direction of the Minister of Finance. The Minister should appoint and approve of all members of the Committee. Without sanction of the Minister, the Committee would not serve the intended purpose, which is to provide a blueprint for Governmental action in the development and regulation of the securities market.

It is essential that the persons selected for the committee, particularly the chairman, be of the highest level of standing in the securities community so that their advice would carry significant weight within both the Government and the private sector. The Government, the private sector and the public should be confident of the integrity of all members of the committee. The committee should be relatively small (8-10 persons) so that it can act as a working committee. It should represent a cross section of the private and public sector. A few interviewees have been requested to provide names of people they believe would be effective. If this course of action is pursued, USAID should request other prominent persons in the securities industry to provide recommended names, at the request and direction of the Ministry of Finance.

USAID could provide a long-term securities market expert to the secretariat of the committee in order to provide advice to the committee. The expert could also coordinate research and other consulting assistance that the committee requires. The manner of and reasons for providing assistance to the committee through a long-term consultant is discussed more fully below under "Methods of Delivering Assistance." (Chapter IV)

b. Provide an analysis of appropriate allocation of jurisdiction over the capital markets

As discussed above, there are significant problems in the allocation of jurisdiction over India's capital markets. A number of countries have requested international consultants with expertise in securities markets to review their regulations and allocation of jurisdiction and to make recommendations to streamline the regulatory process. Such a study would be appropriate and very helpful in India if the Government were interested. Naturally, reallocations of regulatory power are usually controversial.

The likely recommendation of such a review would be to allocate regulatory responsibility by function in order to eliminate the need for coordination, duplication and potential conflict in regulation. This would enhance efficiency and allow a regulatory body to concentrate on and gain expertise in a particular area. For example, it is generally considered advisable to have a securities commission regulate all activities related to financial instruments defined as securities (as well as financial futures) that are traded in public securities markets, and to eliminate the regulation of other organizations, including the central bank and the companies law authorities, over these areas.

c. Support development of SEBI

The problems faced by India in the development of a regulatory body to supervise capital markets are not new. Most emerging markets, and in fact many developed markets, face similar issues. As discussed above, there is a significant problem in India with allocation of authority for supervision of the capital markets, and the scope of the mandate, role and function of SEBI. Related to this issue is the degree of independence SEBI should have in regulating the markets and the extent of its powers. At present its powers are wholly inadequate. There are also significant issues regarding the composition of the board, SEBI's management structure and its expertise in the securities markets.

The solution to these problems is not to turn away from the organization, but to support its proper development. A strong regulatory body is critical to establishing a fair, orderly and efficient market. Further development of SEBI will require policy actions on the part of the GOI. However, much development of the organization can be done even without major policy decisions.

The first step in the process should be for SEBI to review its regulatory philosophy. In order to develop a securities market that conforms with international standards, a securities regulatory authority's principal goals with respect to capital markets development should be to protect investors and the public through a system that relies on disclosure, selective review of documents, monitoring of market participants and a strong enforcement program. SEBI seems to have adopted a regulatory philosophy that is consistent with this approach, but needs the power and expertise with which to carry it out. Its organizational structure requires examination, and it must establish priorities and organize its internal operations. A program for upgrading its staff through a hiring program and training programs should be devised.

USAID missions in many countries have begun projects to upgrade SEC equivalents. For example, USAID missions have often assisted in developing securities markets through the provision of long- and short-term consultants and training programs for the in design and implementation of a regulatory philosophy for a country's SEC equivalent, for organizing the SEC's operations and for training its staff. Generally, the programs include the following types of specialists:

- Regulatory Specialist to assist in the area of implementing rules and regulations
- Organization and Methods/Automation Specialist to assist with organizational procedures and automation issues
- Information Technology Advisor to develop and implement an overall IT strategy
- Human Resources/Training Specialist to develop in-house training programs and capabilities, as well as to interface with private sector-provided training activities.

One important area for assistance would be to establish a public reference facility in which prospectus documents and key corporate reports of public companies are filed and available to the public, preferably through a private contractor. As these reports are presently filed with the Department of Company Affairs, a change in law would be required before companies could be required to provide documents through SEBI. It is recommended that such an upgrade not be done through the Department of Company Affairs, since that Department focuses on all companies. In most emerging markets, companies law divisions lack the administrative efficiency or do not have time to focus on public capital markets. A reference facility should focus only on public companies.

If the GOI would support assistance in development of SEBI, a complete review of SEBI's organizational structure and human resource and training needs should be undertaken.

d. Interface with GOI committees that will conduct a review of laws

The Minister of Finance announced in the budget speech that the MOF acknowledges the continued problem with antiquated laws, and stated that committees would be established to review the laws. If the GOI desires assistance in this area and in fact actually plans to establish the committees and make changes, it would be a good opportunity for USAID to provide research and consultancy services, including comparative approaches from other countries. It would be appropriate for India to conduct a review of laws applicable to the securities markets, and to design a comprehensive legislative framework that conforms with international standards.

Many countries have requested assistance in revising laws from donor agencies, and models exist for a regulatory framework to be applied in emerging markets.

e. Work with appropriate persons in the legal community and the GOI to develop civil enforcement remedies, including a separate tribunal for securities matters

One of the principal problems in most emerging markets is the lack of enforcement by an effective regulatory body and the absence of a viable method for injured investors to obtain restitution for damages resulting from misrepresentations and unlawful practices. The court systems in most countries are inadequate to provide cost-effective remedies. As a result, there is no deterrent to engaging in unlawful practices. India is no exception.

Solutions considered in other countries have included enhancement of the regulatory authority, including its powers to impose penalties and obtain restitution on behalf of investors; development of arbitration remedies; and creation of separate specialized tribunals and administrative court systems to handle securities related matters. India has a separate tribunal for corporate disputes (which is not considered to be particularly effective), and is reportedly creating a special tribunal to facilitate foreclosure actions. Thus, there is precedence for such an idea.

It is difficult to overemphasize the need for developing this type of infrastructure. Its creation can correct a multitude of problems in the markets. It is also, however, a very difficult area in which to effect change. It requires knowledge of the importance of the problem at the highest policy making levels. Cultural issues are also present, and there is a need for balance. It is not desirable, even if possible, to create an overly litigious society. The best method for USAID to provide assistance is through education of policymakers of the need for development of remedies. Further assistance would depend on how receptive the GOI is to developing this area.

Other possibilities for support include:

f. Work with investor associations to educate the public regarding change in regulatory philosophy and assist these organizations in developing effective consumer advocacy groups to improve effectiveness in asserting their rights and achieving greater rights

A number of regional investor associations have been created as consumer advocacy groups to protect the interests of investors. SEBI has provided USAID with a list of these organizations. While these organizations are not particularly well funded and may not be likely to have a major impact on policy decisions, they have succeeded in getting companies to make certain changes and have begun class actions to assert legal rights. It is worth investigating these organizations to determine whether USAID could be of assistance in their training efforts or in their legal process. This would particularly benefit the retail investor.

g. Work with Institute of Chartered Accountants to develop an enforcement program

The Institute of Chartered Accountants (ICA) is well established in India. Accounting principles, which are established by the Institute, are reportedly adequate, but application by the industry is poor. The Institute apparently has a weak enforcement program.

Adequate financial statements are fundamental to a securities market. Accordingly, support to development of an enforcement effort would be a useful project. Such a program could include:

- Institution of a compliance unit (or enhancement of the unit, if one exists), which would require a review of standards for licensing accountants, the procedures for revoking licenses and the legal impact of license revocation

- Development of the relationship between the ICA and SEBI with particular focus on powers of SEBI to restrict accountants that are authorized to audit financial statements of public companies

- Development of a strategic enforcement plan for the ICA

h. Work with self-regulatory organizations

As discussed above, the self-regulatory organizations in India (primarily the stock exchanges) are weak, and many organizations that exist in other countries, such as the U.S. National Association of Securities Dealers (NASD), do not exist. The NASD performs the role of licensing, supervising and disciplining brokers and dealers. Such an organization would be appropriate in India, but is not likely to develop unless a framework is imposed by a regulatory authority, such as SEBI. The exchanges could use training in surveillance and inspection techniques. However, development of such enforcement programs is not likely to occur as long as the exchanges remain "closed clubs" without adequate Governmental oversight. An Association of Merchant Bankers reportedly may be formed in the near future. Discussions could be held with promoters of the Association of Merchant Bankers and with other SROs and potential promoters to determine the needs of these organizations. This should probably occur in a later stage of the project.

i. Conduct training programs that are directed toward regulators and policymakers

This topic is discussed under "Training Component" (Section IV-B)

3. Need for further study before technical assistance can be defined:

The following actions should be taken before technical assistance is undertaken in these areas:

- Determine receptivity of Government to assistance in this area, including analysis of jurisdiction, support for SEBI's development, review of laws and development of enforcement remedies

- Investigate whether the IFC is assisting in establishing an advisory committee and analyze the possibilities for coordination; discuss with the Ministry of Finance whether they support development of a committee; obtain names of potential committee members from key industry and governmental market participants

- If assistance will be provided to SEBI, conduct a more in-depth analysis of SEBI's existing operations and training needs

- Contact investor associations to discuss the possibilities for USAID assistance

- Discuss the problems of enforcement with the Institute of Chartered Accountants, as well as their receptivity to assistance

B. Development of a National Clearance and Depository System

1. Problems to be addressed; why assistance is required

The post-trade processing currently employed in India does not meet international standards, specifically those of the Group of 30. (There are many international bodies which have developed standards, but in essence they all make similar statements. The Group of 30 standards are the most relevant for this discussion.) While there are nine recommendations made by the Group of 30, this discussion concentrates on only the most important.

- The most important G-30 standard is for the creation of a central depository system. Without this, other recommendations diminish in significance or become extremely difficult, if not impossible, to achieve.

- Next to be achieved would be a delivery versus payment facility as part of the CDS. This would assure a delivering participant that the receiving participant could meet his financial commitment and that by relinquishing title to the securities, the deliverer would be assured of payment. In addition, payment should take place on the same day as the delivery is made and be in funds that are good as received.

- Following this would be the conversion of all trade settlements to a rolling settlement, preferably starting at T (trade date) +5 and moving to T+3.

- Finally, the trade comparison function will control how quickly one can shorten the number of days involved in the rolling settlement mentioned above. As stock exchanges achieve trade confirmation on T or T+1, they must be prepared to compare and settle trades directly with institutions if the overall system of settlement is to be efficient and effective.

The specifications for how to achieve the above are included in the Price Waterhouse Draft Final Report on the National Clearance and Depository System, dated January 19, 1993.

2. <u>Action needed to address obstacles; areas for assistance</u>

Ongoing technical assistance should be afforded to SHCIL to assist it in carrying out its mission received from the Government of India, specifically the Minister of Finance. This assistance would take the form of providing industry expertise in the post-trade settlement area and technical expertise to assist SHCIL in evaluating hardware/software/telecommunications platforms to assure adherence to recommendations made by Price Waterhouse and accepted by SHCIL.

3. <u>Need for further study before technical assistance can be defined</u>

The ability to settle funds on the same day as the trade is settled in the National Depository System is critical. SHCIL has received assurances from RBI personnel that such a facility is available throughout India. Unfortunately, other sources are not so positive about the efficacy of the RBI facility. It is therefore recommended that a separate study of funds transfer via the RBI in support of SHCIL's charter be conducted. If obstacles are uncovered, technical assistance to the RBI may be appropriate.

Inherent in the National Clearance and Depository System is the ability of the depository to perform daily balancing with the transfer agents and registrars. This will be effective only if done electronically. Further study is needed to determine the readiness for automation that exists within this group. In particular, the need for technical assistance in the form of software specifications and coding for a low common denominator, readily available personal computer should be examined. Registrars such as Tata will not need assistance, but <u>all</u> transfer agents and registrars must be able to maintain the integrity of the national depository infrastructure.

C. Development of the Marketplace

1. <u>Automation and the National Market System</u>

a. <u>Problems to be addressed; why assistance is required</u>

As discussed above under "Primary Obstacles," (Chapter II-C) the lack of automated trading systems at and between stock exchanges is placing investors at a distinct disadvantage. The automation of an individual stock exchange is one issue, and the implementation of a national market system is another. Regardless of whether an individual stock exchange is automated or the manner in which it is automated, a national market system should guarantee the best price to the investor without regard to where the order originally entered the system and where it was finally executed.

b. Action needed to address obstacles; areas for assistance

The issue of price transparency is of utmost importance to all investors, large or small. It is important that India bring its trading systems up to international standards that provide price transparency and guarantee compared trades in accordance with international standards.

If existing competitive and legal infrastructure problems were resolved, exchanges should feel natural pressures to automate on their own in order to remain competitive. However, as a perfect world cannot be assumed, assistance in this process would be appropriate. The highest priority is for individual exchanges to automate. USAID could facilitate this process by providing technical assistance in matching unique market characteristics to trading options available for automated trading systems.

Assistance should also be directed to development of a national market system. The United States has a model for such a system which could be studied and modified to suit India's requirements. The assistance should be of technical support nature that focuses on designing an intermarket trading system. The Securities Industry Automation Corporation (SIAC) is the facilities manager for the Intermarket Trading System in the United States. Exposure to this system, as well as to regional exchanges to determine their experiences with the system, would be appropriate.

c. Need for further study before technical assistance can be defined

Additional research on these issues should be deferred until governmental policy with respect to this issue is clear.

2. Development of Futures, Options and Other Financial Instruments

a. Problems to be addressed; why assistance is required

The badla system described above represents India's equivalent of a futures market. This system permits brokers to carry forward their settlement obligations into the next settlement cycle by paying what amounts to a service charge on the value of the contract to be carried forward. This is not in keeping with modern or international standards for the hedging of security holdings. Efforts should be made to afford the investor in Indian securities the opportunity to hedge his investments through internationally accepted means such as options and futures contracts. One advantage of doing so would be to separate the speculation in the current market that is fueled by the badla system from normal trading. In addition, market participants in India need to be allowed creativity in designing various types of financial instruments.

Following is a brief description of the needs in this area:

- Options. Options provide investors with the opportunity to hedge an investment in a security by trading in put or call options. A put option is an offer to sell the underlying securities at a specified price at a specified time for a fee. It is often used as a strategy by a large holder of a given security to protect profits that have accrued to the holdings. A call option is an offer to buy the underlying securities at a specified price at a specified time for a fee. It is often used as an inexpensive way to invest in the underlying security if one believes that the underlying security will rise in value. The investor in the call is required to put up only a fraction of the value of the underlying security to be able to take advantage of his hunch that its market value will rise. Anyone can write a call option, but it has become a particularly popular practice among banks, as a way of protecting the profits of their portfolios and trust funds. Many banks in the United States have been willing to write call options against their own inventories as a way of making extra money on their holdings. If the call option is exercised, they only lose the future use of the securities. In any event they receive the call premium. Options should be the first hedging instruments introduced in India.

- Futures. Futures contracts can be used for many items such as farm commodities, precious metals, coffee, foreign exchange, etc. The emphasis here will be on futures as they relate to equity and debt instruments. The most popular futures contracts have been on stock market indexes and interest rates. A futures contract is something that is bought and sold at prices that reflect the increase or decrease in the particular index plus the premium that must be paid for the privilege of guessing which way the market is going. It dilutes the risk factor by eliminating the need for an investor to select the movement of specific securities in order to protect an investment. Instead, profit or loss is based on the movement of a broader group of securities. There are indexes that cover specific industries, groups of industries or broad groupings, such as the Standard & Poors 500 index. In any case, the investor has the ability to protect his equity profits or limit his liabilities by going into the futures market and buying a hedge instrument at a fraction of the cost of the underlying securities.

  Stock index futures will be desirable in India as the market develops and stabilizes. As India's secondary bond market expands and the government continues to take a hands off approach to interest rates, the opportunity for interest rate futures will grow. India has yet to establish bellwether bond rate(s) against which futures contracts can be written.

- Other Financial Instruments. India needs the flexibility to meet the diverse needs of participants in the capital markets through financial instruments such as zero coupon bonds, floating rate bonds, repos, Ginnie Maes, etc. New instruments should be developed by the market, not the government. However, the government must address disclosure rules, including accounting principles, as well as other implications of new instruments and assure that it is in a position to adequately police fraudulent behavior that may occur in connection with any such instruments.

The United States is considered to set the standard in this area; the Chicago Board of Options Exchange (CBOE) and the Chicago Mercantile Exchange (CME) would provide good examples for development of an Indian options and futures exchange. However, it should be noted that options and futures instruments are totally dependent upon a high degree of automation, ready access to trade information from the underlying markets and highly reliable telecommunications. Thus, there is a question of proper timing for their introduction in the market. The Ministry of Finance has reportedly been against development of this market, but may be reconsidering its position. The Study Group for Guidelines Relating to Valuation (Report dated 8-31-91) has analyzed the requirements for a futures and options market. They also noted the need for adequate reform in both trading and settlement before embarking on this path.

b. Action needed to address obstacles; areas for assistance

Further research must be conducted and infrastructure created to implement and sustain options and futures markets. Key issues relate not only to what general categories of new financial instruments should be allowed, but what the proper timing for them is. Methods of clearing and settlement must be agreed upon before commencement of trading. This is an important spoke in the wheel of the capital markets caravan, but the time to put the spoke in place is critical. A strong alliance with the options and futures markets of the United States would be of crucial benefit to India in planning the future of this segment of its capital markets.

USAID could foster the information flow from the United States to India through providing technical assistance from organizations such as the CBOE and CME in deciding when and how to permit options and futures. Assistance in the design of financial instruments could be provided through seminars as part of a training program.

c. Need for further study before technical assistance can be defined

There is a great degree of focus in India on introduction of options and futures trading as soon as possible. It would be helpful to provide assistance in this decision-making process so that a decision is not made to proceed with such a plan before the necessary infrastructure is in place.

D. *Institutional Development*

The institutional obstacles identified above include (a) the absence of strong self-regulatory organizations, (b) outdated transfer agents and registrars, (c) a lack of professional brokerage institutions, (d) the absence of significant private sector institutional investors, and (e) the immaturity of the capital markets financial research function. The first two obstacles have been addressed under "Development of the Legal and Regulatory Environment" (Chapter III-A) and "Development of a National Clearance and Depository System" (Chapter III-B) respectively. The remaining three obstacles are discussed in this section.

1. Weak Distribution Network: Lack of Professional Brokerage Institutions

a. Problems to be addressed: why assistance is required

The number of investors in India continues to grow, and demographics indicate that the investor base is spreading widely over India. However, these investors have generally received securities through the allotment process and have a difficult time selling their securities in secondary markets. The absence of a retail brokerage industry is due to (a) the current tax structure, which makes it disadvantageous to operate a brokerage firm through a corporation, (b) the fixed commission structure which makes it unprofitable to service such investors and (c) RBI lending policies that make it difficult for a brokerage firm to obtain working capital. The absence of a strong retail brokerage industry is considered a major obstacle to the growth of the capital markets. The need for strong retail brokerage was addressed by a majority of the interviewees.

There are many obstacles that stand in the way of the development of a strong retail brokerage industry. As explained by one interviewee, the deck is stacked against the development of a strong retail brokerage firm the likes of a Merrill Lynch or a Dean Witter. The problems, in order of impact, are as follows:

- Taxes imposed on limited liability companies are greater than those imposed on individuals.

- Fixed commission structures make it unprofitable to service individual investors in secondary trading markets.

- The current group of brokers is not adequately capitalized. Borrowing from banks is difficult because banks will not lend on fixed assets nor will they margin against securities for more than 25%, if at all. Fixed assets and securities are the principal assets of a brokerage firm.

- Stock exchanges have just begun to permit corporate members, but taxes and other factors inhibit creation of corporate members. For a broker to convert to a limited liability company, he must pay a sizable capital gains tax.

In addition to the lack of development of a retail distribution network, there has been no development of standards for the manner in which brokerage firms and their employees must conduct business. As a result, there is very little confidence in the brokerage community.

b. Action needed to address obstacles; areas for assistance

The absence of a strong retail brokerage industry not only hurts the individual investor, it hurts the issuer even more. For example, one merchant banker indicates that there is significant demand on the part of issuers to float more equity, but the retail brokerage industry is not capable of handling the task. In the case of the individual investor who may be fortunate to have amassed his share holdings through lottery winnings, there is no reverse lottery for the selling of the shares. This leaves the individual investor at the mercy of the infrastructure already described for trading and settlement.

The issue of creating a retail brokerage industry is a multi-faceted one. Policy issues regarding taxation, broker capitalization and commission policies must be addressed. Assistance could be provided in these matters through development of policies that conform more closely with international practice. Perhaps the best contribution that USAID could make, however, would be to support a licensing and education program designed to elevate the current securities sales force to the U.S. equivalent status of the registered representative. It is envisioned that such a certification would be handled through a uniform program administered by an appropriate SRO (such as the US National Association of Securities Dealers) or by SEBI.

c. Need for further study before technical assistance can be defined

Programs to establish licensing programs for registered representatives have been designed for emerging markets. If a program to assist SEBI is undertaken, this should be one component. Further study is not required at this time.

2. Absence of Certain Institutional Investors

a. Problems to be addressed; why assistance is required

The development of the "equity cult" in India has occurred largely because investors incurred little risk and made large profits through participation in allotments. The Controller of Capital Issues (CCI) established prices at levels such that investors could not lose. This was, of course, to the detriment of issuers. With the abolishment of the CCI, the system has changed significantly. Investors are now subject to a significantly greater degree of risk when they invest in the markets, and will be required to make wise investment decisions in order to profit.

There is a fast growing trend throughout the world for retail investors to lessen their risk through diversification and professional management of their funds, primarily through pension funds and mutual funds. This method for encouraging the middle class to invest in the market is preferred by far to encouraging direct investment because (a) governments do not have the resources to protect retail investors adequately, and some protections that would be helpful to retail investors make markets less efficient; (b) it is often uneconomical for brokerage firms to service the retail industry directly; and (c) most retail investors do not have the expertise to compete fairly in the market.

There is a clear need for India to follow international market trends to expand the investment possibilities for pension plans and develop its mutual funds industry. The first step is to focus on the mutual funds industry. Pension fund issues are not addressed in this report since other market infrastructure will require improvement before pension funds are likely to be permitted to invest in a greater variety of instruments.

A number of steps have been taken to expand the mutual funds industry. UTI has been offering mutual funds for a decade and controls most of the market. It has developed a practice of providing "guaranteed" returns, however, which have had more characteristics of money market funds (which compete with the banking sector) than true mutual funds. A further effect of this practice has been to increase investor expectations of guaranteed, risk-free profits. Investor education will be required to change this perception.

In the last six years other public sector institutions have offered funds, including SBI, Canara Bank, Indian Bank, BOI, Punjab Bank, GIC and LIC. Some of the funds are reportedly having difficulty following scandals in 1992. Reports have also been made that the state controlled funds have no expertise in markets, and thus, the need for private sector funds is apparent. Four off-shore closed-end country funds exist, but are trading at steeper than usual discounts. Authorization has now been given to allow private asset management companies to offer funds.

SEBI has issued guidelines regarding the operation of funds. Both closed and open-end funds can be offered under the guidelines; however, due to the risks and need for liquidity inherent in an open-end fund (and the high capital requirements set by SEBI for open-end funds) UTI is the only institution that presently offers them. UTI's funds are not subject to these rules because it was formed under a separate statute.

It will be difficult for mutual funds to compete with UTI if it is not subject to the same rules as other funds. The size and acceptance of UTI will also make competition difficult. Further, reports have been made that disclosure by UTI regarding its funds is less than adequate. A related problem is that the RBI apparently regulates money market mutual funds, thereby creating a potential for conflict in regulation.

Another regulatory issue is that funds are not permitted to be corporations. They must be trusts and, due to another law, a public trustee votes all shares held by trusts. Since mutual funds are not intended to control corporations, this latter provision is probably not a major problem, but it should be removed. Further, it is reported that trustees are not held accountable for their actions. Accountability and strict supervision of mutual funds is critical. A scandal or major loss in the mutual fund industry can hobble the industry and have a detrimental effect on the market.

The need for a level playing field, for one agency to regulate the market and for a well conceived and comprehensive regulatory framework are the principal issues that need to be addressed in order to develop the mutual fund industry. Due to the illiquidity and volatility of emerging markets, regulation of this industry requires a careful balance, and expertise in the industry is essential in developing any regulatory plan.

b. Action needed to address obstacles; areas for assistance

The needs for assistance in development of the mutual funds industry are primarily of a policy nature. The issues regarding allocation of jurisdiction and creation of a level playing field are politically charged. If the GOI desires assistance, international expertise exists in developing and regulating mutual funds in emerging markets. Governmental mutual fund monopolies have also been created in other developing countries, and these countries are facing similar issues.

Training needs are apparent. UTI Training Institute reports that the six new private asset management companies that intend to operate mutual funds have requested consulting assistance in establishing the funds. USAID could provide international consultants to assist in this process.

The inspection process will also be important. Guidance may be helpful to SEBI in developing an inspection program. Mutual funds experts with (or formerly with) the US Securities and Exchange Commission could assist in the creation of an inspection program.
It has been reported that a trade association for mutual funds may be created. Assistance could be provided in creating the association and in formulating training programs for the organization.

c. Need for further study before technical assistance can be defined

Additional USAID action to formulate an assistance plan in this area is required. The principal need is to determine whether the GOI desires assistance in formulating policy regarding the mutual funds industry. If so, a mutual funds expert should work with the Government to formulate a research and consultancy plan. If not, aid that can be provided in this area is somewhat limited. Further discussions should be held with UTI Training Institute and the new private asset management companies, as well as the promoters of the proposed trade association to determine whether assistance is desired in training and consultancy. In connection with other assistance that may be provided to SEBI, the need for assistance in review of mutual fund regulations and development of an inspection program should be explored.

3. Research and Analysis

a. Problems to be addressed; why assistance is required

As discussed above, the financial research function has not yet developed in India primarily because the pricing policies of the CCI have made research largely irrelevant. A profit was assured when a company made a public offering. Further, inside information has been readily available to major market participants. There has accordingly been little need for organizations to conduct analyses.

As a result of the change in policies of the CCI, merchant banks and others are beginning to engage in analysis. CRISL, India's first rating agency, has a good reputation and indications are (from both CRISL and other market participants) that it does not require assistance. A second rating agency, ICRA, has recently been formed. Databases are presently being established to access company information.

As discussed previously, much needs to be done to improve corporate reporting, including improvements in the application of accounting principles, timely filings that are made publicly available and requirements for additional information in reports, such as a management discussion and analysis that focuses on the company's prospects and problems. Disclosure problems should be addressed through the regulatory system, although institutional pressure can greatly improve the quality of available information.

b. Action needed to address obstacles; areas for assistance

In order to address the lack of development of the financial research function in India, three items are required: adequate information on which to conduct analyses; training in research and analysis techniques; and development of institutions similar to Standard & Poor's to disseminate information. The first two areas are discussed in other sections of this report under "Development of the Legal/Regulatory Environment" (Chapter III-A) and "Training Component," (Chapter IV-B) respectively. Further research would be required to determine the appropriate time for development of a Standard & Poor's equivalent, a Reuter's tickertape or a Dow-Jones type news service.

c. Additional analysis required

The principal users of these services would at first be major investors. These people will readily be courted by vendors of all types once the exchanges provide an automated feed for sale. Further analysis at this time would be premature.

IV. METHODS OF DELIVERING ASSISTANCE

A. *Counterpart Institution for Implementation*

The consultants recommend that the counterpart organization for USAID FIRE funding be either: (a) the secretariat of an MOF-appointed blue ribbon advisory committee or (b) another MOF-designated institution, such as IDBI or SEBI.

1. Secretariat of Blue Ribbon Committee

If a blue ribbon advisory committee is established as proposed, USAID funding could be directed through the secretariat of the committee. The counterpart institution in this case could be either the committee or its secretariat. IDBI has offered to act as secretariat to such a committee; other organizations could also be considered to play this role. Presumably, the Minister of Finance would have a preference in this regard.

It would be ideal to have a long-term advisor provide assistance to the committee and its secretariat in developing a blueprint and working on other securities market policy initiatives as directed by the committee and the Minister of Finance. The advisor could also be charged with arranging short-term research and consulting projects and training as directed by the committee. The Price Waterhouse team is of the view that it is important to have at least one securities market advisor resident in India to (a) provide ongoing advice to an appropriate counterpart institution; (b) identify opportunities and coordinate additional assistance to the capital markets; and (c) provide continuity.

Based on experience in other emerging markets, a resident advisor is important because it enables the expert to become more familiar with the market and its participants, develops mutual trust, and provides expertise for screening assistance requests. The advisor should be associated with a consulting firm so that support can be provided in locating appropriate short-term consulting and training services as needed.

It is important that the advisor be situated with a lead institution and not be located in the USAID office so that relationships with Indian counterparts can be developed and the advantages described can be attained. If a long-term advisor is unacceptable to the GOI to assist the committee, specific goals and guidelines should be agreed upon at the outset, and the FIRE project manager should work closely with the secretariat of the committee.

2. MOF-designated Institution

If a blue ribbon committee is not established, the lead institution should be the organization which the Minister of Finance plans to entrust with securities market policy decisions over the next several years. Desired is the organization most likely to have influence in shaping policy, developing the market and directing assistance to the appropriate places. Further discussions with the Ministry would be required to determine who this would be. Again, a long-term advisor is recommended.

Presently, the most dynamic organization in this field appears to be IDBI. They have taken charge in establishing the National Market System. However, it is unclear exactly what role IDBI will play in securities market development; a country's securities and exchange commission such as SEBI usually assumes this role. There is also a concern regarding rivalries in the industry involving IDBI, as is evidenced in the conflict over development of the National Stock Exchange.

It appears from the budget speech that the Minister of Finance plans to delegate more authority to SEBI. If SEBI will assume a greater role that will give it appropriate stature, it would be the best lead institution. Unfortunately, SEBI has not yet developed the type of reputation that would make it the first choice as a counterpart.

B. Training Component

The principal training need identified was to educate the Government, including policymakers and SEBI, so that a sound regulatory regime could be developed to provide a level playing field for market participants and a fair marketplace. Many one-on-one training needs were cited in connection with specific technical assistance opportunities described in Chapter III. Other training needs were cited for the industry in general, the most important of which is the need for general training in financial analysis and related subjects, including pricing techniques.

In addition to the training needs described in Section III, specific training opportunities that may be relevant are:

1. Develop a Series of Seminars Directed at Regulators and Policymakers

As noted above, one of the principal needs noted by the private sector was the need to educate regulators and policymakers about the issues facing the securities industry. A program of seminars could be designed that is targeted at this audience. UTI Training Institute is in fact proposing such a program in connection with development of a futures and options market. Of course, governmental acceptance of such a program is essential. A training specialist should conduct a needs assessment, and determine whether coordination with a training institute would be appropriate.

2. Develop a Certified Financial Analyst Program

The UTI Training Institute and The Institute of Chartered Financial Analysts of India have certified financial analyst programs. USAID could consider working with one of these institutions to upgrade their programs. Tasks to be accomplished would be:

- Analyze needs and current skills levels
- Evaluate the present programs offered, and determine required upgrading
- Adapt international Certified Financial Analyst programs to the Indian environment
- Adopt qualification requirements, including basic financial knowledge and skills, english language proficiency, an acceptable academic achievement record and recommendations from current or past employers
- Promote the program within the capital market industry
- Assist in the selection of candidates
- Develop a licensing tracking data base or other mechanism to register program graduates
- Package course and other reference materials for private institutions selected to continue delivery of the program
- Monitor course quality and work with appropriate groups to make changes as necessary.

3. <u>Work with an Existing Institute to Tailor a Program for India that is Patterned After the NYIF Program; Initiate Train-the-Trainer Programs to Develop the Program</u>

In order to make NYIF programs more accessible to Indians, a program could be developed with one of the training institutes to tailor the NYIF program to India. Many of the topics covered by NYIF are covered by Indian institutes. However, there have been indications of a need to upgrade and to engage in train-the-trainer programs. Train-the-trainer programs institutionalize international training programs by transferring teaching skills in specialized areas to local trainers. Once a program is designed, international trainers can be provided together with course outlines, procedures, policies, support materials and case studies for use in course development. These trainers contribute to course development and attend practice and pilot sessions.

4. <u>Overseas Training</u>

It is recommended that overseas training opportunities be utilized on a selective case-by-case basis to provide exposure through seminars, courses and executive overviews and internships in organizations such as the US Securities and Exchange Commission, the New York Stock

APPENDIX A

LIST OF INTERVIEWEES

Calendar FOR JOHN RUCKRICH/JAN AALBREGTSE BOMBAY MEETINGS
Staying at Oberoi Towers

Feb. 25

09:30 Chandrasakeran
Managing Director
SHCIL

12:30 Bombay Stock Exchange
M. R. MAYYA
Executive Director
Dr. B.D. GHONASGI
Director
Training & Research Institute
P.J. Towers 25th flr
Dalal Street
275860

15:00 Housing Development Financing Corp
Mr. Deepak SATWALEKAR
Managing Director
Raymond House, 169 BackBay Reclamation
220908

17:00 DSP Financial Consultants Ltd
T. ASPI, Contractor AVP, S. SUBRAMANIAN VP
212 BackBay Reclamation 2nd Entrance
245275 2850966(direct)

Feb. 26

10:00 Infrastructure Leasing & Financing Corporation
Vibhav KAPOOR
Managing Director
ITTS House, Rope Walk Lane near Rhythm House Kala Ghoda
2874818 or 2851235

31

13:00 Suresh S. NADKARNEY
Chairman, IDBI
Other Attendees: DR. R.H. PATIL
Executive Director
K.C. VARSHNEY
General Manager
G.P. GUPTA
Executive Director

16:00 ICICI
Mr. VAGHUL
163 Back Bay Reclamation ICICI BLDG
Behind Secretariat; on same road as MLA Hostel; turn on to Road #3; Hindustan Lever & Old India Radio Office are nearby

18:00 N. SURESH
Partner
Price Waterhouse

February 27

08:00 R. RAVIMOHAN
Chief Executive
OTCEI MEET IN LOBBY OF OBEROI AND HAVE BREAKFAST MEETING

14:30 Dr. M. THIRIPALRAJU
Vice-President
UTI Institute of Capital Markets
Meeting at Oberoi 7672205

March 1

10:00 CRISIL
Pradeep SHAH
Nirlon House
Worlie 4939445

March 2

10:00 Nimesh N. KAMPANI
Chairman
J.M. Financial & Investment Consultancy Services Limited
131, Maker Chamber III
231237

12:00 Dr. S.A. DAVE
Chairman
Unit Trust of India
13, Sir Bithaldas Thackersey Marg
292799

14:00 SEBI
C.B. BHAVE
Head (Secondary Market Dept.)
Securities and Exchange Board of India

<u>March 3</u>

10:30 Dr. R.H. PATIL
Executive Director
Ravi NARAIN
Deputy General Manager
IDBI
IDBI TOWER- CUFFE PARADE
2189111

12:30 Mr. & Mrs. SHROFF
Lunch at Oberoi
273494,2623500,2620942

Calendar FOR JOHN RUCKRICH/JAN AALBREGTSE NEW DELHI MEETINGS

<u>MARCH 4</u>

10:00 Richard O. WADA
Chief, India Resident Office
Asian Development Bank
37 Golf Links

11:30 Mr. VARDARCHARY
Joint Secretary, Department of Economic Affairs
Government of India
R.K. PANDEY
Executive Director
Delhi Stock Exchange

33

MARCH 5

10:00 Mrs. Sudha PILLAI
Joint Secretary
Ministry of Law
Dept of Company Affairs

17:00 Ashok V DESAI
Secretary and Chief Consultant
Ministry of Finance

19:00 Dr. L.C. GUPTA
Director
Society for Capital Market Research and Development

MARCH 10

Mr. Paul JOSEPH
Joint Director (Stock Exchange)
Department of Economic Affairs
Ministry of Finance
3012882

APPENDIX B

TERMS OF REFERENCE

1. Identify the primary obstacles to the balanced growth of India's equity market and industry. The consultants will identify the constraints in terms of (a) market operations and systems, (b) technology gaps and requirements, (c) legal and regulatory shortcomings, and (d) the need for new and improved institutional arrangements/systems.

2. Identify the legal and regulatory (including self-regulation) provisions that inhibit or constrain the orderly development of the securities market; recommend key solutions.

3. Describe and prioritize the inefficiencies in the primary and secondary stock markets and suggest corrective courses for action.

4. Examine the issue of transparency in debt and equity markets by reviewing the availability of reliable financial information about (i) equity and debt instruments themselves (ii) the instruments' underlying activities (e.g., inadequate company information disclosure), and/or (iii) the institution sponsoring or trading in the instrument. Recommend solutions (e.g., the development of rating institutions and securities analysis branches of investment and merchant banks) and identify possible USAID F.I.R.E. project opportunities.

5. Identify the need for new equity and debt market instruments which spread risk (e.g., options, futures, derivatives, securitization, etc.) and make general recommendations regarding potential project opportunities in these areas.

6. Identify key institutions that are involved in India's equity market/industry (a compendium and a categorization), and make recommendations regarding possible lead institutions which might implement a major portion of this project.

7. For all of the above, identify reasonable F.I.R.E. project (i) consultancy assistance (ii) research/feasibility study assistance and (iii) training opportunities (both in U.S. and in India) that might be appropriate for consideration and further examination during the design of the project paper which would be prepared before June 1993.

35

APPENDIX C

BIBLIOGRAPHY

"Capital Markets in India: Prospects for the 1990s," The Associated Chambers of Commerce and Industry of India (1990)

"Creating a Secondary Market in Debt," H. Sankaran, Infrastructure Leasing & Financial Services Limited (February 8, 1993)

"Investor Grievances-Rights and Remedies," SEBI (December 1991)

"Report and Recommendation of the President to the Board of Directors on a Proposed Loan to India for a Financial Sector Program," Asian Development Bank (November 1992)

"Report of the High Powered Study Group on Establishment of New Stock Exchanges," (June 30, 1991)

"Report on Indian Capital Markets Through the Eighties," Price Waterhouse New Delhi (June 1989)

"Securities Trading in India," L.C. Gupta (undated)

"Stock Exchange Trading in India: Agenda for Reform," L.C. Gupta (1992)

"Study Group for Guidelines Relating to Valuation: Issue Procedures and New Instruments" (August 31, 1991)

"Technology Perspective," The Bombay Stock Exchange (1992)

"The Indian Capital Markets Industry," Rekha Bhagat, USAID/New Delhi (August 1992)

"The Indian Mutual Fund Industry," L.C. Gupta (undated)

"The National Stock Exchange and Share Trading Reforms," L.C. Gupta (undated)

"The Study of Securities Market & Supervision in Bank DMCs," The Aries Group, Ltd. (December 1992)

APPENDIX D

SUMMARY OF DATA COLLECTED FROM INTERVIEWS REGARDING THE DEBT MARKET

In order to enable the PW Team to focus on the equity market, it was determined that other consultants would focus on the debt market, but that the PW Team would report any information they obtained during the course of their interviews regarding the debt market. The following information is based solely on interviews and has not been verified.

1. One important reason why debt securities have not been issued recently has been because investors could make so much money in equity markets. Institutional investors (primarily UTI and other large governmentally owned institutions) purchased debt securities in 1989-90 at face values of approximately 12.5%. The lack of a secondary trading market is due in part to the rise in interest rates; institutions are holding the securities so as to avoid recognizing a loss. UTI is an exception because it was able to purchase securities at a discount in the past.

2. There are no floating rate instruments due to the lack of an index. [Note, however, that the GOI has recently begun to auction treasury obligations.] HDFC reports that it cannot price off its cost-of-funds as a replacement for an index because it cannot support this to investors, and no index is available that approximates its cost of funds. HDFC also reports a lack of experience in the market in general in modelling interest rates for trading as well as setting interest rates; investors are hesitant to take positions until they understand how to deal with the interest rate risk.

3. Some commercial paper exists; only those with B-1 or B-2 ratings can issue and there are restrictions on the amount that can be issued. RBI apparently decides who can issue commercial paper.

4. OTCEI is starting to permit trading in approximately 10 "blue chip" debt issues, which are presently held by UTI. These securities have coupon rates of 14-15% and were originally purchased at a discount, so that UTI does not anticipate incurring a loss. They will be sold to yield approximately 17.5%. Infrastructure Leasing & Financing Corporation (ILFC) will act as market maker. The instruments are not rated, as they are old issues. ILFC anticipates corporate purchasers. Stamp tax will be paid by the buyers.

5. Legal issues related to creating securitized debt include

   --Urban Lands Ceiling Act limits how much land an individual can own and there is a concern that owners of securitized debt may be deemed to own the underlying land

   --There is no law permitting out-of-court foreclosure

31

--Stamp duties, which are imposed by states on transfers of securities make transfers uneconomical. Bank promissory notes and short-term debt are not subject to the taxes, but other debt instruments are subject.

--There is a lack of a level playing field in terms of interest withholding. There is no withholding from bank deposit interest, but there is on debentures

6. SEBI rules require debt obligations (other than commercial paper) to be secured.

7. According to the recent budget, the Government is planning to establish a special tribunal to expedite legal action by banks for recovery of debt. It is unclear whether this tribunal would be available for other lenders.

8. The ADB intends to require liberalization of commercial paper and CD requirements as part of its financial sector loan.

9. The Nadkarni (IDBI) committee is writing a report on trading procedures for PSU bonds

10. An ILFS paper has presented ideas to solve the problem of a lack of a secondary trading market for debt securities.

APPENDIX E

PRINCIPAL INEFFICIENCIES IN THE PRIMARY MARKET

1. The present system relies on an allotment process to determine who will be entitled to purchase shares in an initial public offering. This system is designed to ensure that everyone has the opportunity to obtain shares. The allotment system was particularly relevant when the CCI established prices at less than their value.

   There are many inefficiencies in the system; in particular, requiring that investors tie up funds pending the allotment. Further, offerings must be priced far in advance of the time at which the shares begin to trade. Many studies have been done in attempts to improve the system; a primary market committee has recently been established to assist SEBI in this area.

   Eventually, India should move to a more traditional market-driven system in which offerings are placed through underwriters and the allotment system is eliminated. A retail brokerage industry could assist in this process. Presently, pursuant to SEBI rules, every offering must have a merchant bank as a lead underwriter; the merchant bank's commitment is to purchase securities only if the allotment fails. It does not organize an underwriting syndicate to distribute the shares. Individual brokers distribute allotment forms and receive commissions based on allotments which are distributed through them.

2. The standard of care regarding misrepresentations in connection with an offering or false and misleading statements in a prospectus imposed on merchant bankers and directors and officers of an issuer is lower in India than the international standard.

3. In spite of improvements made through SEBI intervention, disclosure in prospectuses is reportedly not as good as it should be.

4. Due primarily to CCI pricing policies, there has been inadequate focus on the financial research function.

5. There is a need to develop the mutual funds industry so that individual investors can participate in the markets through professional managers.

PRIMARY INEFFICIENCIES IN THE SECONDARY MARKET

1. The clearance, settlement and transfer systems are outdated and cause significant delays.

2. The brokerage community is not adequately regulated.

3. Exchange operations do not provide price transparency.

4. The market is speculative.

5. The financial research and analysis function has not been developed.

6. Governmental institutions control too much of the market.

7. Brokers do not provide secondary market services to retail investors.

8. It should be noted that foreign institutional investors cite price transparency and settlement as the principal issues to be resolved before they enter the market.

APPENDIX F

LIST OF INSTITUTIONS INVOLVED IN INDIA'S FINANCIAL AND CAPITAL MARKETS

Banking Institutions

Reserve Bank of India
275 commercial banks
28 public sector banks
196 regional rural banks
24 private banks
24 foreign banks
3 nonscheduled banks
28 cooperative banks

Development and Other Financial Institutions

Industrial Development Bank of India (IDBI)
The Industrial Credit and Investment Corporation of India, Ltd. (ICICI)
Industrial Finance Corporation of India
State financial corporations
State industrial development corporations
National Bank for Agriculture and Rural Development
and other agricultural financial institutions
Life Insurance Corporation
General Insurance Corporation
Non-banking financial companies
Stock Holding Corporation of India Limited

Organizations that Act as Merchant Banks (As of 1989)

ICICI
IDBI
SBI Capital Markets
Canbank Financial Services
Grindleys Bank
Citibank
Hong Kong Bank
Standard Chartered Financial Services
JM Financial & Investment Consultancy Services, Ltd.
Champaklal Investment
DSP Financial Consultants Ltd.

H

Credit Rating Institutions

The Credit Rating Information Services of India Limited
ICRA

Institutions that Offer Mutual Funds

Unit Trust of India
State Bank of India
Canara Bank
Indian Bank
Bank of India
Punjab Bank
General Insurance Corporation
Life Insurance Corporation
(6 private asset management companies have recently been granted licenses to operate mutual funds)

Venture Capital Activities

Three companies promoted by all-India DFIs
Two companies promoted by state DFIs
Two companies promoted by commercial banks
Three companies in the private sector

Stock Exchanges

Bombay Stock Exchange
Over The Counter Exchange of India
Other stock exchanges located in:
Madras, Calcutta, Delhi, Hyderabad, Ahmedabad, Ludhiana, Indore, Jaipur, Gwalior, Kanpur, Patna, Guwahati, Nagpur, Bhubaneshwar, Cochin, Bangalore, Mangalore, Pune, Baroda and Rajkot

Governmental Oversight

Securities and Exchange Board of India (SEBI)
Ministry of Finance, Department of Economic Affairs, Division of Investments & External Commercial Borrowing
Department of Company Affairs
Reserve Bank of India

APPENDIX G

GRID TO ASSIST IN SEQUENCING USAID ASSISTANCE

Type of Assistance	Need for Policy Changes Prior to Assistance	Need for Other Actions Prior to Assistance	Impact of Assistance Without Policy Changes
Automation and National Market System	No	NCDS in place	(1)
Futures & Options	(2)	CDS in place	(3)
Development of Retail Brokerage Industry	Yes	(4)	(5)
Mutual Funds	Yes	(6)	(7)
Research & Analysis	No	(8)	N/A

(1) Automation of the exchanges will improve price transparency; however, without investment in the regulatory environment (surveillance and enforcement), unlawful behavior will not only continue, but may increase. Automation and regulatory improvements should proceed simultaneously.

(2) A regulatory structure must be in place to supervise these instruments before a futures & options market is established. While a futures and options market should not be introduced until an NCDS is in place, assistance should be provided immediately to develop understanding of futures and options and the time at which they should be introduced.

(3) Without a regulatory structure in place to supervise such a market, the market would be devoid of adequate protections.

(4) Changes in the commission rate structure, tax and other laws should take place before assistance is provided to develop this industry. In connection with regulatory assistance, a program to train and license registered representatives could be undertaken before policy changes occur, however.

(5) The industry is not likely to develop significantly until policy changes are made.

(6) A level playing field with UTI should be established before assistance is provided in this area. Assistance could be provided to the GOI in understanding this need and in developing a sound regulatory framework for mutual funds, however.

(7) The industry is not likely to develop significantly until there is a level playing field with UTI.

(8) Before assistance is provided in this area, an evaluation of whether the private sector will develop these skills on its own would be in order.

- 44