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USAID/New Delhi

Financial Institutions
Reform and Expansion Project Design
Phase II

Final Report

August 16, 1993

Office of Government Services
1801 K Street, N.W.
Washington, DC 20006

Telephone 202 296 0800

Price Waterhouse

August 16, 1993

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

Dear Mr. O'Rourke:

Re: AID/PRE Financial Sector Development Project
Contract No. PDC-2206-Z-00-8191-00
USAID/New Delhi - Financial Institutions Reform and Expansion Project Design, Phase II

Enclosed please find 10 copies of the Final Report regarding our recommendations for the design of the Financial Institutions Reform and Expansion Project, prepared by Price Waterhouse, prime contractor under FSDP.

It has been a pleasure working with USAID/New Delhi and the financial market participants of India on this important assignment. We look forward to further collaboration in the future.

Sincerely.

J. Richard Breen
Project Director, FSDP

cc. Rebecca Maestri, PRE/EM

Financial Institutions Reform and Expansion Project Design
Phase II

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I. BACKGROUND AND OVERVIEW

India has embarked on a new course of economic and financial policy that marks a dramatic change from that prevailing for the last 40 years after independence. Almost every area of economic and financial policy is in process of change, modernization and reform. The year 1992/1993 has marked the second year of this comprehensive program. The general direction of these changes is toward a progressive liberalization of the rules that have constricted India's economy. The effect is to open the way to India's entry into the global economic and financial system.

From an inward looking, highly statist economic system, India is trying to build an open, market-based model characterized by a competitive and vigorous private sector, including privatized state-owned industries, that is supported by a strong and competitive financial sector which is able to attract new capital investment in the global financial markets.

Economic Stabilization:

During the past several years, India along with support and assistance from the IMF and the World Bank, has been quite successful in achieving greater stability in the economy. The 1992 inflation rate fell to about 7 percent from a 1991 level of 14 percent. The prospects for continued economic stability are considered positive by the World Bank, setting the stage for improved growth as business confidence and investment take hold. This overall reduction in inflation is even more remarkable in that it has been achieved while at the same time permitting rapid increases in administered prices of key commodities - a key condition to long term reform. Both the World Bank and the IMF remain committed to the support of these reforms and the GOI's determination to maintain the hard won gains in economic stability of India's economy already achieved.

Investment:

Undoubtedly, an effect of the stabilization program, and the disciplines it imposed on spending, have been to slow the pace of private sector investment. While GDP growth is estimated to have more than doubled that achieved in 1991, investment in the economy remained sluggish. Nevertheless, the brightening prospects for India's economy and its opening to the world, attracted a great deal of interest by foreign investors. Several billions of dollars of foreign investment projects have been proposed to India and much of this agenda has been approved. This has served to stimulate the private sector greatly. Reduction of artificial controls over prices, and elimination of several burdensome taxes, added considerably to the momentum being experienced in virtually all segments of the private sector. The combined effect of these developments should result in large increases in private sector investment in the coming years, beginning with 1993.

Privatization:

India has developed as a highly statist economy. Public Sector enterprises (PSU's) occupy a central position in the Indian economy, and absorb a great amount of the government's fiscal resources. Policies toward these enterprises are thus central to the whole reform effort. In both the industrial and financial sectors, the GOI's programs toward these enterprises will determine the depth and sustainability of the reform process.

The GOI reform strategy involves a significant reduction in the role of the state in the production of economic goods and services. Nevertheless, in the face of a huge task, progress toward privatization has been modest. The sheer size and scale of the task, and threats to the jobs of a large number of employees of these public enterprises are daunting. Some progress has been made, however, by selling equity shares - up to 25% in some cases - in the more commercially viable of the PSU's in the capital markets. For the PSUs whose commercial prospects seem less certain, the GOI has created the Board for Industrial and Financial Reconstruction (BIFR). Over 150 sick PSU's have been referred to this board for review and determination of the most feasible course of action - restructuring or liquidation.

Further efforts in privatization are crucial to the reform strategy. The measures taken to introduce international competitiveness into the economy will aggravate the fortunes of the lease viable of these enterprises. If no action is taken, they will constitute a greater drain on fiscal resources, and could threaten the very stability so hard won to date. The funds and technology that only the private sector can provide are vitally needed in those sectors that have been reserved to the state. This will take a more determined effort to encourage the private sector, both domestic and foreign, to become active in these areas.

Financial Market Reforms:

Nowhere is the impact of privatization, liberalization and the lifting of controls over the market more evident than in the financial sector. While still largely dominated by state owned banks, there is now greater scope for private sector owned financial institutions than ever before. Several foreign-owned private banks are competing vigorously in the sector. Further, the elimination of certain direct controls over the capital markets, particularly the freeing of the pricing of new issues, have led to a spurt of new financial institutions, and increased activity in the financial markets.

Interest Rate Policy:

First and foremost, the financial markets have been stimulated by the partial lifting of the repressive interest rate policies. While not yet totally free of controls, current rates are now determined more by market influences than government fiat. This measure is critical for virtually every aspect and institution of the financial and capital markets.

Banking System Reforms:

For many years, the GOI has preempted about two thirds of the resources of the banking system to supply resources to the public sector. In return, the GOI has paid for these "loans" with below market interest rates. At the same time, the GOI has imposed upon the banks the obligation to use their remaining funds to lend to public sector entities of doubtful prospects. Thus, over time, the banks have become passive instruments of government social and economic policy, and virtually unable to perform the true role of a banking institution that is to mobilize savings, and channel them into enterprises of the highest efficiency and return. The result is that today the state banks are facing technical insolvency due to large amounts of unrecoverable loans. The GOI is obliged to restructure these institutions and has budgeted Rs. 57 billion as a first tranche of recapitalization of these state banks. The GOI has also announced plans to introduce legislation that will allow new private banks to enter the sector, and to permit the state banks to tap the capital markets for new equity, thus effectively partially privatizing the banking system.

Impact on the Capital Markets:

The link between government policy and action and the future health of the financial sector will require that the government move to a market based policy for future government financing needs. Government borrowing should move as rapidly as possible to the creation of a government securities secondary market. In all competitive financial systems, the government segment of the market represents the reference against which all borrowers, of many gradations of risk, are measured. Truly market based government bond issues are essential for the development of deep and effective long term debt markets. In India, government bonds at market rates will signal the depth of commitment to the reform program, and along with reductions in bank reserve requirements (SLR and CRR) which preempt resources, will remove a huge element of distortion in the capital markets of India. Government action during the 1992-1993 year to reduce modestly both these reserve ratios has been commendable. At the same time, parallel actions by the central bank to gradually raise the coupons on new issues of government debt has brought them to, what some market observers say, is "near market". These instruments are nearing the point of being attractive to the private sector as investment vehicles. As further progress is made here, dramatic progress toward a free competitive financial sector will be made possible.

Capital Markets:

As noted above, the prospects for a market based government debt market is a sine qua non for the development of a deep and effective long term debt market. This is underdeveloped in the Indian capital markets at the present time. Nevertheless, the equity markets have been growing at impressive rates for several years. New equity issues to finance new industrial investment have set records for several years as the realization of impending liberalization has taken hold in the private sector. The total number of new issues in the primary market in the five months (April-September) 1992 increased some 450% over the

II. EXECUTIVE SUMMARY

A. Regulatory Developments and SEBI

It is important to consider the history of India's securities market in order to better understand the nature of its regulatory system and the best method of intervening to support market development. While India is said to have developed an "equity cult," until pricing controls were eliminated most investors in the primary market were not participating in a true market but were relying on the government to not only protect them against loss, but also assure them of profit.

India is in the process of converting the regulatory system that provided this protection from a system of direct government controls to one that attempts to create a fair, orderly and efficient market in which prudent investors receive a reasonable degree of protection from predatory practices and unconscionable acts but make their own investment decisions and bear the risks and obtain the benefits of those decisions. A major educational process is required so that the public, regulators and market participants are aware of their roles and responsibilities in such a market. In making this kind of change, transition measures are often required until appropriate infrastructure is in place so that investors do not completely lose confidence in the market.

Substantial problems exist in the Indian regulatory framework that will make the transition more difficult. These are:

- fragmentation of authority to regulate among many government agencies,
- an absence of appropriate focus on enforcement, and
- residual tendency to substitute government decisions in the market in the name of investor protection.

The GOI's apparent plan is to reallocate authority and convert to a full disclosure system. The intention is to provide SEBI with virtually all regulatory authority over markets, except for authority over issuers, which will continue to be handled by the Department of Company Affairs.

USAID can best support India's process of modernizing and changing its regulatory environment by providing high quality international expertise on a short term basis to highlight important issues and provide background information from international markets; and through large amounts of training in regulatory matters in order to develop the human resource base of its supervisory institutions. SEBI appears to be sensitive to receiving assistance about policy matters. However, as one of the regulators said to the consultants, there are no people experienced in the regulation of the capital markets in India today. This similar period in 1991. New issues of equity in the primary market are estimated to have reached a level of US$10 billion by the end of 1992.

The establishment of a new Capital Markets Regulatory Authority - The Security and Exchange Board of India (SEBI) - represents an important and positive change that will favor the further development of India's capital markets. How this organization develops its regulatory program will influence heavily India's prospects to integrate its financial markets into the global financial system. To achieve its goals, SEBI will require access to the best international practice in capital markets regulation.

F.I.R.E.:

While the prospects for reform and expansion of the financial system of India are very positive, USAID/New Delhi has recognized the need on the part of Indian institutions for expertise and training of an international standard. Major new institutions will be put in place, and major changes in practice will be implemented. The program proposed by USAID/New Delhi - F.I.R.E. - is under consideration at the most opportune time possible. The tide of reform springs from the initiative of the Indian government and private sector. The technical expertise and training proposed in this program is eagerly sought by the progressive forces in both sectors.

The Scope of Work:

With this opportunity confronting it, USAID/New Delhi contracted the Financial Sector Development Project (FSDP), an A.I.D./PRE project for which Price Waterhouse is the prime contractor to provide specific capital markets expertise to advise possibilities for reform. The team consisted of: J.R. Breen, Director, FSDP, John Ruckrich, securities market systems consultant, Steve Bloch, securities market consultant, and Jan Aalbregtse, capital markets regulation consultant. This team investigated specific opportunities designated by the members of the USAID/F.I.R.E. Project Committee. The team conducted interviews with members of the government most closely involved with the financial sector, and with a wide range of private sector participants in the capital markets. This process yielded many different ideas for potential help to the process of reform which were evaluated by team members, and presented as options to the F.I.R.E. Project Committee. This report contains a summary of these options, along with comments on their significance to the future of India's capital markets development. As such it constitutes not a comprehensive program, or a project paper, but rather a menu of options from which the USAID may draw to compose the project it will negotiate with the GOI.

is the gap to be bridged. In approaching the task, USAID can put together a program for SEBI which allows this regulator to draw upon expert consultants in the specifics of the techniques of regulation, rather than policy which is appropriately left to Indian government decision-makers.

Specific short term consultancies and workshops focusing on important issues affecting capital markets could be extremely beneficial in initiating discussions and providing exposure without crossing over this line. For example, the SHCIL conference facilitated a greater awareness of issues affecting creation of a central depository among policymakers. Workshops on policy issues must be designed carefully as forums for education and discussion. They should be designed, sponsored and promoted by market participants with USAID involvement focused primarily on providing expertise through training materials and lectures.

Short term consultancy would be useful in designing automation requirements for handling document flow for the process of regulation and regulatory enforcement, as well as other technical regulatory matters.

Possibilities for developing the capabilities of the following institutions were considered: SEBI, The Department of Company Affairs, The Institute of Chartered Accountants and self regulatory organizations. We recommend that most efforts be focused on SEBI primarily because SEBI is expected to be the principal regulator of the capital markets. SEBI plans to hire a human resource director by January, 1994. At that time they would be willing to develop a training program in coordination with an expatriate design team comprised of training, regulatory and IT experts.

Another major program initiative, that will have profound long term impact on the workings of the capital markets, could be the development of a system to certify the competency of licensed registered representative of broker-dealers. This program, similar to the "series 7" examinations and certifications conducted by the National Association of Securities Dealers (NASD) in the U.S., is one in which SEBI representatives have expressed a great deal of interest.

SEBI has suggested that assistance be provided in conjunction with investor associations to prepare a videocassette to educate investors about fundamentals of the marketplace. This would be appropriate and beneficial in view of the major changes in the marketplace.

Representatives of the Department of Company Affairs were receptive to receiving assistance with respect to policy matters, although they were somewhat protective of their territory. This Department continues to exercise control over issuers, including significant enforcement powers. In our view that assistance would best be directed primarily at SEBI, with participation of members of the Department of Company Affairs also recommended.

B. Disclosure and the Accounting Profession

Although some problems remain with accounting principles and the accounting profession, the Institute of Chartered Accountants is well designed and operating reasonably well. It does not lack knowledge of international standards or the ability to discipline accountants. To the extent there are problems with adoption of adequate standards or enforcement, they are probably due to political pressures and the absence of appropriate market forces that cannot be corrected by technology transfer. Assistance to the Institute may be programmed in the category relating to Industry Associations.

C. Self Regulatory Organizations

Although, SRO's currently exist in the Indian framework, primarily at the stock exchanges and, the Institute of Chartered Accountants, they function poorly. One of the major reasons is the lack of an adequate regulatory program that relies on SRO activity, and is backed up by a vigorous enforcement program at the top. Furthermore, the principles of self regulation should be applied more broadly. The SRO at the level of the stock exchange should be complimented by SRO activity at the level of the brokers to govern their members conduct and sales practices toward their clients, and the public. At the present time, there is no organization of brokers comparable to the National Association of Securities Dealers (NASD) in the U.S. Nevertheless with over five thousand brokers said to be operating in India, and estimated 50,000-100,000 "sub-brokers" also active in the markets, the need for organized self discipline, with genuine enforcement powers carried out through formally organized business conduct committees in every region is evident.

Mr. Javeri of ICICI, the coordinator of the plan to establish the Merchant Banker's Association, has requested consultancy and training assistance to establish a Self Regulatory Organization (SRO) for that group. Such assistance would be appropriate and is supported by SEBI.

D. Stock Holding Corporation of India Ltd.

With the National Stock Exchange (NSE) linking with SHCIL in fulfilling its clearance, settlement and depository needs, there has been a formidable challenge given to SHCIL to meet the time frames that the NSE aspires to achieve, viz. debt trading system operational by end of 1993 and Equity trading system by mid-1994. Since the time of the publication of the Price Waterhouse report on the National Clearing and Depository System, the NSE requirements have been made known and is perceived to be the driving force behind SHCIL activity in developing the NCDS. The NSE requirements envision three different depositories as follows:

- RBI will provide the depository for book entry of dated Government Securities and Treasury Bills

- SHCIL will provide the depository for book entry of PSU bonds, Commercial Paper, Certificates of Deposits, Equities and Corporate Debt

- UTI will provide the depository for book entry of the Unit '64 Mutual Fund

The National Clearing System and the National Trade Reporting and Comparison System are adversely impacted by this multiple depository approach. The Price Waterhouse recommendations for both systems and education requirements are fundamentally sound but will need to be enhanced if SEBI and its working committee on clearing and settlement modify some aspects of SHCIL's Central Depository System (CSD) design for all securities.

There are three basic components to the assistance that SHCIL requires that can be met with assistance from USAID. The fundamental requirements of a National Trade Comparison and Reporting System, National Clearing System and National Depository System are known and the infrastructure of the SHCIL central office supported by branch offices is still intact. This leaves SHCIL with a large requirement for technical assistance to develop and guide its development of these three basic entities and also the requirement to educate a large internal staff and the participants and investors who will use their facilities.

One thing that has remained constant through the last year is the fact that today's clearance and settlement systems are the major obstacle to further advances in the efficiency and effectiveness of the capital markets in India. While price transparency is of great importance to attracting investors, a certain, and efficient delivery versus payment, and a low transaction cost of settlement is critical. Striking the right deal is useless if settlement costs and complications undo or alter the desirability of the deal.

Progress in the clearance and settlement area can only be made after the necessary legal and regulatory changes, covered in other sections of this report, have been made.

E. The Over the Counter Exchange of India Ltd. (OTCEI)

This new market is just 14 months old. It is a unique market in India, or for that matter in any region or country. While it is loosely modeled on the U.S. NASDAQ, it is designed soley to meet the equity and debt capital needs of small and medium companies. The early listings on this exchange demonstrate that it serves as a an exit for the venture capital financiers who take the early risks of new start up companies, and desire to redeploy their invested capital resources to new start up opportunities.

This market has been organized on modern principles of regulation. The standards set for the performance of its members and dealers are high, and are designed to give confidence to the investors in the market.

One of its new initiatives in recent months is to list debt issues on its screen-based market.

This raises the prospect of a genuine secondary trading market in corporate debt issues, in the context of a well-regulated market. While the OTCEI is only a small player in both the debt and equity markets, it shows much promise as a stronger element of the overall capital markets, and as a factor in the mobilizing of capital for small and medium companies.

The options to assist the OTCEI are based on its need for trained personnel, and for technical help with its regulatory program, and its electronic systems. Particularly important is the requirement to provide opportunities to the management personnel of OTCEI to gain exposure to the practical problems of market-making, and the issues of market oversight as practiced in developed screen-based markets such as the U.S. NASDAQ.

F. The National Stock Exchange

The National Stock Exchange (NSE) will be operated by a newly formed company called the National Stock Exchange of India Limited (NSEIL). As an organization the NSEIL is a company promoted by the leading financial institutions and banks in India. The NSE has a strong sense of direction for the next year's activities. There will be a great need for training of staff of the NSE as they get into operation. It is recommended that the F.I.R.E. project support the establishment of the NSE through technical assistance and training. The most immediate need mentioned by the Vice President of the NSE is for staff training. It is recommended that a level of funding of about $75,000 to $100,000 per year be provided for training during the course of the F.I.R.E. project. In addition, technical consultancies to assist with such issues as futures and options. At a minimum, the Chicago Board of Options Exchange and the Chicago Mercantile Exchange should be engaged in effecting a technology transfer. This program would be coordinated by a U.S. based management consultant with Indian Capital Markets experience. The first phase of the program would be the design of the program itself. The program itself will require visits by Indian executives to the United States and the United States cooperating executives should visit India. This will be beneficial for understanding and idea exchange, as well as establishing relationships between the corresponding capital market entities. Internships for key employees of the NSE and SHCIL would also be required.

G. The National Market System (NMS)

The proposed National Market System would electronically link the 22 stock exchanges of India into a network which would offer best price to Indian investors wherever they are located. However, the present conditions prevailing in these exchanges suggest that certain preconditions of improved transparency on these exchanges should be established before such an idea becomes feasible. It is suggested that the proposed F.I.R.E. project offer technical assistance to these exchanges to implement automated systems which would make possible necessary price and trading transparency, and train their members in these techniques. This would make possible the implementation of a consolidated tape which would report sequential last sale price information from all exchanges.

H. Secondary Debt Market Transactions

Proposals to improve the operations of a secondary market in debt instruments must take into account that the great majority of these transactions do not take place on an exchange as such. In most markets these transactions are made on a "telephone market" between dealers that specialize in these instruments. Nevertheless, trade transparency of these transactions is possible, and of great benefit to the development of active secondary markets in debt instruments. The system that would produce a consolidated tape on these transactions should be undertaken with assistance under the proposed F.I.R.E. project. The project should also include the organization of a SRO for participants in this market.

I. Capital Markets Training, Research and Public Education

There is a great need to develop the human resources institutions which can supply the capital markets with the skill and management training that will be required by the sophisticated institutions needed for India's future markets.

Several institutions are operating in the markets today in India, and some of these show excellent prospects for success. Among these are the UTI Institute of Capital Markets, and the Institute of Certified Financial Analysts of India.

The former is planning to offer a program of courses in various aspects of the capital markets including attention to the most modern practices in use in international markets. (see Appendix B) This exposure to the best international practice is a vital necessity to the people operating in the markets. They must be equipped with the skills and understanding necessary to make the vital changes to modernize India's markets, and integrate India into the global capital markets.

The ICFAI is the most promising institution to implement a national program to qualify Certified (or chartered) Financial Analysts. This program merits support in the form of a modest level of technical and training assistance to work with the U.S. Institute of Certified Financial Analysts.

Other institutions of education can and should also participate, and the F.I.R.E. program should have the flexibility to support these institutions as the opportunities arise.

1. Research

A strong program of capital markets research would also yield great benefits to the development of India's capital markets. The management committee of the F.I.R.E. program, with the active participation of private sector members, should forge a program of research, along the lines proposed in this report, which can be implemented by a wide range of institutions in India.

2. Public Education

The changes proposed by the GOI, and supported by the International Financial Agencies, are profound, and will require changes in practices and understanding of the need for these changes by the investors who ultimately make the market possible. The Regulator, SEBI, has approved the chartering of a dozen Investor Associations, and is inviting these associations into formal working groups deliberating new regulations. The F.I.R.E. program can assist these new organizations in the implementation of programs of public and investor education. Such a program would require modest levels of funding, and would yield large benefits per dollar expended, in engendering informed public support for change.

III. CAPITAL MARKETS REGULATORY DEVELOPMENT

A. Background

In spite of, and perhaps in part because of, a massive body of regulation, India's regulatory framework for oversight of its capital markets lags behind that of many other Asian countries with emerging markets and is not commensurate with the size of its securities market. This can be attributed primarily to the historical nature of the securities market and the social and legal structure of the country. The structure is evidenced by regulations that have historically controlled not only the price at which securities may be issued but also the manner of issuing securities (through a system which allots securities in primary offerings to applicants through a lottery system favoring investors who purchase small quantities). These regulations were designed to accord small investors an opportunity to participate in the market on beneficial terms. Due to governmental underpricing of securities, however, the normal functions of a market were usurped, and the primary market became a lottery in which an investor who won an allotment could not lose. In effect, the policies could be viewed as having a purpose of redistributing wealth instead of developing a capital market designed to allocate capital resources. The result is that the Indian public is accustomed to assured profits and government protection against risk of loss. One often hears that India has developed an "equity cult." This term is misleading, however, as it implies that a significant group has learned to participate in a true securities market.

B. Evolution toward a Disclosure Based Regulation

The approach of controlling decision making with respect to capital markets by having a government make market decisions, often labelled as a "merit review" system, was historically adopted by a number of other Asian countries in attempts to "protect" the public and redistribute wealth. Most countries are now finding that a "full disclosure" system is more effective in developing the markets. Under such a system, investors make their own investment decisions but the process is supported by (a) requiring full disclosure of material information so that investors may make informed decisions with respect to securities, (b) licensing market participants and establishing minimum financial and operational standards for their conduct, and (c) defining just and equitable principles of trade for persons engaged in the securities business. Under this approach, investors have the opportunity to obtain certain information about securities and persons engaged in the securities business. With this information, investors may make their own investment decisions. With a full disclosure system, the government does not attempt to protect investors, either individually or as a group, from the results of their own decisions. However, there are penalties for misrepresentation, deceit, market manipulation and other fraudulent acts and practices. In brief, this method attempts to provide a fair, orderly and efficient market in which prudent investors receive a reasonable degree of protection from predatory practices and unconscionable acts.

India has begun the process of converting to such a system. In fact, the Indian capital markets and regulatory system are in a state of transition as they attempt to incorporate free market principles. These factors must be taken into account in evaluating the type of regulatory framework that is appropriate for a securities market and the type of intervention that is acceptable.

Some patience is required in the process of converting a bureaucratic, socialistic system that has relied on "merit review" into a full disclosure system. Not only will such a conversion take time, but also an immediate conversion without transitional measures is unwise until the appropriate infrastructure is in place. While internationally it is generally accepted that the latter approach is far superior, it is important to recognize the differences between a developed and an emerging market in making the transition.

Legitimate concerns are raised about the quality of information available to investors to make decisions and the ability of investors to protect themselves against unscrupulous practices. Effective deterrents to unlawful practices are key to the functioning of a regulatory system that relies on fair, orderly and efficient markets. Such deterrents are usually provided by an effective regulator, defined as one that not only has sufficient legislative powers to enforce laws, but also has the full resources to exercise those powers effectively, and an efficient method for investors to recover losses due to unscrupulous or illegal behavior (as distinguished from losses due to market and business risk). Until such systems are in place, some reliance on merit review systems can be appropriate. In addition, due to the completely different environment that a full disclosure system provides, a major educational process is required to educate the public about the risks and opportunities of such a market, and to redirect most small investor funds to the market through mutual funds and pension funds that provide professional management.

C. Applicable Law

There is no legislation that consolidates regulatory authority over the Indian capital markets and creates a comprehensive body of law for their regulation. The principal laws applicable to the capital market are:

- The Securities and Exchange Board of India Act, 1992 (SEBI)
- The Securities Contracts (Regulation) Act, 1956 ("SCRA Act")
- The Companies Act, 1956 ("Companies Act")

In addition, the Foreign Exchange Regulation Act (which regulates foreign investment in India), the Chartered Accountants Act, 1949, the UTI Act, 1963 and income tax laws impact the capital markets.

The Companies Law is proposed to be replaced in its entirety by the Company Law Bill, 1993 ("Company Bill"). The MOF is also presently drafting amendments to the SEBI Act, which are designed to give SEBI more powers, including the ability to assess penalties. The

MOF has indicated that the Company Bill is intended to better define the roles of SEBI and the Department of Company Affairs, but this is not apparent from a review of the Bill. In fact, the Bill is disappointing as it retains too many merit review provisions and does not incorporate amendments required to establish a central securities depository.

To provide general background, certain aspects of these laws and related regulations are summarized in Section E below by subject matter.

D. Authority Over Capital Markets

A high level committee, comprised of the Chief Executive Officer of SEBI, the Governor of the Reserve Bank of India and the Finance Secretary, has been formed to determine how regulatory authority over the capital markets should be divided as well as to direct policy over the capital markets generally. The absence of the Department of Company Affairs on the committee is notable.

The MOF appears to have a clear view of how it believes authority should be allocated. The RBI will continue its role of deciding the extent of foreign involvement in the markets and regulating money market mutual funds. Its policies will also have a significant impact on the debt market. The MOF is of the view that virtually all other regulatory authority over markets will be vested in SEBI (although the MOF is likely to continue to oversee SEBI to a certain degree) except for authority over issuers, which will continue to be handled by the Department of Company Affairs. SEBI's view is that it should have authority over all matters concerning the relationship between the issuer and the investors, but not other matters of corporate governance. As a result of this position, SEBI reviews prospectuses for public offerings, but it still has no authority over the types of disclosures legally required by issuers or the types of disclosures that must be made by issuers to secondary trading markets following an initial public offering.

SEBI is small and inexperienced at present, but has plans to expand. Currently, it has four departments: a primary market department with two executive directors, a secondary market department with three executive directors, a general counsel's office and an investigations department. It anticipates having 150 professionals within one year and regional offices in Calcutta, Madras and Delhi. In light of the stage of SEBI's development and the extensive regulatory work needed to oversee market participants properly, the division of authority between SEBI and the Department of Company Affairs outlined above is probably not detrimental at present so that SEBI can concentrate its efforts on oversight of participants. As SEBI and the markets develop, however, it is likely that this division of authority will prove cumbersome and SEBI will require authority over all aspects of corporate disclosure by public companies.

E. Selected Aspects of Regulatory Environment

1. Authority over the accounting profession and accounting standards

The Institute of Chartered Accountants was formed pursuant to The Chartered Accountants Act, 1949. That Act gives the Institute the power to license, discipline and revoke licenses of chartered accountants. An examination, which is reportedly quite rigorous, must be passed before a license will be issued. There are presently approximately 20,000-25,000 individuals practicing as chartered accountants. Most of these individuals practice as sole practitioners or in small firms. There are apparently only 2-3 large firms (800-1000) in India and 5-6 medium size firms (100-300). A Council is elected by the membership to carry out the Institute's powers. The Council is dominated by small firm members.

The Council appoints an Accounting Standards Board, which establishes accounting principles and auditing standards. The general view seems to be that financial statements of listed companies are not in accord with international standards but that they are better than those in most emerging markets in Asia. The principal deficiencies are reported to be with respect to consolidation principles and off-balance-sheet items. Segment reporting is not required. Tax considerations are said to influence the process of establishing effective standards. The Institute is a member of the International Society of Chartered Accountants and does not lack knowledge about international accounting principles and auditing standards.

The Companies Act requires a company to appoint a registered chartered accountant to audit its accounts, and specifies certain items that must be verified by accountants, as well as the form of audit report. It also specifies the format for financial statements and the times at which these financial statements must be presented. Accounting principles and auditing standards issued by the Accounting Standards Board supplement these principles. There is no legal requirement that companies follow the Institute's principles, however. The Company Bill is said to incorporate many accounting principles previously established by the Board.

The Institute claims that the principal problem with the quality and availability of financial statements is the lack of penalties against companies under either the Companies Act or stock exchange listing rules for failure to file financial statements or to comply with accounting principles established by the Institute. It also claims that half-yearly reports are abysmal. There is little disagreement with these views, but there is also an industry view that certain accountants assist in the process of obscuring financial data without punishment.

Various opinions have been expressed about the Institute, including opinions that the Institute fights with industry and that it is controlled by industry. The Institute views itself as a tough regulator of the accounting profession; this view is not held uniformly by regulators and the private sector, however. Accountants can be disciplined for professional misconduct, including failure to "invite attention to any material departure from the generally accepted procedure of audit applicable to the circumstances." The Institute receives only approximately 200 complaints each year; of these, an average of 80-90 cases are brought, and penalties are imposed in approximately 40 cases. Licenses are rarely, if ever, withdrawn.

2. Prospectuses; pricing; periodic disclosure

The Companies Act specifies the disclosures required in a prospectus and also governs certain aspects of the allotment process. SEBI reviews prospectuses, and the Registrar of Companies does not approve a prospectus unless SEBI's approval has been received. SEBI has no specific legislative authority to specify disclosure requirements for prospectuses used in public offerings or otherwise to participate in this process.

Although the Controller of Capital Issues has been disbanded, price controls lifted and SEBI has no specific legislative authority to do so, SEBI guidelines have been issued with respect to pricing of issues. Pursuant to these guidelines shares of new companies must be issued at par. However, most other companies may freely price their securities provided promoters and other investors are treated uniformly and the prospectus justifies the price. SEBI guidelines have also been issued for "disclosure and investor protection."

There are apparently no legislative or other regulatory requirements for disclosure of material events and periodic reports typically made to assist secondary market participants in evaluating an issuer's securities, and will acquire greater importance in the future.

3. Market intermediaries

The SEBI Act provides SEBI with the power to license and regulate all market intermediaries. Pursuant to this authority SEBI has issued particulars to be followed by intermediaries when registering.

a. Brokers, sub-brokers, merchant bankers and portfolio managers

SEBI has issued guidelines for registration of stockbrokers, sub-brokers and merchant bankers, which permit a form of "merit" review by SEBI to determine whether a the applicant will be licensed, based on eligibility for membership of a stock exchange, infrastructure and experience (in the case of stockbrokers) age, absence of convictions and general education (in the case of sub-brokers), experience, professional competency, personnel, capital adequacy, track record and reputation for fairness (in the case of merchant bankers) and infrastructure, experienced employees, capital adequacy and professional qualifications (in the case of portfolio managers).

b. Exchanges

The SCRA governs licensing and regulation of stock exchanges. That Act gives regulatory power over exchanges to the Central Government, but most powers have been unofficially

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delegated to SEBI. Broad power is given under the Act to impose conditions on exchanges regarding qualifications of members and the number of members. Further, power is given to require that exchanges amend existing rules, to direct that new rules be made and to require that rules be made in conformity with such conditions as may be prescribed with a view to ensuring fair dealing and protection of investors. Rules have been issued under the SCRA specifying membership criteria (including age, citizenship, absence of conviction, etc.) and the eligibility of companies to become members of the exchanges.

Thus, the GOI has the power to require the exchanges to open their membership and to operate as effective self regulatory organizations. In fact, SEBI has recently ordered exchanges to reconstitute their boards of directors to provide for 50% representation by nonmembers. SEBI expects this to occur by the fall of this year, and to result in significant changes in exchange policies.

SEBI is empowered to inspect exchanges and has recently undertaken an inspection of the Bombay Stock Exchange.

F. Market malpractices; remedies; enforcement

There are few legal prohibitions against market malpractices such as market manipulation, failure to disclose material information or the making of misleading statements, and there have been no enforcement actions. SEBI has recently issued draft regulations governing insider trading. The Companies Act imposes civil and criminal penalties on directors, promoters and other persons who authorize the issue of prospectuses containing untrue statements.

Legal prohibitions have little effect in the absence of a concerted enforcement effort and accessible means to collect civil damages. Further, while it is currently fashionable internationally to discuss eradication of insider trading from markets, such cases are extremely difficult to prosecute and should be a lower priority than addressing other more blatant types of unfair market practices by brokers and dealers.

SEBI enforcement activities have to date consisted of inspections of some exchanges, all mutual funds, a few merchant bankers and 14-15 brokers. Their strategy, in the absence of more effective enforcement powers, is to publicize deficiencies. SEBI has the power to revoke licenses, however, and pursuant to the terms of licenses, to direct a licensee to restore unfair profits obtained by market participants from customers. SEBI intends to focus attention on enforcement in the future.

Under the Companies Act, the Department of Company Affairs has significant power to inspect companies, to impose fines and to initiate prosecutions. These activities are not likely to be effective to prevent capital market abuses, however, unless efforts are concentrated on detection of abuses by public companies and imposition of effective penalties. This can best be accomplished by a regulatory body that is focused on public capital markets, such as SEBI.

G. Takeovers

Indian law protects existing management to an extreme degree. The SCRA permits companies to refuse to transfer shares if the transfer is likely to result in such change in the composition of the board of directors as would be prejudicial to the interests of the company or to the public interest. Instead of relaxing this position, the Company Bill would incorporate the same provision. These restrictions are not in accord with international practice and inhibit creation of a central depository. Internationally accepted practice is evolving to require disclosure and to protect minority shareholders in connection with takeovers and not to give existing management special powers to prevent takeovers. SEBI has drafted a "Regulation for Substantial Acquisition of Shares in Listed Companies" which, while including some questionable provisions, attempts to provide for regulation more in accord with international practice.

The MOF recognizes the need for a complete review of takeover regulation, but wants to defer its consideration (as well as consideration of other changes required for a central depository) until the Companies Bill and the proposed SEBI Act amendments are passed. The takeovers issue will be extremely controversial.

H. Investor protection: the small investor in the marketplace

As a result of the transition from a protected market to a market that relies more heavily on free market principles, there is a need to consider alternative methods to involve small investors in the securities markets. Under the controlled price system many investors apparently became involved in the market who would ordinarily not participate directly in securities markets. India's legal and market infrastructure is not sufficiently developed to protect this type of investor, who generally is not sophisticated in market practices. Even if a regulatory structure could be developed to protect such investors adequately, it would likely restrict development of the market. It is in fact inappropriate to encourage unsophisticated investors to participate in a market directly, particularly in the absence of appropriate infrastructure. By doing so, the GOI risks being blamed for losses incurred by such persons. Required is a change in strategy to redirect participation through mutual funds and pension plans. As part of this process, consideration should be given to replacing the allotment system with more traditional underwriting arrangements.

I. USAID Role

1. Receptivity to Assistance

Through consultations with the MOF, SEBI and the Department of Company Affairs, the GOI's present view of the boundaries for assistance on regulatory matters was made relatively clear. In general, the GOI is receptive to human resource development but does not desire assistance with respect to policy matters such as determining the roles of each regulatory body, the structure of laws or regulatory strategy. The Department of Company Affairs was in fact more receptive to consultancies to help develop implementation strategies than were the MOF and SEBI.

Past experience suggests that the most effective assistance to develop an emerging market's regulatory system combines advice on policy matters with specific technical consultancies on regulation and enforcement, as well as training. However, much can also be accomplished by supplying the needs for expert consultancies at the technical levels of regulation and enforcement, by conferences and workshops covering regulatory issues, and especially by human resource development of regulatory staff. SEBI executives have acknowledged that experience in regulation of the capital markets is not available in India, and will have to be developed. The assistance pattern outlined above, can make a crucial contribution to improvement of capital markets.

While the SEBI Act is presently inadequate, and regulatory authority over the capital markets remains fragmented, the GOI plan appears to be to eventually focus substantially all regulatory authority over public capital markets in SEBI, to create a full disclosure system and to fortify the SRO structure. Accordingly, the direction in which the GOI intends to move is appropriate and, as discussed more fully below, assistance to train SEBI's staff would be worthwhile.

The GOI is sensitive to the designation of the type of assistance. For example, assistance in development of an enforcement plan is unacceptable, but training in enforcement techniques is appropriate. It also seems to be important to the GOI agencies that they not be singled out as those most in need of training and that training sessions include both regulators and market participants. This could, in fact, be advantageous as training sessions targeting both the private sector and the regulators could bring practical understanding of Indian industry and market practices into the sessions.

The private sector is virtually unanimous in its call to educate the regulators, both from a policy and an institutional standpoint. They are willing to participate in the process, but there is also some sense of frustration that their views generally receive little weight. It has been suggested that the most appropriate USAID role in the policy process is to sponsor a number of workshops that are designed to raise the most important issues, furnish international expertise for exposure regarding how such issues are handled in other parts of the world and provide a forum for policy dialogue. Private sector market participants also support institutional development, which they believe should be directed primarily at SEBI. These two possible avenues of assistance (selected policy workshops and institutional development) are each discussed more fully below.

2. Selected Policy Workshops

Workshops focusing on important issues affecting capital markets could be extremely beneficial in initiating discussions and providing exposure without threatening the GOI. For example, it is apparent from our meetings that GOI officials are more aware of the issues involved in establishing a central depository (though their views may be different from ours) because of the SHCIL conference, which provided a forum for exposure to the issues. In view of the GOI's sensitivity to assistance in the policy arena, workshops on policy issues must be designed carefully as forums for education and discussion. They should be designed, sponsored and promoted by market participants with USAID involvement focused primarily on providing expertise through training materials and lectures. USAID could also supply research as required to support the process. There should be a limited number of workshops throughout the life of the project so that attention can be focused on those subjects that are of the most importance. Further, the workshops should be small and involve primarily influential representatives from GOI and private and public sector market participants.

The committee proposed to be formed to direct the USAID project would be an ideal organization to decide which issues should be the subject of workshops. Issues for workshop topics would be identified over the life of the project. Possible topics of immediate interest include the following:

- <u>Futures, options.</u> It is apparent that India is in need of expertise from developed markets about the alternatives for separating its present equivalent of a futures market, the badla system, from normal trading. A study group has analyzed requirements for such a market, but the need has been expressed for advice from international experts. Expertise is particularly required about the appropriate timing of introduction of such a market. Even though it may not be appropriate to establish a market at the present time, in view of the continued focus of market participants on this issue, it is important that market participants and GOI officials acquire an understanding of the prerequisites for such a market.

- <u>The role of the small investor in the marketplace.</u> The concerns with small investor participation in the present market were outlined above. An educational effort will be required to make both policymakers and the public aware of the risks of continuing with the present system. Topics for a seminar on this issue could include methods of protecting the small investor in other jurisdictions as compared to those available in India, the advantages and disadvantages of traditional underwriting practices as compared to the allotment system and alternative methods used internationally to involve small investors in the marketplace.

- Takeovers. As discussed previously, the present legal environment governing takeovers restricts development of the market, particularly establishment of a central depository. The MOF has stated that the takeovers issue will be considered after the Company Bill and the amendments to the SEBI Act are completed. India could benefit from exposure to alternative approaches to takeover regulation from international models.

Other possible topics (which have as yet received less attention than the topics outlined above) might include (1) appropriate methods of involving pension funds in a securities market, (2) obstacles and solutions to creation of a retail brokerage industry, (3) alternative remedies for investors who are injured by unfair securities market practices.

3. Institutional Development

a. SEBI

As discussed above, the need for development of SEBI is apparent. SEBI is interested in receiving assistance in training in all aspects of securities markets and market regulation, as well as systems design to organize the flow of documents through the organization. They do not want assistance in developing regulatory policies. They also have requested that training be directed broadly at the marketplace and that they not be singled out; they would like any training courses to include both market participants and SEBI because they believe the market participants need training and because they believe SEBI staff could benefit from the practical market experience.

SEBI is planning to hire a human resource development director by January 1994. At that time SEBI would be willing to establish a small committee to design a long-term training and organizational plan in coordination with a USAID team of training, regulatory and IT specialists. They are not interested in resident consultants and would like the design team to stay for no more than 2-3 months. They anticipate that the training program would consist of a series of short-term seminars, although one-on-one assistance could be incorporated. Initially the design team would conduct a skills assessment to determine the level of knowledge of executives and other SEBI staff. The receptivity of SEBI to assistance in designing a human resource development plan could be evaluated at that time.

SEBI is receptive to assistance in designing and implementing a licensing and certification program for registered representatives of broker-dealers. Such a program would include design of professional standards for brokers, testing materials and an educational program to train brokers in acceptable market practices. The program would be patterned after that used by the U.S. NASD to license registered representatives of broker-dealer firms. A copy of a rule requiring such an examination and a syllabus for the examination used in another emerging market is attached as Appendix A.

SEBI has also requested assistance in developing strategies for handling document flow to support the regulatory process. Depending on their receptiveness at the time, consultants could be provided to assist in developing operating procedures and designing a records management system.

Finally, SEBI has suggested that assistance be provided in conjunction with investor associations to prepare a videocassette to educate investors about fundamentals of the marketplace. This would be appropriate and probably beneficial in view of the major change in the nature of the marketplace that has taken place in India. However, it is important to assure that the focus of such a video would be on the risks and benefits of participation in a free securities market, rights and remedies available to investors and alternatives to direct participation in the market, such as mutual funds. A well designed video could serve to assist in developing support for market reforms.

SEBI Staff Training Programs

Examples of possible training programs for SEBI staff and other market participants that the design team may structure include:

- International market trading practices; minimum standards for floor traders and market makers; execution priority rules; best execution rules; detection of unlawful practices and enforcement techniques
- Broker/dealer capital adequacy, and other regulatory practices, including know-your-customer rules and record keeping and reporting requirements
- Oversight of SROs
- Standards for investment advisors
- Sales Practices standards for brokers and sub-brokers.
- Market malpractices--their detection and possible remedies
- Underwriting processes and pricing techniques
- Listing standards
- Due diligence techniques and underwriters' duties
- Issuer disclosure to secondary trading markets
- Selective review of prospectuses; role of a "red herring" prospectus; profit forecasts

- Mutual funds--methods of operation and inspection techniques
- Achieving a balance between regulation and market development

b. Department of Company Affairs

The officials we visited at the Department of Company Affairs were quite receptive to receiving assistance from USAID. Whether this is dues to their awareness that powers over the capital markets are increasingly being shifted to SEBI, or to their acknowledgement of the need for more information about international practices is not clear. (It is also not clear whether these persons' views represent the position of the Department). They suggested the formation of a committee comprised of SEBI and Department of Company Affairs officials to coordinate enforcement efforts, to establish the appropriate allocation of authority and to consider establishing a separate court to handle securities law matters. They were receptive to USAID consulting assistance to such a committee to provide them with information on how such allocations of authority are accomplished in other jurisdictions and to develop an enforcement plan. They indicated a specific need for assistance to determine how a new investor protection fund, which is provided for in the Company Bill, should be established. The MOF and SEBI were not responsive to the suggestion that such a committee be created, however. Their plan seems to be eventually to obtain all authority over disclosures of issuers in public markets and not to coordinate efforts with the Department of Company Affairs (although they do not intend to attempt to obtain authority to control corporate governance matters).

In spite of the cooperative front, the Department of Company Affairs representatives expressed the view that more responsibilities should not be transferred to SEBI until the organization is more knowledgeable. They were protective of their role and the fact that they possess most of the enforcement powers over issuers. They also indicated that their status as a legislative body answerable to Parliament provides them with powers of prosecution which SEBI, under its current ordinance, cannot have. This apparently would apply only to criminal penalties and not to civil remedies, which could be used effectively to deter market malpractices. In any event, the Department of Company Affairs is likely to continue to have some role in establishing corporate disclosure practices for some time.

Nevertheless, it is our view that assistance efforts should be directed primarily at SEBI and only in a limited way at this Department. For the next few years, regulatory focus should be on correcting market malpractices of market intermediaries, over which SEBI has authority. Improvements in transparency of corporate information can be made but at a slower pace. While issuer disclosure practices require improvement, these practices are apparently not in such a state that they would prevent participation in the market by foreigners and other non-speculative investors.

In addition, based on our experience in other emerging and developed markets it is our view that regulatory authority over public capital markets should be unified. Eventually, SEBI should have authority not only over market participants, but also over all disclosures required in public markets. We recommend that USAID F.I.R.E. programs of training and consultancy in the regulatory area be directed primarily at SEBI, which is likely ultimately to be the principal regulator of the capital markets.

While no major effort to develop the Department of Company Affairs is recommended, its officials should be included in training sessions to the extent possible. The lack of understanding of the Department of Company Affairs about securities matters is apparent. In light of their current powers, this lack of understanding can be extremely detrimental to the capital markets. For example, one of the representatives (who was a retired Company Law Board member) expressed the view that a depository should be established only if it can comply with the present law and noted that they had made a special point of incorporating anti-takeover provisions into the Company Bill, thus evidencing a complete lack of understanding of the existing legislative barriers to a central securities depository.

c. Institute of Chartered Accountants

Although some problems remain with accounting principles and the accounting profession, the Institute of Chartered Accountants is well designed and operating reasonably well. It does not lack knowledge of international standards or the ability to discipline accountants. To the extent there are problems with adoption of adequate standards or enforcement, they are probably due to political pressures and the absence of appropriate market forces that cannot be corrected by training or consultancies. In addition, the Institute does not appear interested in receiving help. It should be noted, however, that SEBI is of the view that the Institute needs assistance and this could be implemented as the project proceeds.

The Institute suggested that the Institute and SEBI jointly coordinate a review of financial statements of public companies to detect abuses and initiate prosecutions, with USAID providing accounting expertise to establish financial statement review programs. The Institute noted that SEBI does not have sufficient expertise to analyze financial statements. SEBI is not interested in such a coordinated effort.

d. Self Regulatory Organizations (SROs)

The only existing SROs are the stock exchanges and the Institute of Chartered Accountants, although the merchant bankers are planning to form an Association of Merchant Bankers.

As the minimal level of SRO enforcement activity at the level of the stock exchanges demonstrates, SROs only function when an oversight structure is in place that prompts SROs to do their jobs effectively and punishes those who do not. SEBI wants to create more effective SROs and to have the SROs do a major portion of the enforcement work. It has the power to do so and in fact has begun the process by requiring that 50% of exchange boards be comprised of nonmembers. Once the exchange boards are reconstituted, it would be appropriate to provide assistance to exchanges in developing their rules, enforcement techniques and arbitration procedures, provided the exchanges want assistance and indicate a sincere intention to cooperate with the regulators. This assistance should go hand in hand with the proposals made elsewhere in this report to assist the stock exchanges to improve the transparency of their trading systems.

Possible avenues of assistance to SROs are to assist in development of presently existing SROs and to assist in the creation of new SROs.

We investigated the possibility of establishing an organization similar to the U.S. National Association of Securities Dealers to license and regulate brokers, but in view of the present poor reputation of the brokerage industry and the animosity between SEBI and brokers, it seems at this moment that this idea will take some time to mature in the minds of all those involved. It is recommended also that as SEBI shows interest in promoting a national Self Regulatory Organization of brokers, that the F.I.R.E. program be ready to provide a mix of appropriate assistance including short term consultancies, and training workshops and conferences to develop this important concept here in India.

While the OTCEI has developed an excellent framework for their self regulation, the Chief Executive of this market has indicated that more needs to be done, and has requested further assistance in that field. Assistance to the new, and as yet unformed, National Stock Exchange (NSE) should also be available if requested.

SEBI has suggested that any of the exchanges of the country that desire to act as role models should be encouraged and supported with technical assistance. The management of the project should have the flexibility to respond to the initiative of individual exchanges to improve their transparency, as recommended elsewhere in this report. The utility of assistance to exchanges should also be evaluated in light of developments in the NSE and/or a national market system, but it should be noted that a national market system would be infeasible without significant improvements in the transparency of operations of the individual exchanges that would be tied together.

Mr. Javeri of ICICI, the coordinator of the plan to establish the Merchant Banker's Association, has requested assistance in the manner of establishing a securities regulatory organization. Such assistance would be appropriate and is supported by SEBI. The assistance should consist of one-on-one consultancies with expertise from international self regulatory organizations, such as the NASD. There is no equivalent self regulatory organization in the United States because merchant bankers (underwriters) are not regulated separately from broker-dealers in the United States. However, appropriate persons with NASD or similar experience could provide appropriate expertise.

J. Conclusion

It is abundantly clear that India needs assistance in developing its regulatory system to a level that can provide a reasonable degree of protection to investors that they will be treated fairly if they participate in its markets. Although the GOI is hesitant to accept advice on policy matters, there are methods in which USAID can have an impact in this area, primarily through policy workshops and support of institutional development. Policy workshops limited to a few key issues can bring international expertise to India and give regulators the exposure they require to make informed decisions. Training and one-on-one consulting assistance focused initially on SEBI is likely to not only increase the competency of that agency but to create an environment in which opportunities to provide input on policy matters will be presented.

K. Summary of possible levels of assistance

1. Establish a Testing and Certification program for brokers. Consultancies, training and test materials, over a three year period at a cost of $800,000.

2. Staff Training; a five year program of staff training, including overseas training could be conducted at a level of $600,000 over a five year period.

3. Industry Training Conferences & workshops

4. Self Regulatory Organizations: Technical consultancies and training resources to promote the development of SRO's (cost: $430,000 over five years)

5. Specific technical consultancies as required in various technical skills of the regulatory process should be made available to SEBI to advance the process of regulatory development. (cost $900,000 over five years)

IV. MUTUAL FUNDS

A. Role of Mutual Funds in a Capital Market

The principal benefit anticipated from developing a mutual fund industry is stimulation of the growth of the securities markets by introducing vehicles that promote professional investment and encourage investment from diverse sources. It is generally good policy to encourage mutual funds to develop because they are natural holders of stocks, bonds and money market instruments and their presence is likely to stimulate constructive growth in each of the markets in which the underlying portfolio securities are traded.

For mutual funds to succeed in a competitive market, several essential conditions must be satisfied:

- The types of portfolio securities held by the funds must be attractive themselves, as compared to alternative financial assets;
- The attractiveness of the portfolio securities must be enhanced rather than diminished by gathering them together within a fund;
- The fund's structure must be economically sound;
- The funds must be subject to appropriate, but not overbearing, regulation.

India's mutual fund industry has developed to a certain degree through UTI and other public sector institutions even in the absence of some of these factors due in part to the limited alternatives available to investors. However, the concentration of investment power in UTI, governmental investment policies and the lack of competition have limited the potential of the industry to benefit investors and provide a broader institutional base for the market. It has been reported that returns from UTI funds have not even kept pace with inflation, and that the accounting policies used to report the performance of many funds are, at least by international standards, misleading. This refers to the reported practice of some of the public sector offered funds of manipulating reported returns through arranging inter-fund transfers of assets at less than market value. The receiving fund, normally a new one still being sold to investors, is thereby able to show higher returns.

In a more competitive environment, it is likely that closed-end funds, which necessarily operate under a handicap, will become less attractive. Closed-end funds, which are not redeemable at net asset value on demand, are unable to provide investors with assurance that fund shares can be bought or sold at prices which are linked closely to net asset value. Thus, an extra layer of uncompensated risk is imposed on the unit holder. This results from the fact that fund shares will be traded in a secondary market at prices that often differ from net asset value by considerable amounts due to the inability of an investor to liquidate his investment. In addition, brokerage fees must be paid on purchase and sale of fund units, thereby further increasing the cost to the investor. As a result, the funds are generally less popular with investors.

The benefit of an open-end mutual fund industry is the greater popularity of this organizational form with investors, and the larger pool of assets which such funds are likely to attract. Of particular concern to development of open-end funds in an emerging market, however, is the limited market liquidity inherent in most such markets. The lack of liquidity makes it difficult for such funds to liquidate their investments at fair value in order to respond to redemption requests. As a result of the liquidity concern some developing countries have not permitted open-end funds to operate. India has decided to allow both closed and open-end funds, but open-end funds are subject to high capital requirements. Private sector management companies believe they will be able to market closed-end funds because of the nature of the investing public in India and that open-end funds are not likely to be introduced in the next few years.

1. Regulatory Environment

a. General requirements

For a mutual fund to avoid failure, it ordinarily is necessary to accomplish the following:

- Assets must be "marked-to-market" accurately;
- The manager must maintain accurate administrative control of the fund's participant accounts and general ledger and remain in compliance with applicable legal requirements;
- Fraud must be avoided to the extent possible and, in any event, should be covered by insurance;
- The portfolio must be protected against demands for liquidity which cannot be accommodated by receipts from the sale of portfolio securities during the settlement period available to redeeming participants.

It is also essential to creation of an effective mutual funds industry that tax treatment of funds and their holders be considered carefully. Due to the nature of mutual funds as a conduit for holding investments, it is essential that there be no double taxation of income from the investments (at the fund level and the investor level). Otherwise, purchasers of fund units could instead purchase the securities that would be held by the fund directly and pay tax only once. The character of the income at the fund level (e.g., as capital gain or tax-exempt income) must be retained at the investor level in order to be competitive.

Finally, the funds must be subject to appropriate regulation to assure that the industry as a whole deserves and retains the confidence of actual and potential investors. Scandals in the mutual fund industry can produce negative legacies that can undermine the entire fund industry's development. Regulation must focus on the threats to structural soundness mentioned above, accurate and transparent accounting policies, and also on marketing practices to assure that investors are provided the information they need about the funds, their managements and the portfolios which they offer.

The principal elements that are generally included in a regulatory system to supervise mutual funds are:

- Disclosure to investors of terms of the fund, including investment strategy, background information about the investment manager and other persons involved with fund management, risks, fees, expenses and other rights of investors;

- Specification of the method of pricing fund shares or units, limitations on the types of investments that can be made by the fund, and restrictions to lessen certain risks;

- Restrictions on the types of persons that may be involved with fund management, prohibition or regulation of affiliated transactions, placing of securities with a custodian or trustee, and requirements for fidelity bonds;

- Oversight by board of directors or trustee or similar body, with imposition of liability for failure to perform this role properly;

- Oversight by a regulatory body; bookkeeping, audit and reporting requirements.

In emerging markets, due to the illiquid nature of the market additional attention must be focused on redemption policies.

b. The Indian Regulatory and Competitive Environment

SEBI has issued guidelines regarding the operation of funds. Both closed and open-end funds can be offered under the guidelines. These guidelines

- require funds to be operated as trusts and include provisions designed to assure the independence of trustees;

- restrict certain business activities of asset management companies, which manage mutual funds;

- require independent custodians;
- require prospectuses for schemes and registration with SEBI;
- establish minimum amounts that must be raised for open-end and closed-end schemes;
- require publication of net asset value, and require that the difference between the purchase and sale price of units not exceed 7% of the sale price;
- limit certain types of investments by funds;
- establish ceilings on management and advisory fees;
- specify accounting, disclosure and reporting requirements.

In general, the guidelines appear to provide a reasonable regulatory base, and the private sector organizations that we interviewed who intend to establish funds believe they can operate under the rules. Although adjustments may be required as experience is gained, the principal issues will be whether the limit on management fees is too restrictive to make fund operation profitable and whether there need to be further restrictions on open-end funds to address liquidity concerns; in addition, it will be essential for SEBI to monitor funds effectively in order to limit the potential for market scandals. It is our understanding that the general tax structure in India will not deter creation of mutual funds.

In India, the existence of UTI presents an additional factor that must be considered, both from a regulatory and a competitive standpoint. UTI claims that the SEBI rules do not apply to it because it was formed under a separate statute. SEBI is presently challenging this position. UTI holders receive favorable tax treatment although this is apparently being phased out. UTI has virtually a free hand to operate without regulatory supervision. However, its investment policies seem to be directed to a certain extent by the GOI, and this is said to have limited its ability to perform.

In the absence of a level playing field whereby all mutual funds are subject to the same rules, competition with UTI will be more difficult. UTI's control over a substantial share of the market creates an additional competitive concern. Part of the controversy about subjecting UTI to SEBI authority centers around UTI's activities as a lender. Under SEBI rules, funds will not be permitted to invest in term loans. L.C. Gupta takes the position that SEBI rules are too strict and that UTI has performed a vital role in mobilizing investor funds for lending and created a form of asset-backed security in India. He therefore concludes that UTI should not be bifurcated and subjected to SEBI regulation. He reaches these conclusions without considering the apparent absence of supervision of UTI, the actual safety (as compared to perceived and disclosed safety) of investor funds with UTI, the rate of return investors have been able to obtain, the potential benefits to investors of a private industry or experience in other Asian countries with similar state controlled funds. He has made these arguments to top policy makers; it is unclear how much weight his views will be given.

Private entities who anticipate forming funds believe they will be able to compete with UTI even in the absence of a level playing field. Some have expressed the view that the regulatory issues concerning UTI will be addressed and that there will be a more level playing field in the future.

2. Required Infrastructure

A new mutual funds industry will require operational systems. The normal strategy followed by either closed-end or open-end funds in the start-up stage of operations relies heavily on the use of outside vendors to support fund operations.

The most important and most difficult of these functions to develop internally are custody of fund assets and shareholder accounting and transfer agency services. Portfolio accounting is a function which often is contracted out to third parties. Legal services and independent accounting services also are necessary for the support of mutual fund operations.

All that remain to be handled internally by investment management companies are portfolio management, product development and marketing. One would expect management companies to be willing and able to develop the staff and facilities needed for these purposes, from both local and foreign sources, provided sufficient profits may be anticipated.

B. USAID Role

The mutual funds industry in India is at a turning point as the private sector enters the market. A regulatory structure has been framed, although some adjustments are likely to be required to adapt it to the market. The change in the industry results in a need for exposure by private sector market participants who will operate funds and by SEBI to the methods of operating mutual funds. In addition, there is a need to educate the investing public. UTI may also be required to restructure its operations and may need assistance in doing so.

1. Private Sector

If the opportunity for profit is sufficient, the private sector is likely to acquire the needed advice on its own. In some other emerging markets, private entities that have desired to acquire this knowledge have formed partnerships with foreign firms that are in the mutual fund business. Some Indian firms are considering doing this; others have indicated the desire to avoid the high management fees required to do so. In a less developed market, it would be appropriate for USAID to provide such assistance to private sector participants. USAID assistance to private sector market participants in other countries has been justified on the basis that:

(a) the purpose of the provision of the cost subsidy to such institutions is to innovate new activities in the field of financial markets and improve the functioning of the market,

(b) the costs of the management technology may be considered prohibitive by the institutions in relation to their perceived benefits at the present time

(c) the techniques established would be expected to be adopted by the larger financial community and the benefits would effectively be passed beyond the initial target institutions, and

(d) having experienced professionals in key decision making slots in these organizations would reduce the risk levels associated with new financial instruments and avoid costly errors during their introduction stage. However, the Indian market is sufficiently advanced that private sector participants should have the resources to acquire the knowledge on their own.

Nevertheless, as part of the public education efforts proposed in other sections of this report, seminars would be useful to support the process of developing awareness in mutual funds and international techniques that might take longer to be introduced in the market by the private sector on its own. Initial general seminars directed at both SEBI and market participants could include the following topics:

- Addressing liquidity problems: hybrid mutual funds (a closed-end fund that allows periodic repurchases);
- Marketing strategies;
- Managing closed-end and open-end funds;
- Pricing funds: sales charges, management fees, total expense ratios;
- Investment portfolios;
- Operational infrastructure.

2. <u>SEBI</u>

In order for SEBI to carry out its regulatory role properly, it is essential to train SEBI personnel generally about mutual funds and portfolio management and specifically about methods of inspecting funds. Small group training sessions with a mutual funds expert would likely be the most effective method of training staff initially. In particular, it would be helpful to have a mutual funds inspection expert train SEBI personnel. These types of training could be incorporated into the overall training program that is expected to be designed for SEBI.

3. Public Investors

As discussed in other sections of this report, Indian investors are accustomed to a securities market that provides risk-free returns. Although the public has some experience with public sector mutual funds, there will be an educational process required both to redirect funds from direct purchases into mutual funds and to evaluate funds that provide alternatives to UTI. Methods of educating the public about the change are described in the "Regulatory Development" and "Investor Association" sections of this report.

4. UTI

In connection with the controversy about subjecting UTI funds to SEBI authority, discussions have taken place about the need to separate UTI's institutional operations from its mutual fund operations. We considered the possibility of providing consultancy assistance to UTI in effecting such a reorganization. While we would not rule out this possibility depending on developments in the industry in the next 1-2 years, the future of the industry should be with the private sector, and it therefore would seem most appropriate to focus attention on this sector. Providing assistance to UTI might be analogized to assisting Indian Airlines to restructure now that there are private sector airlines. On the other hand, if privatization of UTI were considered, providing assistance to the process would be worthwhile.

C. Conclusion

In the future small investors are likely to find that they can best participate in the market through mutual funds. Accordingly, assistance to develop that industry is an important element of an overall capital market development plan. As India transitions from public sector to private sector funds, there is a major need for training in India about operational methods and marketing strategies. This training should be focused on private sector investors, SEBI and public investors.

V. IMPROVING THE OPERATING ENVIRONMENT OF THE MARKET

A. Clearance, Settlement and Depository Systems

The problems with India's current clearance and settlement systems were identified in the Report of the High Powered Study Group on Establishment of New Stock Exchanges, dated June 30, 1991, reconfirmed by a team of Price Waterhouse international experts and appropriate recommendations were made in the Price Waterhouse publications produced during the period April 1992-December 1992, and again by additional review in February-March 1993. The conclusion is always the same, viz. Address the Clearing and Settlement problem in the capital markets of India. because the settlement systems of today are unacceptable and not in keeping with 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 center 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 two weeks 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 at the end of the settlement period are required to be settled by actual delivery in the case of non-specified shares. While member payments are effected through the clearing house by checks, the deliveries of securities have to be physically made directly between members on the basis of delivery orders issued by the computer center of the exchange. Hence, the paper work is enormous.

4. Pay-out Problems

Settlement by the BSE is between exchange members. It is for each member to 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, the buyers of securities have to lodge them with the companies concerned or with the companies' registrars or transfer agents to get the ownership of the securities transferred into their names. This involves considerable time, often months.

6. Problem of Bad Deliveries

Undue delay and agony may be caused to buyers of securities due to "bad delivery." Currently 8-10 per cent of the total deliveries are "bad." 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 of the date-stamp placed on the transfer form 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 problem of bad delivery. Attempts to correct the problem of bad delivery have not been effective.

7. Paperwork Gridlock 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 checks/drafts and not through electronic transfers. The present 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.

8. Payment Systems

In 1992 Price Waterhouse recommended as part of the design of the National Depository System that the Reserve Bank of India inter-bank payments system be utilized for funds settlement. This settlement would be accomplished on the same day that the net due to and due from amounts would be published to depository participants. Several visits with RBI officials had convinced us that with the establishment of appropriate priorities and establishment of an RBI account for SHCIL, there should not be no great difficulty in implementation. This recommendation caused some surprise because of the reputation that check clearance has for slowness in India. We did not, however, envision using checks for this process, but rather wire transfer.

At the time of our fact-gathering in 1992 the RBI was in the process of implementing an even faster payments system called "Banknet" that would be the equivalent of the U. S. "Fedwire" system operated by the Federal Reserve banks. It is important to note that our recommendation was in no way dependent on the implementation of Banknet.

As part of the F.I.R.E. project we determined to revalidate our findings of last year. Visits to several RBI officials confirmed the ability of their system to handle funds settlement on the same day instructions are received from member banks. Further, the Banknet system is now implemented in Bombay, Calcutta, Delhi, Madras, Nagpur, Bangalore, and Hyderabad. The plan is eventually to service all of India. In addition to funds transfer the plan is to add GOI securities movement to the system, permitting delivery versus payment book-entry settlement on trade date if desired by the contra-parties or rules.

In our opinion the RBI appears to be doing well with its funds transfer development and is not in need of any assistance.

Expert advice, however, would be very useful in connection with the detail design and implementation of the specific payments system rules and procedures during the implementation of the National Depository System. There is a discrete piece of work to design the method of notifying participants of their net due to and due from settlement amounts and then actually using the funds payment system on a test basis to insure that all entities involved (participants, participants' bank branches, their banks' head offices, the RBI, and SHCIL) are capable of executing the funds movement on an immediate basis. Implied in this is a training component so that after testing, all involved personnel can operate the system unassisted.

Resources necessary are approximately seven to eight man- months of assistance, deployed as follows:

- One person for a month of detailed design.
- One person as coordinator for six weeks located in Bombay who would relate

to the SHCIL and RBI head offices as well as to the road implementers.

- Four road implementers, each of whom would spend one week each in five or six key cities relating to participants and banks. The cities would tentatively be the locations of the stock exchanges, inasmuch as those locations represent the centers of financial interest and, therefore, of the trading activity that would generate the need for funds settlement.

9. Recommendations

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.) India does not have a very good record against these standards. While there are nine recommendations made by the Group of 30, we shall concentrate 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 equity and corporate debt 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 Final Report on the National Clearance and Depository System, dated May 24, 1993.

B. Technical and Industry Assistance

This 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 affording 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. Given the time schedule of the NSE, it is recommended that industry and technical assistance be afforded SHCIL no later than September 1993, to assist it in sorting out the changes that the SEBI, MOF and NSE have upon the NCDS functional specifications since their original writing. The final design of the NCDS called for a total of thirty six man months spread over the period September 1993-September 1996. This amount should be sufficient to address the issues where experience is lacking within SHCIL. In addition, this level would also permit the design of the NCDS to be modified to accommodate new instruments such as corporate and government debt into the design.

1. Education and Training of SHCIL Staff

Technical assistance should be given to SHCIL to assist it in the development of courses for education of its staff personnel who at both the SHCIL central office its vault locations and branch locations. Again, the Price Waterhouse study dated May 24, 1993 contains the detail educational assistance required. The cost for this element was targeted at $1,029,000. We recommend that SHCIL be supported for 75% of this amount, or $750,000. The remainder can come from SHCIL and GOI contributions.

2. NCDS User and General Public

It is also important for the NCDS to train its users how to use its operating system. Considering there will be an estimated 4,000 plus users of the system, this training need presents NCDS with its biggest training challenge. It is recommended that the branch network systems and operations training be expanded to include NCDS users. Branch training will be conducted by a team of 10 "road show" trainers. The trainers, working in 4 teams of 2 and 2 working individually, will travel to branch locations and coordinate start-up training. This training program is projected to take up to a year to complete.

During their visits to the remote sites, they will conduct well publicized open enrollment seminars for users. This approach maximizes use of existing staff, utilizes the same training materials used for branch office staff, and minimizes expense.

The investing public is best educated through a mass media approach. It is recommended that NCDS training manage the production of informative video tape and accompanying brochure for distribution to exchanges, brokers, NCDS branch offices, professional organizations, banks, etc. The tape would cover such topics as the NCDS Charter, how it works, value to the financial sector and how interested participants should go about finding out more information. The video should be approximately 20 minutes in length, be scripted to an audience of non-financial professionals, and in a narrative format. The narrative format allows for voice-over dubbing which enhances translation into other languages.

Cost for this Activity is estimated to be $650,000, of which it is recommended that the F.I.R.E. project contribute $500,000, the remainder to come from SHCIL and GOI contributions. For a more detailed breakdown see Appendix F of the Price Waterhouse report dated May 24, 1993.

3. International Training

This training is meant for key executives and managers who will participate in international seminars or serve internships with operational depositories or clearing corporations. Such programs afford key managers the opportunity to learn from industry experts, make valuable contacts and promote the NCDS. Key managers can also 'learn' through doing" in fully functional state-of-the art depositories. The cost for this activity is estimated at $200,000. For a more detailed breakdown see Appendix F of the Price Waterhouse report dated May 24, 1993.

N.B. These dollar figures are subject to change depending upon the SEBI, MOF and NSE impact on the SHCIL basic infrastructure.

C. Conclusion

USAID is an excellent position to assist SHCIL in development of the NCDS through both technical assistance in industry expertise plus underwriting the education of both SHCIL personnel and the investing public. The mission of SHCIL is to attack the current sorry state of clearance and settlement in India. The need for an NCDS institution is unquestioned by all involved in the capital markets. SHCIL as the facilities manager for the NSE must not fail in its mission and USAID should do what it can to assist SHCIL.

VI. NATIONAL MARKET SYSTEM AND STOCK EXCHANGE TRANSPARENCY

A. Background

While many participants in the capital markets community have the idea that a National Market System (NMS) is a good idea whose time will eventually come, no one seems to have a precise idea of what is involved. The questions that need answers have not been identified, and the agreements that are required are only vaguely understood. Nevertheless, NMS remains a valid goal for the Indian securities markets but it must be approached in steps. The best example of a NMS is the United States. At the start, there were only four trading floors to be linked. In addition, all four functioned under a specialist system which provided a two way quote (buy/sell) for each listing. Thus, the goal of the NMS could be precisely understood as providing the "best execution" to the buying or selling investor, wherever that price was quoted. The Indian stock exchanges, however, operate on an "open outcry" system, which does not provide a quotation or buy or sell price. They can only report the last sale price. Thus, under the current situation, an NMS could not offer "best execution". Indeed, given the current lack of transparency in the trading operations of these exchanges, it is doubtful that an NMS would offer any advantage.

There is a great deal of cost in infrastructure and cultural change required to implement this system across multiple exchanges. We recommend that the real problems of transparency on the existing exchanges be resolved first before an NMS is put in place. This could be done in the form of offering technical assistance to the regional exchanges that are willing to change, along with training of their operating staff. After each exchange is producing transparent price reporting, it will be appropriate to consider NMS.

The primary impetus behind the US Congress passing the legislation that created the NMS was the then current and predicted market fragmentation which denied the investor the best execution price. That is not the case in India where most regional exchanges are still truly regional and not actively trading in the same security as another exchange. What trading there is in common issues is primarily restricted to the five largest exchanges. While we already know that the presidents of 20 stock exchanges met on September 25, 1992 and ratified the setting up of a NMS under the aegis of the Stock Holding Corporation of India along with the capital adequacy norms for the brokers of all the exchanges, we do not think that the NMS need include all exchanges at once.

The objectives of a NMS will always be the same regardless of country. They are as follows:

- fair competition among all brokers and dealers;
- the efficient execution of securities transactions at "best execution";

- enhancement of a broker's ability to execute customer orders in the best market;

- the availability to brokers, dealers and investors of information with respect to quotations for and transactions in securities;

- an opportunity to execute customer orders consistent with the preceding goals and without the intrusion of middlemen in the process;

- maintenance of a stable and orderly market with maximum capacity for absorbing trading imbalances without undue price movements.

New data processing and communications techniques make this a now more than ever achievable goal for any country interested in achieving an NMS. It is in the public interest and appropriate for the government to afford protection of investors and to promulgate the necessary laws which advance this cause through effective and efficient market operations espousing the principles stated above. The linking of all markets for "qualified" securities through communication and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investors; orders, and contribute to best execution of such orders. The term "qualified" is defined as a security agreed upon to be traded both in a primary market and one or more secondary markets. A market need not be an exchange but rather anywhere that a trade takes place.

Two major components are required to achieve the objectives. All trades executed in the qualified securities must be recorded and made available electronically, in sequence for dissemination to all interested parties. This will be a quantum leap in addressing the multi-faceted transparency issue at these exchanges. And second, there must be an automated screen-based trading system in place which too makes available electronically relevant trade information in keeping with the trading scheme(s) designed into the system.

B. Recommendations

While the objectives of an NMS system are in keeping with the goals as set out in the PID, it is recommended that the F.I.R.E. offer to work first with the individual exchanges to resolve transparency problems, and then to create a consolidated tape among those participating exchanges. We believe that this will be consistent with the objectives of the stock exchanges of India which will all be busy trying to upgrade their trading facilities. The Bombay Stock Exchange is already engaged in trying to automate its trading. Direct assistance to implement an NMS should therefore be deferred until the above objectives have been accomplished at least at the major regional exchanges. It is expected that this would occur only in year four or five of the F.I.R.E. program.

C. Conclusion

The need for a NMS in India is indicated because of the market fragmentation witnessed today by the arbitrage which currently exists between the five major stock exchanges. This inequity born by the investor will continue until complete transparency is assured in the trading of securities, and the qualified securities are placed under a NMS. The alternative, of course, may be that a single stock exchange could achieve a monopoly. The candidates could be either the newly proposed National Stock Exchange (NSE), or the Bombay Stock Exchange (BSE).

VII. NATIONAL STOCK EXCHANGE

A. Background

The National Stock Exchange (NSE) will be operated by a newly formed company called the National Stock Exchange of India Limited (NSEIL). As an organization the NSEIL is a company promoted by the leading financial institutions and banks in India. These are:

- Industrial Development Bank of India;
- Industrial Credit and Investment Corporation of India;
- Industrial Finance Corporation of India;
- Life Insurance Corporation;
- State Bank of India;
- General Insurance Corporation;
- Stock Holding Corporation of India Limited;
- Infrastructure Leasing & Financial Services Limited;
- SBI Capital Markets Limited.

The NSE today is radically different from the National Stock Market System advanced by M.J. Pherwani in mid-1991. The report of the high-powered committee that he headed had outlined a three-tier structure: five principal stock exchanges in Bombay, Delhi, Calcutta, Madras and Ahmedabad; 21 regional stock exchanges in smaller metros; and additional trading floors as the third tier of the system--all of which would be networked. Besides, there would be a model exchange in New Bombay, called the NSE, which would create a secondary market in debt instruments and list medium-sized companies too.

All this has now changed. IDBI's Chairman, S.S. Nadkarni is quoted now as saying that "Pherwani's idea was just a seed of an idea". Nadkarni is now proposing a truly national exchange which will allow anybody to trade in shares from anywhere in India. In the first phase expected to be operational on "December 31, 1993", the NSE will see trading in inter-bank call money market, government securities, and public sector undertaking bonds. Later, private sector debentures will be added with equity trading by mid-1994.

The NSE, based upon its goals and objectives, has the potential to make the National Stock Exchange and the National Market System one and the same. From the purist point of view it holds the promise of the totally unfragmented market with the greatest likelihood of best execution price, and price transparency. In order to achieve these goals, it would have to eliminate the trading of dually traded securities on the other exchanges. This would have, at a minimum, the effect of reducing the Bombay Stock Exchange to an exchange of regional stature. However, the competitive responses of the exchanges is yet to be seen. It is possible for them to respond by improving their transparency to the investor, or perhaps implementing market maker or specialist services which could attract the investor. The increased competition would only benefit the investor.

In any case, the NSE has a strong sense of direction for the next year's activities. As they open their system to trading vehicles beyond those currently specified, additional knowledge of these new trading vehicles and their attendant requirements, will have to be absorbed cleanly into what will then be a very sophisticated environment. There will be a great need for training of staff of the NSE as they get into operation.

Already the memorandum of understanding and the articles of association of the NSEIL have been signed, its regulations have been cleared by the SEBI and its board has been constituted by the IDBI. Government clearances are predicted by Nadkarni to soon follow. The NSEIL board has set up three sub-committees to expedite the implementation of the exchange and decide upon the NSE's operations and systems; its infrastructure and administration; and membership norms. This is the fastest moving locomotive that the consultants have witnessed since they began working in the Indian Capital Markets beginning with the technical assistance given the OTCEI commencing in March of 1992.

An RFP has already been released to vendors of trading software systems. A review of the RFP reveals a system which if implemented as requested, will provide India with the following:

- a nation-wide trading facility for the Money Market and Capital Market;

- the latest in electronic trading systems and book-entry settlement to provide a securities market of unsurpassed efficiency and fairness to investors;

- a system that ensures investor protection through speed and quality of services;

- a system that provides risk management both of a systemic nature and participant failure risk;

- a system which will attract the foreign investor.

While these objectives are general in nature they are supported with specifics as follows:

- Automation of the trading function;

- market quality will be optimized by pooling orders from all trading members to maximize the opportunities for orders to be exposed to counter-parties;

- the market will be easy to monitor, control and regulate;

- the system will be able to be accessed nationally;

- The market will be an order-driven market and as such will not require market makers to give two-way quotes continuously. Orders from the trading members, who can be located across India, will be concentrated in a centralized trading system to be matched automatically according to price/time priority;

- Trading will take place from 10:00 a.m. to 2:00 p.m.

- Settlement will have a rolling settlement cycle with book entry settlement taking place in one of three places, viz. RBI, SHCIL or UTI, depending upon security type.

- Last sale prices will be available over the NSE's terminals and in addition will be broadcast by the Press Trust of India and Reuters through infoterminals

In response to the question "what if you built a stock exchange and nobody came?" Dr. Patil of IDBI declared that all the major stock brokers have said that they will want memberships in the NSE.

B. Recommendations

It is recommended that the F.I.R.E. project support the establishment of the NSE through technical assistance and training. The most immediate need mentioned by the Vice President of the NSE is for staff training. It is recommended that a level of funding of about $75,000 to $100,000 per year be provided for training during the course of the F.I.R.E. project. In addition, technical consultancies should be provided to assist with such issues as futures and options. At a minimum, the Chicago Board Options Exchange and the Chicago Mercantile Exchange should be engaged in effecting a technology transfer. This program would be coordinated by a U.S. based management consultant with Indian Capital Markets experience. The first phase of the program would be the design of the program itself. The program itself will require visits by Indian executives to the United States and the United States cooperating executives should visit India. This will be beneficial for understanding and idea exchange plus the setting up of the bond between the corresponding capital market entities. Internships for key employees of the NSE and SHCIL would also be required. The anticipated project expenses would be as follows:

- $360,000 for approximately three man months of expert consultancy for each of four years of the program;
- $100,000 Travel and living expenses for ten executive trips;
- $120,000 Travel and living expense for ten internships;
- $280,000 for staff training in India of NSE staff.

VIII. THE OVER THE COUNTER EXCHANGE OF INDIA (OTCEI)

The OTCEI has been operational for about 14 months at this writing. During that time it has listed about 25 new equity issues, and has implemented a unique market in India to list specific debt issues.

The uniqueness of this market lies in its concentration on the problems of small company finance. Only companies with net worth below that required to list on the major exchanges are eligible for listing on the OTCEI. This makes the market an ideal exit for venture capital companies. In fact, this is what happened with the first listing on the exchange. The venture financier sold its holding in a company that it had helped to start up only two years ago. The OTCEI opens a new and unique avenue to finance for small and medium companies.

USAID has made technical assistance available to the OTCEI during 1992, as the market was organizing itself. This assistance helped with the business strategy of the market, and its regulation. For the future, the OTCEI plans further expansion out of Bombay, into other cities of India. A significant challenge lies ahead of the staff and members of this market.

The OTCEI began its operations with the best regulatory framework extant in the Indian markets. High standards of ethical behavior are set by the exchange members, and organized self regulatory committees are charged with responsibility to enforce them.

The details of the OTCEI development plan are contained in the Price Waterhouse report of April, 1992. The F.I.R.E. program offers an opportunity to follow up with the needed technical assistance in regulation, and screen-based systems, and most important in the training of OTCEI personnel.

IX. The Debt Market

A. The need for clarity

There appears to be no consensus among writers in the Indian markets on the use of such terms as "debt", the "debt market", and "debt instruments". In order to target potential assistance precisely for optimum effectiveness, it is essential to first specify the definition of these terms as they are understood internationally.

1. Debt

What is debt? It is any commercially made loan of money. It does not include a loan from father to son or brother to brother, but it does include bank deposits, postal savings deposits, fixed deposits, call money, debentures and many other instruments and forms. There is a tendency for some persons to focus on only certain types of debt, overlooking the whole picture, thereby potentially distorting their analyses.

2. Debt Market

The debt market, therefore, very simply consists of (1) the acquisition of money commercially with the intent to repay, granting interest and possibly other benefits as an inducement, and (2) the subsequent purchase by third parties of evidence of that debt. Included in this category, incidently, are repurchase agreements--"repos", for short--(or ready forward agreements as they are called in India). While technically these are sales and repurchases, rather than loans, from a legal point of view, repos are loans from a business point of view. Also included in this definition, therefore, are switches (swapping debt instruments) and double ready forward agreements (repos of switches).

3. Size of Debt vs. Equity Markets

One result of writers' focusing on only fragments of the debt market is the notion that equities, rather than debt, are the larger of the two elements of the capital market. In fact, a complete definition of debt allows us to see that debt dominates by orders of magnitude. TDL (time and demand liabilities) of the banks alone exceed two trillion (or two lakhs crores, if you prefer) rupees. TDL is the basis of the CRR (cash reserve ratio), which drives the call money debt market, and the SLR (statutory liquidity ratio), which is a major driver of the bond market.

Consider this statistic: Equity issues peaked in 1993 in February at Rs.640 crores (June was only Rs. 174 crores) while 14 state governments are issuing Rs. 1200 crores worth of ten-year bonds in July. In other words, only one bond issue is nearly twice the size of the biggest total equity month this year.

4. Capital vs. Money Markets

Another anomaly is the confusion in definition of capital versus money markets. Some writers define the money market in India as a short-term market; others include long-term debt such as twenty-year gilts. There appears to be no consensus. Given goals of improving capital market transparency and likewise stimulating a secondary debt market, distinctions between the money market and the capital market are not seem useful and this paper will deal with the entire debt market from short to long term.

5. Other Definitions

Other definitional confusion clouds discussion of the debt market. Short-term inter-corporate borrowings are sometimes called "call money", though strictly speaking call money is borrowed by banks exclusively (by definition).

The term "secured" (debt backed by assets) is used interchangeably with "securitized" (evidence of debt underlying another evidence of debt), thereby ignoring that securitized debt is only one type of secured debt.

Failure to distinguish the primary from the secondary market is another problem in discussion of the debt market (and to a limited degree of the equity market as well). As discussed in the third paragraph above there are two elements of the debt market-- 1.) the lending of money which is the creation of debt, and 2.) the subsequent purchase of the evidence of that debt. The former is called the primary market and the latter the secondary market. Papers complaining about the lack of a debt market in India, or the need to stimulate one, often do not make clear if they are referring to both markets or just one. The significance of this lack of clarity will be discussed later in this analysis.

To make matters a little more confusing there is another set of definitions for primary and secondary market, used in discussing stock exchanges (where, of course, debt is also traded): The primary market for dually listed issues is the biggest stock exchange trading them, while the smaller markets are called secondary markets. In the Indian context, the Bombay Stock Exchange is the primary market; the others are the secondary markets. This definition is relevant in certain contexts such as discussion of the development of stock exchange specialist systems or a national market system, but in this debt discussion the definitions of the preceding paragraph will be used.

One final point of clarification is indicated: Debt is debt, even if at some later time it is convertible into equity. Some writers seem to feel, for example, that convertible and partially convertible debentures are really to be thought of more as equity rather than debt instruments. They are, however, clearly debt instruments with features that make them more attractive to the prospective buyer.

B. Structure of the Debt Market

1. Classification by Borrower

Below is a classification of the issuers of debt (in other words, borrowers) together with some of the types of evidence of their debt (in other words, instruments or forms) that may further help to define terms in such a way as to aid analysis:

- The central government of India (as a whole entity).
  - Treasury bills (under one year)
  - Dated gilts (long term; typically 3 to 20 years).

- Central government departments (as distinguished from the central government as a whole and central government-owned enterprises). Examples include:
  - The post office
  - The Reserve Bank of India
  - Postal savings
  - Provident Fund special deposits

- State governments.
  - Bonds

- Central government-owned enterprises. Examples are some banks and the railways, as well as the Delhi and Bombay telephone companies.
  - Bonds

- State government-owned enterprises. Examples include the electric utilities.
  - Bonds

- Commercial and other banks, which are in either the public sector or private sector.
  - Call money
  - Demand deposits
  - Participation certificates
  - Certificates of deposit
  - Repos

- Financial Institutions. Examples include IDBI and ICICI.
  - Bonds

- Private sector corporate bodies
  - Debentures
  - Fixed deposits

Commercial paper
Inter-corporate deposits
Trade bills

Note: The above list is not intended to be exhaustive for instrument types. Also, there are transactions related to the debt market, which strictly speaking are not sales of debt instruments, such as transactions in UTI '64 units by banks for liquidity purposes (not valid for satisfying the SLR requirement) and switches (the swapping of debt instruments).

2. Classification by Lender

Another way of looking at the primary debt market is by lender, rather than borrower as in the prior section. Lenders with investible funds represent the supply side of the primary market (i.e. the demand for attractive instruments). In the interest of brevity the lenders will be divided into two categories:

The Retail market. Examples are individuals, husbands and wives jointly, and Hindu Undivided Families.

The Institutional Market. The institutional market can be thought of, broadly speaking, as aggregations of the public investing (lending) through intermediaries. Thus, when lending rather than borrowing, the eight classes of borrowers listed above are institutional lenders. Mutual Funds, though not specifically cited above, are important Financial Institution lenders, as are Provident Funds, and charitable trusts.

It is obvious that each type of instrument may POTENTIALLY have lenders from each of the two categories. Why, in practice, they do not will be discussed below.

C. The Secondary Debt Market

The secondary debt market as defined above can be classified in several ways, which will be helpful in determining future action.

The market for each instrument or form of debt to determine can be classified as one which has:

- Little to no secondary market; e.g. PSU bonds, or
- An active secondary market; e.g. call money.

Thus, a broad statement about the lack of a secondary debt market in India without indicating the instrument(s) being discussed would be meaningless. It is simply not true that there is no active secondary debt market in India, although that market might not cover as many instruments as may be desirable.

Another classification of the secondary market is that for each instrument having an active secondary market, who are the players? These may be divided broadly between retail and institutional as defined above. Often when the statement is made that there is no secondary market for a given instrument, the writer really means that there is no active retail secondary market, such as the treasury bill secondary market.

1. Exchange Markets vs. Telephone Markets

Another classification of the secondary debt market where it exists is whether it is exchange-based (whether electronic screen-based like the OTCEI, or with ring or floor like Bombay does not matter) or telephone- based. Contrary to the assumptions behind what one often reads, the debt market that exists today is for all practical purposes telephone-based, and any attempt to deal with stimulating or improving the secondary debt market must recognize that reality. Only corporate debentures are listed on exchanges and there is very little secondary market trading in them. Stimulating that market may be a worthwhile goal (to be discussed later in this report); the point here is that stock exchange-based trading, even if active, would still be a relatively small part of the debt market, as is true in other country's financial systems.

One final classification of secondary market trading where it exists either on an exchange or in a telephone market, is by type of trading system:

1. order driven, in which all buy and sell orders are compared as they are entered into the system; if they match on terms and size, they are executed. There is no market maker; or

2. quote driven, in which market makers offer continuous buy and sell quotes, allowing investors to see the market price, and depth of the market before they buy/sell, or

3. both, in which both systems co-exist in the market.

Any of these classifications is potentially workable, depending on market characteristics such as size, players, geographical dispersion, and so forth.

There is one point, however, specifically to be made in this connection. Many writers have suggested that the absence of market makers is the reason that there is no active secondary market. This is an unproved assertion. The National Stock Exchange is planning to trade non-corporate debt instruments on an order driven basis and there is no reason why the absence of market makers means they are doomed to fail. Market makers will enter the market place when the environment encourages them to do so profitably, but their absence does not automatically lead to a thin market. Indeed, many active vibrant markets throughout the world operate on an order driven basis.

D. The Issues Involved

What difference does it make? The discussion above is all by way of introduction to the central issues. What difference does it make if we do nothing? Is the debt market in India contributing to slower economic growth? If there is a problem, is it in the primary market, secondary market, or both? Does the problem affect all instrument types or just some? Is the problem with institutional players, retail players or both? If there are problems, will they go away by themselves (through natural market forces) or not? Can some specific things be done to expedite alleviation of the problems? The rest of this discussion will be devoted to dealing with these issues.

Yes, it does make a difference. The bottom line is that any time there are distortions in the secondary market, such as no active market for some instruments, some potential players not allowed to trade, and so forth, there is a corresponding distortion in the primary market. Distortion in the primary market means suboptimum rationalization in the acquisition and deployment of capital with corresponding potentially lower profits, lower sales, and lower employment. This is true even, as is the case in India, there appears to be no problem in marketing primary debt issues. The fact that, for example, there is more incentive to turn to the equity market for fresh capital or to offer optional equity incentives that may not be in a corporation's shareholders best interests is the direct result of (for whatever reasons) the lack of a secondary market in corporate debt. Many other examples could be cited: the captive market in gilts, interest rate repression, restriction on both foreign investment and foreigners' investing in Indian instruments, restrictions on provident fund and charitable trust portfolios, are just the tip of the iceberg. The conclusion here is not to favor a totally uncontrolled marketplace; rather it is simply stating that the freer and more robust the secondary markets are, over the long run, the healthier the economy will be.

To the extent that India, therefore, has constraints on potential investors' judgement, the result will be to inhibit the development of its capital markets. A process to review and revise these restrictions would be desirable.

Fortunately, as discussed below, the constraints can be identified and positive programs can address many of the problems. Also, it is not essential to change any government economic policies in order to obtain substantial improvement, especially in the debt market (although it would certainly be desirable).

E. Demand Side Constraints

There are three broad categories of constraints preventing secondary debt market development to optimal levels. It should be noted that these are all constraints on demand for debt instruments. There is no demonstrable shortage of debt instrument supply.

1. Governmental - laws, regulations and policies that distort the free market. (The issue of whether the free market should be distorted because the alternative is worse is beyond the scope of this paper.) The most glaring example is the artificial cap on government securities interest rates. Other examples include forcing banks to buy securities that meet government requirements, regardless of whether it makes economic sense for the banks to do so, permitting only the RBI to invest in foreign bonds, restricting the government securities eligible for repo agreements, severely restricting provident fund investment choices, sponsoring and funding a specific stock exchange to trade in certain debt types rather than opening the marketplace to competitive forces with the government insuring fairness for all players, and permitting accounting rules that allow banks to overstate the current market value of their bond portfolios.

2. Cultural--characteristics of the Indian people that influence their investment choices. Among these characteristics (which obviously vary by individual) are preferences for keeping cash rather than investing in securities, a dislike of debt as an institution, a preference for debt instruments that are both liquid and have guaranteed principal repayment at any time (as contrasted with instruments that are liquid but in which the principal amount varies prior to maturity), preference for the perceived capital gain opportunities of the equities market, lack of knowledge of the debt markets (even when theoretically open to them, such as government debt auctions) and profound distrust of brokers.

3. Infrastructure - the mechanical characteristics of the securities markets in general, and the secondary debt market in particular. Among these characteristics are a generally-disorderly telephone market, lack of disclosure about prices and sequence of trades, the lack of disclosure of the existence of a market (the eligibility of the public to bid at RBI auctions and the alleged willingness of the RBI to maintain individuals' accounts), lack of a modern book-entry delivery system and depository, lack of a modern settlement payment system, lack of regulation assuring honest broking/dealing and the difficulty of access by the retail customer to the marketplace.

At this point it would be well to state something that is often suggested as a problem in the Indian debt market that is really another myth: the notion that lack of more instrument types than currently exist, especially the modern creative kind, like mortgage-backed pass-throughs (example in U.S.--Ginny Maes), inhibits the growth of the debt market. This idea is sometimes presented as an opportunity for Western assistance as if the Indian securities market players would or could not invent instruments that meet their needs, and what is more, did not stay up with what is happening in foreign securities markets. No one who has read the Pherwani report dealing with this subject could fail to be impressed with the catalog of prospective security types presented therein. The fact is that the Indian debt market today has two security types virtually unknown in the United States: non-financial company fixed deposits, and debentures with intermediate partial call dates. Also, the Indian marketplace has created innovative instruments to stimulate demand by specific investor groups; the deep discount bonds marketed to over one million customers by JM Financial are an example. The real issue here is that with the desirable loosening of government restrictions will the marketplace bring forth too many instruments for the investing public to keep up with, rather than not enough.

F. Recommendations

There are many specific projects that can be undertaken to address the constraints addressed above.

First of all, however, this paper will not further address the governmental constraints. They are the most well-known and are addressed in GOI discussions with the World Bank and the Asian Development Bank in connection with their Financial Sector Loans. In many cases it appears from policies adopted and statements made that the Indian government has already begun the process of change. This is clearly the case with interest rate policy for government debt (gilts). It does seem clear that the GOI is moving cautiously to inch closer to the market rates. With each such move, the markets show evident interest; and there is general agreement that the rates on new issues of gilts are becoming more attractive. The focus, then, should be on cultural and infrastructural projects. As suggested above, these can proceed regardless of the governmental constraints.

1. Develop the National Clearance and Depository System as proposed, plus broadening the scope to include all debt instruments. In the absence of one agency becoming the depository for all securities a pattern of depositories by security type will likely develop. The RBI will be the gilts depository, UTI will maintain the depository for transfer of fund units, SHCIL for equities and so forth. There are two things wrong with this development--the obvious one is creating unnecessary overhead by depositories with separate managing directors and other executives. The other problem, while subtler, is actually worse. Each depository will require its own participants fund plus the collateral backing payment will be fragmented. The result of the stretching of participants' capital will be to constrict the market unnecessarily simply because of the mechanics involved.

2. Create an all-India International Security Identification Number (ISIN) compatible Securities Identification Number (SIN) system. This should

be done even before starting the detailed work on the NCDS, and would be necessary even if there were no NCDS. Two related tasks are necessary:

a. Create a parallel financial institution numbering scheme, and
b. Standardize securities related message formats compatible with ISO standards.

3. Implement sequential last sale reporting, with locked-in trade (where possible) for every stock exchange in India which does not have an independently funded program already well under way as the Bombay Stock Exchange reportedly has. This improved transparency will initially benefit the equities market, but given the listing of corporate debentures on the exchanges, it should improve the secondary debt market as well.

4. Implement a time sequenced composite tape so that all executions in a given security will appear on one tape, regardless of the exchange of execution. In order to accomplish this, each exchange will have to feed this information to all interested information vendors. This will greatly improve transparency in both the equities and corporate debt market.

5. Implement a telephone market last sale and quote (where available) reporting service for debt instruments. At least one quote vendor has already made a start on this, but there is much to be done. Also, other firms will likely be interested. This project will provide transparency in the debt market similar to the proposed projects for stock exchanges. As part of this project, when NSE starts trading in governments and other debt securities, the telephone market reporting should carry the NSE prices; in other words, a debt composite tape.

6. Promote development of a telephone market Self Regulatory Organization (SRO) comparable to the Stock Exchanges SRO responsibilities governing their activities. This would involve not only broker-dealers' ethics (the topic usually associated with SROs) but also trading and delivery rules.

7. Assist the Investors Associations, Industry Associations and SEBI to educate the public about government debt, including establishing easy

access to participating in primary offerings, and access to a transparent secondary market.

8. Implement a series of middle-class oriented seminars in investment, with particular emphasis on variety of choices and the risks/rewards potential of each.

9. Promote the development of a research service which publishes data about every entity (other than the government) issuing securities to the public. The publication would be in summary form updated quarterly. The Standard & Poor's yellow sheets would be the model. This should help transparency and encourage through the data presented more knowledge of the debt market on the part of the investing public.

10. Fund courses for corporation treasurers and financial officers in money management, with special emphasis on equity versus debt considerations in financing their business. The idea here is to stimulate debt offerings where they are preferable to equities. The course, perhaps by the UTI Institute, should also include considerations of choices in investing excess cash, which again is debt-oriented education, this time on the lending rather than borrowing side.

APPENDIX A

Proposed Program to Test, Certify and License Brokers, Underwriters, and Mutual Fund Salesmen in the Indian Capital Markets

1. Problem

While all brokers are required to obtain a license from SEBI, there is as yet no requirement that the broker prove his competence by passing an examination. Moreover, the broker's sales personnel who interact with the public are not required to be licensed, and also do not have to achieve certification of competency through the passing of an appropriate examination.

2. Program Prerequisite

The first step in implementing such a program is to publish a rule applying to all personnel in the market who act as brokers, underwriters, mutual fund salesmen, who interact with members of the public. This rule would apply to the person himself, and not to the firm. The licensing requirements should concentrate on different qualifications, including capital adequacy. The person who intends to act in the above capacities, whether in a firm or one his own, must first register as a broker, and prove his competence by achieving certification through passing a test on relevant material applicable to investing in the capital markets.

3. Implementation Plan

The appropriate authorities including SEBI and the Ministry of Finance must first determine whether this testing and certification function is to be carried out by a national SRO composed of the brokers and underwriters, or by the regulatory authority. There are many implications which flow from this choice and it is a fundamental one. It would be advisable to obtain experience from other markets to use as a basis for this decision. SEBI personnel have indicated their preference that SEBI be the sponsor and manager of the testing and certifying process.

<u>Committee of Professional Standards</u>

Whatever the above choice, there should be formed a Committee of Professional Standards to serve as a board of examiners, and to administer the testing and certifying process. This Committee or Board must then also maintain and keep current the records of those who have achieved certification, and its current status.

Objective

The major technical objectives of the project are to:

1. prepare a curriculum and syllabus for the material to be examined.

2. prepare a study guide of all the material to be tested.

3. develop procedures for a national register of licensed brokers and underwriters.

4. develop sources of training which will prepare candidates for taking the test, and offer these courses.

5. develop a plan and schedule for administering the test, and grading the results.

6. publicize and administer the testing process.

Tasks

1. Work with SEBI, and the Committee to develop consensus on the type of material to be tested.

2. Advise SEBI and the Committee on the structure of the program and workplans to meet the above objectives.

3. Assist in creating a pool of questions for each group to be tested, on topics which at a minimum would include Indian capital market laws, codes of ethics, financial analysis, corporate finance, securities and product knowledge.

4. Write study guide relating to the pool of questions.

5. Work with relevant training institutions to prepare courses which candidates may take to prepare themselves.

6. Publicize the testing process and its purposes.

   o create information booklet and registration forms.
   o computer data base for registration, rosters and score reports.
   o Design announcements and advertisements for tests.
   o Format test books for printing.
   o format answer sheets for printing.
   o Design process for distribution of information and results.

Staffing

The project will require an experienced capital markets training specialist with experience in type of industry competence testing and certification. Experience with the "series 7" examination in the U.S. would be ideal. In addition a licensing specialist, with some experience in the capital markets would be required. The estimated time for each of these experts would be 6 months, probably in two or three phases.

In addition, local personnel experienced with examinations and testing, advertising and the organization of a nationwide effort.

In addition, the preparation of test materials, and the implementation of workshops and conferences to explain the program, and to assure adequate training resources are available to the applicants.

APPENDIX B

REVIEW OF UTI INSTITUTE OF CAPITAL MARKETS

OVERVIEW

On May 31, 1993, John Ruckrich of Price Waterhouse spent a day at the UTI Institute of Capital Markets in Vashi, New Bombay. His host was Dr. Thiripalraju, Dean of the institute. The following is a review of the institution, its faculty, and curriculum.

The UTI Institute of Capital Markets (UTI-ICM) was established in 1989, with the objective of supporting the needs of the investment community for professional education, training and research. The rapid strides that the Indian economy has taken since the eighties, and the challenges thrown open by the liberalization process initiated in the nineties, have necessitated increased professionalism in the financial services industry. The need for specialists and sophisticated analysts in the capital markets is being increasingly felt in the context of the changed economic environment.

The Institute serves these needs through a multi-faceted approach that combines training and research. Professional training programs, catering to various segments are organised by the Institute throughout the year. Appropriate research is conducted on an on-going basis. The Institute also undertakes consultancy assignments with a view to assisting both new entrants and established participants in the capital markets.

The Institute conducts short duration professional development programs and a long duration Certificate Course. The Institute has physical facilities to conduct concurrently four courses at a time.

The class rooms are suitably designed to accommodate a group of approximately twenty five participants. Group study/case study rooms are available to the students and integral to the teaching methodology. Each group study room had a terminal for access to the Institute's own centralized DEC mini-computer. A large auditorium with a capacity for seating 75 was equipped with the latest in audio visual equipment, including an electronic chalk board.

The Institute, while once completely owned by UTI, has since been spun off and is a totally separate entity from UTI. It is a non- profit organization housed in six stories of a building donated to it by UTI. UTI has committed to continue supporting the Institute with the necessary capital required for physical plant used in pursuit of the educational aspects of the Institute. The Institute is primarily a resident program with the students being housed in a nearby hostel owned by the Institute, and tuition covers both room and board. The students and faculty share the same dining room which makes for an informal environment where it was witnessed that the students felt free to interact with the faculty during the lunch period.

Especially worthy of note is the excellent library housed in the Institute and readily accessible to the students, both through terminal access and physical browsing. The library is supported by a state of the art, library science software management system. The system had an outstanding browse capability which searches by topic through all the electronically stored books, magazines, newspapers and various periodicals available in the library. The Institute is administered through a Governing Council with Dr. S.A. Dave as Chairman.

INSTRUCTIONAL METHODOLOGY

The Institute is equipped with the latest technology in teaching aids, which include PC-projectors, Mega-monitors, Electronic Copy Board and a DEC VAX mini-computer. The courses are designed to include interactive sessions comprising case studies, group discussions, workshops and role-play games. The Institute also has computer based simulation games, developed to provide hands-on training in a simulated environment, in various capital market operations and techniques. The Institute has a number of educational films, covering primary markets, options, future, swaps, etc.

The Institute provides reading material for all the courses, incorporating up-to-date information on various topics. The material also includes elaborate conceptual and practical inputs developed after thorough research and review.

CORE FACULTY

Dr. M. Thiripal Raju, Dean, obtained his doctorate from the Indian Institute of Technology, Bombay. His doctoral dissertation was on "Behavior of Share Prices in India". He was earlier associated with the NITIE, Bombay, for seven years and had taught various management development programmes in the area of Financial and Portfolio Management. He has been involved with the design and development of courses in the areas of Merchant Banking, Corporate Strategies, Primary Markets for Securities and Portfolio Management. He has published several research papers in leading journals.

He worked with the Bombay Stock Exchange for approximately 2 1/2 years in different positions. He was a consultant to some of the leading Public Sector and Private Sector Organizations. He presented papers at International Conferences and participated in International Seminars and Conferences. He is a Visiting faculty at various reputed National Institutions and has addressed several National Seminars.

Hemalatha Chandrahasan, Associate Professor, is a post graduate in Economics. She has co-authored two widely received books on Investment Management and International Payments. She was earlier associated with the Institute for Financial Management and Research, Madras, and had worked on consultancy project. She has been involved in the courses in Fund Management, Investment Research, International Finance and Economic Analysis. She has presented research papers at various seminars and has published many of them.

Uma Shashikant, Assistant Professor, is a post graduate in Commerce and is working on a doctoral dissertation on the "Risk and Return on equity investments in India". She was associated with the Institute of Chartered Financial Analysts of India, Hyderabad, as a Faculty Member prior to her joining the UTI-ICM. She is involved in the training programs in the areas of Fund Management, Technical Analysis, and Stock Market Trading and Operations.

Dr. Narayan Rao, Research Faculty, is a post graduate in Management and obtained his doctorate from the Indian Institute of Technology, Madras. His doctoral dissertation was on "Corporate Financial Policy and Signaling Theory: A study of cash dividends, bonus issues, and equity rights issues". He has been involved in training programs in the areas of International Capital Markets, Money Markets, and Corporate Finance.

Naresh Raut, Research Faculty, is a B. Tech from the Institute of Technology, Kharagpur, M.S. (Mechanical Engineering) from the University of Manitoba, Canada and M.B.A. and M.S.A. from the University of Houston, USA. He has taught as Visiting Assistant Professor in the Department of Economics and Finance, Lamar University, Texas, USA. He has been involved in courses in Fixed Income Securities Management, Fund Management, and Investment Analysis. He has also designed an educational software for training in Finance.

PROPOSED COURSES TO BE OFFERED

Fund Managers' Course--The course covers the Indian capital market Environment, Investment Analysis and Security Valuation and Portfolio Valuation.

Course objectives:

- o To provide an understanding of the capital markets with a view to identifying investment opportunities.
- o To introduce tools and techniques of investment analysis and management.
- o To provide a systematic framework for management of individual and institutional portfolios.
- o To provide an opportunity to practice acquired skills in a simulated environment.

Course Duration: 3 weeks

Introduction to Technical Analysis--The course covers trends, price patterns and their interpretation, analysis and application of Technical Indicators, Elliot Wave Theory, Trading Strategies.

Course Objectives:

- o To familiarize investment analysts with the tools and techniques of Technical Analysis.
- o To provide practical know-how on chart-reading and trend analysis.
- o To introduce the utility of technical indicators for investment analysis.

Course Duration: 3-5 Days

Securities Trading and Market Operations--The course covers Stock Exchange Operations in India, Trading and Settlement Systems, Rules, By-laws and regulations for stock trading, OTCEI, Asian Stock Exchanges and Custodian and Central Depository Services.

Course Objectives:

- o To understand the mechanics of trading in equity shares.
- o To learn procedural aspects relating to placement and execution of orders.

- To appreciate the role and functions of various participants in the market.

- To practice floor trading and computerized screen-based trading through a specially developed computer-based simulation game.

Course Duration: 5 Days

Fixed Income Securities Management--The course covers Fixed Income Securities, Analysis and Pricing, Fixed Income Portfolio Construction and Management.

Course Objectives:

- To provide a conceptual base for fixed income portfolio management.

- To introduce modern techniques in fixed income securities management.

- To introduce new derivative securities and their features.

Course Duration: 3 Days

Investment Research--The course covers Conceptual Foundations for Investment Research, Analysis of the Impact of Economic Policies, Organizing and Planning Investment Research, Quantitative/Statistical tools, Presentation of Research Findings.

Course Objectives:

- To provide guidelines for value added research.

- To highlight the quantitative and qualitative inputs required for successful investment research.

- To identify various sources of data and information relevant to investment research.

- To expose participants to quantitative and statistical tools and their applications.

Course Duration: 5 Days

Management of Mutual Funds--The course covers Mutual Fund Concepts, the Regulatory Environment, Successful Marketing of Mutual Fund products, Investment and Mutual Fund Evaluation.

Course Objectives:

- To convey the central features of domestic and international Mutual Funds.
- To be familiar with - Marketing of Mutual Fund Products/Index funds/Fund Management/Disclosure requirements.
- To be familiar with the entire back office operations including the accounting entries.

Course Duration: 5 Days

Marketing New Issues--Addressing Indian Corporate Capital Structures, Assessing Corporate Financial needs, Evolving an appropriate capital structure for the client, Designing a financial product, Legal and procedural aspects in Issue Management, Drafting a Prospectus, Underwriting, Market Timing and Issue placements.

Course Objectives:

- To impart skills and techniques in managing new issues.
- To provide practical inputs for effectively pricing and placing new issues.
- To update knowledge on innovations in financial product packaging.
- To acquaint issue managers with legal and procedural aspects.

Course Duration: 5 Days

Merchant Banking and Underwriting--Regulatory Framework and SEBI guidelines on merchant banking activities, Role of the Merchant Banker in issue management, Stock Exchange listing, Lease Financing, Venture Capital, Factoring and Bill discounting, portfolio Construction and Management.

Course Objectives:

- To review the current status of merchant banking in India and explain relevant procedures involved.
- To analyze strategies required for effective marketing and management of issues.
- To review and define the regulatory environment.

o To cover the analysis required to price an issue.

Course Duration: 10 Days

Valuing, Pricing and using Capital Market Instruments--Process of Financial Engineering, covering various financial instruments, taxation and accounting of same along with case studies on valuing different instruments from issuer's point of view as well as the investor's.

Course Objectives:

- To explain the features and suitability of capital market instruments.
- To impart skills for selection and utilization of capital market instruments.
- To analyze implications of pricing and valuing capital market instruments.
- To evaluate new capital market instruments.

Course Duration: 3 Days

Accessing International Capital Markets--World Capital Markets and Merchant Banking, Overseas Stock Exchanges, Lead-managing a Eurobond Issue, Structuring an International Equity Offering, Euroconvertible Bonds and Equity Offerings, International Securities Documentation, Disclosures in Euroissues Documentation and Accounting and Reporting Practices in the USA, UK and India.

Course Objectives:

- To analyze opportunities and issues involved in accessing international capital markets.
- To provide inputs on procedural aspects relating to international issues.
- To update knowledge on innovations in international markets.

Course Duration: 3 Days

Risk Management for Financial Services--Financial Risk Measurement and Identification, Risk Management Techniques and Hedging Instruments including Financial Futures and Options.

Course Objectives:

- To highlight financial risks peculiar to financial services organizations.

- To suggest risk management methods appropriate to different financial service companies.

Course Duration: 5 Days

Regulation Financial Services--Regulation of primary and secondary markets and all related institutions such as SEBI, Mutual Funds, Leasing and Hire purchase Companies, Central Depositories, etc.

Course Objectives:

- To provide an overview of the regulatory environment in the Indian capital markets.

- To analyze issues involved in regulating various players in the market.

- To critically evaluate the effectiveness of regulation in India.

- To provide and overview of the regulation of international capital markets.

Course Duration: 3 Days

Corporate Strategies for Capital Market Access--Structure and working of Indian and International Capital Markets, Capital Market Instruments their features and suitability in various markets, planning the capital structures, market segmentation and its impact on accessing decisions, financial product packaging, issue management, accessing international capital markets.

Course Objectives:

- To equip corporate finance executives with skills required in accessing capital markets.

- To provide know-how on practices and procedures involved in tapping Indian and international capital markets.

- To impart inputs on framing strategies for capital market access.

Course Duration: 5 Days

APPENDIX C

REVIEW OF INSTITUTE OF CHARTERED FINANCIAL ANALYSTS OF INDIA

OVERVIEW

Established as a non-profit educational society in 1984, ICFAI functions under the guidance of its Board of Governors consisting of eminent practitioners and academicians. The Academic Council of the Institute provides advice and support to the Board on all academic matters. The responsibility of day-to-day administration is entrusted to the Executive Director soon to be named Dean, a title which does not currently exist.

While the ICFAI refers to their campus in their literature, they own a single building which houses their faculty, library, and administrative staff. They have wisely avoided investing money in physical infrastructure when so much is readily available to them on demand and at minimal cost. The Institute is able to concentrate its efforts on running the Institute and not dilute its efforts by being hotel managers. The nature of the program is correspondence based at this time, but future plans call for a yet to be developed program held in Hyderabad but in residence. Again, freely available already existing facilities would be used.

The Institute of Chartered Financial Analysts located in Charlottesville, Virginia, USA gave freely of their time in the first five years of ICFAI in assisting them to set up their programs for developing a cadre of Chartered Financial Analysts. The United States organization served on the Advisory Board for the first five years of its existence. It is worth noting that the ICFAI has a more robust curriculum than its U.S. counterpart because of the additional emphasis placed on Corporate Finance, Investment Banking and International Securities.

The demographics of the first applicants to the Institute were as follows:

- 70% Working Experienced Business Executives
- 20% Working Novices Engaged in Business
- 10% Recent College Graduates with no business experience

The demographics have remained very much the same for the CFA course

There were 24 students in the first graduating class. The fourth class just graduated in January 1993. The program is a three year program although there is latitude in just how long a student will take to complete the course.

- There are currently 200 Certified Financial Analysts in India
- There are 10,000-12,000 currently enrolled

- 5,000-6,000 are considered active

- 80% of the student body is located in one of seven cities: Bombay, Delhi, Calcutta, Madras, Bangalore, Hyderabad, and Ahmedabad

There are two other programs of study available from the ICFAI, namely the Diploma in Business Finance (DBF) and the Post Graduate Diploma in Merchant Banking and Financial Services (MBFS) Program.

The DBF program has been designed to facilitate students in gaining insight into concepts and techniques which are usually not included in the commerce courses at the undergraduate level and which are relevant to the corporate and financial services sectors. The program is also useful to the non-financial executive, self-employed persons, entrepreneurs, college teachers and others who wish to gain a thorough understanding of the concepts and techniques of corporate finance. In particular the DBF program seeks to:

- impart knowledge of basic concepts in corporate finance, accounting, investment, tax planning and statistical applications in finance

- provide basic skills in finance for solving practical day-to-day problems in business

- develop appreciation of the interface between finance and other functional areas of production, marketing, purchasing, personnel, etc.

The MBFS program has been designed for the experienced business managers to improve their conceptual, managerial and operational skills as related to the merchant banking and related financial services. In particular the MBFS program seeks to:

- impart basic but current knowledge of basic concepts in merchant banking and financial services

- improve ability to rationally evaluate alternatives in the decision-making process

- deepen insights into ways and means of rendering high quality merchant banking and financial services to meet the demands of the customers

- develop an appreciation of the interface between merchant banking and financial services and other areas of banking, capital markets, corporate finance and related areas.

INSTRUCTIONAL METHODOLOGY

The basic methodology is one of the correspondence school. The concept is supported by the providing of the students with text books, having well-structured and easy-to-follow lessons in each subject. Each subject contains exercises and assignments for self-evaluation. A detailed plan of study is provided for each subject. A special supplement on "Effective Study Skills" specially geared to the correspondent student is included. The students are encouraged to get in touch with academic advisors conveniently located in each of the seven already mentioned cities in addition to the faculty/research fellows/associates at the Institute for any guidance or clarification. Regularly scheduled week-end review sessions are held in the seven cities for questioning, material review and idea exchanging. These review sessions are optional but regularly attended by anywhere from five to twenty five students. The students must pass all examinations. The examinations are conveniently held in Ahmedabad, Amritsar, Bangalore, Bhopal, Bombay, Bhubaneswar, Calcutta, Chandigarh, Cochin, Coimbatore, Gauhati, Hyderabad, Indoree, Jaipur, Kanpur, Lucknow, Madras, Madurai, New Delhi, Nagpur, Patna, Pune, Trivandrum and Visakhapatnam.

A student is permitted to take the examination again, but he must wait for the next regular scheduled examination of the particular module that he has failed.

CORE FACULTY

The core faculty consists of six full time employees who develop and refine the courses and conduct the research necessary to publish their monthly journal. They are assisted by a cadre of research assistants. The policy of the institution is to underwrite the continuing educational efforts of their faculty. The one faculty member I was unable to interview was on a paid sabbatical in Germany conducting research and learning about the German capital markets.

Having met them all, having reviewed their academic credentials and having had the opportunity to review their research papers, I am satisfied that the staff is qualified.

ADDITIONAL PROGRAMS

The Institute has two additional program worthy of note because of their exceptional nature and in their worthy contribution to the capital markets of India.

Management Development Program--These programs held in major cities throughout India bring together senior executives from a wide range of sponsoring organizations. Each program treats its subject in depth with a focused curriculum designed and taught by ICFAI faculty and qualified guest speakers.

Teaching methods include lectures, case studies, group and panel discussions, project work and presentations. Most importantly they provide the forum for the exchange of ideas and real-world experiences among all participants.

Summer Training Program for College Students--The program is specifically geared to the senior level student who seeks knowledge and skills in the Capital Markets. Career planning is integral to the program.

APPENDIX D

INVESTOR ASSOCIATIONS

A. Executive Summary

The creation of investor associations is a positive development in India. The purpose of investor associations is to educate investors and to represent the interests of investors in policy dialogue with the GOI. An All India Federation of Investors has recently been formed to consolidate those efforts. The Tamil Nadu Association, which has been the most active regional association, will chair the Federation.

In light of the major change in the nature of the securities marketplace, there is a substantial educational job to be done. Investor associations can assist in that process in a positive manner provided their views are consistent with development of a free marketplace. In would be worthwhile for USAID to support these organizations by encouraging them to participate in USAID-sponsored projects. The All India Federation could be considered as a cosponsor of a policy workshop. The Federation would also be an appropriate organization to work with to develop a videocassette to educate investors (as suggested in the Regulation Section of this Report), if such a project is undertaken.

B. Background

A substantial number of investor associations have recently become active in India. Their purpose is to educate investors, and to represent the interests of investors in policy dialogue with the GOI. One of the most active associations, the Tamil-Nadu Investor Association ("TNIA"), publishes a magazine, entitled Investors Digest. The Digest contains articles on recent developments in the securities industry as well as industry profiles. This association charges a small fee for membership (100 Rs. per annum) and has approximately 15,000 members. The only qualifications for membership are that the prospective member be an investor and be over 18 years of age. The TNIA has sponsored seminars, including recent seminars to discuss the changes in pricing policies for securities offered in primary markets and the establishment of a central depository. A Southern Investor Center is scheduled to open in the near future. It is intended to serve as a resource center for investors to obtain prospectuses and educational materials.

The TNIA has initiated the formation of an All India Federation of Investors (formed on May 20, 1993), and the chairman of the TNIA is serving as secretariat of the office. The purpose of this organization is to coordinate the efforts of the nationwide investors associations and to attempt to influence policy as a unified voice through meetings with government officials and by sponsoring seminars. They believe a number of macro issues must be addressed, particularly the failure to implement the laws that are available to protect investors. The chairman of the TNIA is also a member of a SEBI advisory committee.

C. USAID Role

Coordinated efforts by investors to protect their interests can be effective provided the leaders of the association have a general understanding of the appropriate role of the investor. If investors have sufficient power they can encourage not only the government to provide them protection, but can influence a market to change. For example, the concentration of shares in the hands of institutional investors, such as pension funds, in the United States has recently enabled such institutions to require corporate reforms that could not be demanded when shareholdings were more widely dispersed. Investor associations may not have this type of power, but it appears that they could have some role in educating and possibly influencing policymakers. More importantly, there is a need in India for a major educational effort to assist the investing public in understanding the opportunities and risks of a genuine securities market.

It would be worthwhile for USAID to support this process by (a) assisting these associations to educate investors and (b) providing international expertise to assist in developing seminars directed at policymakers. The best method of educating investors may be to develop a videocassette as suggested by SEBI (See Chapter I, Regulation). The investor associations could also be considered as co-sponsors of selected policy workshops suggested in the Regulation section of this report. Specific requests for other types of assistance from associations should be considered on a case-by-case basis by The Capital Markets Reform Committee formed to oversee the project.

As the TNIA is the most active and is leading the All India Federation, efforts should be concentrated on this association. Prior to providing assistance to an investor association, it is important to assure that the views of the association are consistent with development of the market, i.e., encouraging a full disclosure system with appropriate remedies and not a return to forms of merit regulation. Based on materials from the pricing seminar, it appears that there is a proper understanding on the part of the association.

D. Conclusion

While the role of investor associations in the securities market is not as great as that of regulators and market participants, these organizations can be useful in performing part of the large task of educating the public about a true securities market, and they may have some input into the policy making process. As a result of the need to educate the public and policymakers, investor associations may be able to assist to a degree in achieving the objectives of elements of the USAID program.