



**United States Agency for International Development**

**Assessment of the Impact of USAID Support to the  
Securities and Exchange Board of India  
And Its Future Technical Assistance Needs  
RFP 386-04-021**



**REPORT**

Submitted to:  
**Mr. Ashok Jha**  
USAID/EG/New Delhi

Submitted by



8500 Leesburg Pike, Vienna, VA 22182, USA  
[www.BankworldInc.com](http://www.BankworldInc.com)

December 29, 2004

Mr. Ashok Jha  
USAID/EG/New Delhi  
India

Dear Mr. Jha:

Bankworld Inc. (BWI) is pleased to offer our Report on the Assessment of the Impact of USAID support to the Securities and Exchange Board of India (SEBI). The assessment was conducted by Bankworld advisors, Mr. Michael Mulligan, Team Leader Mr. Richard Dvorin and Dr. Rachana Baid. As required in, we have commented on the success of the USAID program, identified gaps and vulnerabilities, and have made recommendations for the future.

Bankworld is honored to serve USAID in this capacity. We are most grateful to Mr. Walter North, Dr. William Martin, Ms. Rebecca Black and to you for this opportunity and support. Our work has greatly benefited from the valuable discussions with the following USAID officials: Mr. John Crihfield, Ms. Georgia Sambunaris, Mr. Chris Barltrop, Mr. David Dod, Mr. Christian Hougen and Mr. N. Ramesh. We appreciated the insight shared by Tom Torgerson of the US Department of Treasury; by Mr. Robert Strahota, Mr. Ester Saverson, and Mr. Sean Watterson of the US SEC; and by Constantin Abarbieritei, Mr. Donald Hart and other members of IBM.

We would also like to thank Mr. U. K. Sinha, Joint Secretary and his colleagues in the Department of Economic Affairs, Ministry of Finance, for their support. Most importantly, we are grateful for the valuable cooperation and support of Chairman G.N. Bajpai and other officers of SEBI, as well as the vast number of important officials from the Indian government, market institutions and corporations.

Sincerely,

A handwritten signature in blue ink that reads "Bharat Bhargava".

Bharat Bhargava  
President

## TABLE OF CONTENTS

<b>1. Executive Summary</b>	<b>1</b>
<b>2. FIRE-R Performance and Outcomes</b>	<b>4</b>
<b>3. Gaps and Vulnerabilities</b>	<b>10</b>
<b>4. Areas for Future Interventions</b>	<b>18</b>
<b>5. Conclusions and Recommendations</b>	<b>24</b>
<b>Annex I. Bankworld's Approach and Methodology</b>	<b>27</b>
<b>Annex II. Bankworld's Meetings</b>	<b>29</b>
<b>Annex III. Documents and Materials Reviewed by Bankworld</b>	<b>31</b>
<b>Annex IV. Areas of Needed Adherence to IOSCO Principles</b>	<b>43</b>
<b>Annex V. SEBI Concept Paper on Professional Rating of Intermediaries</b>	<b>47</b>

## **Assessment of the Impact of USAID Support to the Securities and Exchange Board of India And Its Future Technical Assistance Needs**

### **1. EXECUTIVE SUMMARY**

#### **1.1. Overall**

By all accounts, the Financial Institutions Reform and Expansion Project – Regulatory (FIRE-R) Phase II program has been a success. It has strengthened the institutional integrity of the primary regulator of the capital markets, the Securities and Exchange Board of India (SEBI). The program has also played a significant role in establishing a Self Regulatory Organization (SRO) system that not only promotes the development of a broadened market, but also has established the fundamental market controls necessary for performing inspections, investigations and sanctioning of market participants. It has, by analogy, created a superhighway upon which a reliable, transparent and functional system for investment and allocation of resources can be built. We at Bankworld, based upon our experience in capital markets in developing economies in other parts of the world, feel that the successes in India to date stand as a model for other developing markets. We attribute this success not only to USAID and its consultants and agents, but also to the “economic renaissance” that began in the early 1990s in India and continues today. We applaud the Indian regulators and market participants as well as USAID and its consultants for the dramatic and material improvements in the Indian markets. With the help of USAID, India has built an infrastructure that can accommodate large transactional volumes and can substantially mitigate market participant and institutional credit risk.

Nevertheless, we find there remain significant impediments to the achievement of the USAID strategic objective of a broad-based, efficient and effective mobilization of investment in the capital markets in India. We believe that efficient and effective use of financial resources is critical to correct the poverty-related problems that transcend the Indian economy and the Indian way of life.

Toward that end, we conclude that continued support of SEBI in certain key areas is critical to the maintenance of a strong and reliable capital markets regulatory regime. However, because the Indian regulatory structure (and SEBI in particular) has attained competence and complexity that is specific to the Indian system, we feel that additional assistance to SEBI should be nominal in terms of level of effort, and we feel it should be short term in nature, as needed.

In the event that SEBI obtains jurisdiction for regulation of certain other capital market-related activities (e.g., the commodities futures market regulation or financial disclosure and corporate governance regulation), we feel that a strong need for long-term technical assistance to SEBI will arise in these areas.

As discussed more fully below, we believe that commodities regulation, financial disclosure and corporate governance, and judicial reform are the areas in Indian capital markets development where USAID resources could be used most effectively in the future. Our recommendations herein will elaborate on why and how USAID should use its resources to best solve the most pernicious problems in the Indian capital markets. Our recommendations are aimed at SEBI and its authorities, but it likely will be that the most effective means of improving India's capital markets will require that USAID focus its resources and efforts on other counterparts.

In the event that SEBI does not obtain jurisdictional authority for corporate governance and financial disclosure, which is more likely, our assessment is that USAID should consider immediately shifting its technical assistance efforts to support the Ministry of Company Affairs and appropriate judicial, or quasi-judicial, bodies. This recommendation of shifting focus to another counterpart is based upon our assessment of the jurisdictional authority of the various governmental bodies as well as the requisite development of proper counterpart relationships. Should the proper counter-party relationship develop,<sup>1</sup> we recommend that USAID consider the herein proposed efforts to be implemented immediately, and that they be considered a long-term effort. We make the following recommendations based upon our assessment that, USAID by shifting its focus, will more effectively enhance India's capital market mechanism for mobilization and appropriate allocation of capital resources.

We make the following general recommendations.

#### A. Continue to Support SEBI

We recommend that USAID continue to assist SEBI in training and technical assistance in the following areas:

- Short term TA from SEC to SEBI and SROs in the areas of
  - Surveillance
  - Inspections and investigation techniques
  - Enforcement proceedings
- Review of training curriculum of the National Institute of Securities Markets (NISM)
- Training during the implementation of the surveillance system where USAID has been already participated in selection of the system for Integrated Market Surveillance System (IMSS)
- Investigation and Enforcement
- IOSCO Compliance: Short term TA to help SEBI in ensure that SEBI is able to act in accordance with IOSCO Principles

Generally, we noted that officials at SEBI, officials at the SROs, and market participants as a whole are quite sophisticated. India has passed the stage where it needs general technical

---

<sup>1</sup> As discussed below, representatives of the Ministry of Company Affairs in our meetings informally solicited our advice, and stated that they believe a long-term counterpart relationship would be beneficial.

assistance. Currently, their needs are very specific and cover complex developmental and implementation issues.

### B. Commodities Regulation

USAID should provide technical assistance (TA) and training programs aimed at regulating the commodities futures trading market.<sup>2</sup> We found that the commodities market, which has grown tremendously in value of trades, remains, in essence, unregulated, and the regulator in place is largely ineffective. Although the firms that trade in commodities are the same firms that are trading in securities, the commodities futures positions are not incorporated into the broker dealer financial capital rules. Consequently, we fear there is a significant risk that a collapse in the commodities futures market could “cross-over” into the SEBI-regulated capital market with unknown, and possibly services, financial liquidity crisis for the capital market.

### C. Regulatory and Legal Frameworks/Corporate Governance

Bankworld recommends an immediate refocus of resources to assist in the development of a corporate governance and reporting regulatory framework now being created by the Ministry of Company Affairs (MCA). The framework, which we understand will ultimately result in a legislative initiative, will establish an entire regime for regulation, investigation, and enforcement as well as sanctions for financial statement fraud and corporate governance malfeasance. MCA has requested technical assistance in this process. As discussed in depth below, we believe that corporate governance and financial reporting are perhaps the weakest aspects of the Indian capital markets, and because currently, no formal system of regulation exists in these areas, we believe USAID should consider both short- and long-term technical assistance in the framework and subsequent legislative development process. Additionally, should the legislative agenda be accomplished, we recommend long-term technical assistance in implementation of an appropriate regulatory approach to these very complex matters.

### D. Judicial Training and Reform

We recommend that USAID undertake efforts to assist in the improvement of India's judicial system; particularly as it relates to economic issues. We perceive the effective lack of access to the Indian court system as an enormous impediment to the development of the capital markets as well as the development of commercial activity in general. First, we recommend some kind of formal exposure of judges and lawyers on issues related to the seriousness of economic misconduct and crimes in capital markets. Second, we recommend a training and/or framework development initiative at the Indian Supreme Court level that would help implement a more responsive judicial system – towards one that would be relevant and useful for both broad commercial as well as capital market issues. Both of these recommendations

---

<sup>2</sup> We understand that there is a current legislative initiative to move jurisdiction for commodities futures market regulation to SEBI. We believe that SEBI is the proper arena for regulation because SEBI has the institutional understanding and systems in place to appropriately respond to credit risk issues relating to commodities trading. Nevertheless, we do not believe they currently have the capacity to respond to the “real economy” regulation aspects of commodities regulation. Consequently, this is an area where mid-range term technical assistance would be appropriate.

have prerequisites of finding an appropriate Indian counterpart with which USAID representatives could become involved. Should that occur, Bankworld recommends that USAID begin with a short-term technical assistance program (up to six months) in each of the categories. Subsequently, we recommend a reassessment regarding the effectiveness of the program before committing additional resources.

## **2. FIRE-R PERFORMANCE AND OUTCOMES**

We at Bankworld conclude that the USAID FIRE-R program has been successful in significantly assisting the development of the infrastructure and regulatory regimes in the Indian capital markets. We will discuss each focus area of the program in detail and will briefly mention areas where gaps have been found.<sup>3</sup> In general, market professionals and regulators in virtually all categories have made significant achievements in the capital market infrastructure in India. While conceivably many of these achievements may have occurred irrespective of FIRE-R assistance, we conclude that India would not have been able to develop and reform its market institutions so swiftly and appropriately without USAID assistance. We attribute this success to USAID's vision and leadership, and to the efforts of its contractors, IBM Business Consulting Services (IBM) and the US Securities and Exchange Commission (SEC) toward helping implement international best practices in India. Broadly, Phase II of FIRE-R was focused in five areas, which are discussed in detail below.

### **2.1. Impact of FIRE-R Assistance – Based Upon Stated Goals**

Broadly, Phase II of FIRE-R was focused in five areas. We summarize our assessment of the current state of development of these five focus areas:

#### **A. Institutional Strengthening of SEBI**

The most significant accomplishments of the USAID project appear to have been in the areas of institutional strengthening of SEBI through organizational restructuring, implementation of new regulatory systems, and in building staff competence in rule-making, market oversight, surveillance and enforcement. Although there are weaknesses in the Indian system, as there are weaknesses in any capital markets and regulatory régime, we found that SEBI understands the problems and has systems and competencies set up to appropriately respond to them. Fundamentally, as well as from a business perspective, SEBI officials seem to recognize many of the problems that market intermediaries are concerned about with regard to its oversight. We note that SEBI officials appear to have a proper sense of balance between legitimate concerns in market regulation versus the costs and drawbacks that those regulations have on the market. Consequently, SEBI actively and appropriately seeks the opinions and concerns of market participants as it proposes to introduce new rules and regulations.

Many of the reforms that occurred during the relevant period (2001-2004) were due especially to the government's response to market scandals. We understand a widely

---

<sup>3</sup> Gaps and vulnerabilities will be discussed in more detail in the following section.

recognized stock market-related scandal occurred in 2001. The Indian government responded with far-reaching legislative changes that empowered SEBI in many ways. The new Chairman, Mr. G. N. Bajpai, who assumed the lead post at SEBI, was a driving force behind SEBI's empowerment. Mr. Bajpai has been a strong promoter of SEBI authority and capital market reform. These events created a fertile ground for acceptance of USAID advice.

Bankworld finds that the consequence of a willing counterpart in SEBI, and good USAID advice, has resulted in a clear and appropriate understanding of SEBI's role in capital markets regulation. Not only do the market participant firms and institutions understand the role of SEBI, they respect its authority and correspondingly have integrated systems for self-regulation. (See further discussion of SROs below.) We further note that SEBI has a system in place for investigation and sanction of market participants in both market manipulation and insider trading cases. Finally, we find that SEBI actively investigates and prosecutes cases using its new administrative powers, obtained through the amendments to securities-related laws in 2002.<sup>4</sup>

With regard to oversight of market intermediaries, SEBI has implemented a continuous process of modifying its inspection, oversight and enforcement programs. We find there are multiple tiers of credit assurance and corresponding systems for ensuring that all trades settle without substantial systemic financial risk.

Despite these controls, however, there exists a view that additional mechanisms are needed to protect investors' accounts. Specifically, even though India currently has a guarantee fund that will pay investors up to approximately \$4,000 in the event of broker dealer insolvency, a case can be made to form an Indian-equivalent institution analogous to the Securities Investor Protection Corporation (SIPC) in the United States. This perceived weakness will be discussed more fully below.

#### B. Training, Licensing and Certification of Market Intermediaries; Development of SROs

There are various programs in place for the training, testing, and licensing and/or certification of broker dealers, traders in derivative instruments, and asset managers of mutual funds. We note that both major exchanges have methods in place to systematically assess and control credit-related risk in both the stock and derivatives trading market. The systems in place are uniquely Indian. Although, like other systems in the world, they are not foolproof, the systems for delivery versus payment and for mitigation of market institution credit risk are robust. We note that both major exchanges have systems in place for self-regulation of their members, and that members are, in fact, being inspected, investigated and sanctioned within a systematic, expeditious and transparent quasi-judicial forum. Also, both major exchanges have arbitration procedures that allow for settlement

---

<sup>4</sup> We note, however, that 2004 appeals to the Securities Arbitration Tribunal (SAT) and their judgments have not been made public on SEBI's web site.

of disputes between broker dealers, between broker dealers and their clients, and even between clients and sub-brokers.<sup>5</sup>

Nevertheless, nearly all people we interviewed felt that the lack of systematic training and licensing of financial advisors (e.g., “sub-brokers” who sell insurance, securities, government bonds, mutual funds and other government-sponsored fixed payment schemes) was a significant systemic weakness in India.<sup>6</sup> We conclude, however, that this necessary training must be done, by Indian regulators, educational institutions and market participants.

Our conclusion is based upon the notion that any sub-broker arrangement that involves the public capital markets currently requires a three party agreement. In other words, the licensed broker dealer, the sub-broker or AMFI-certified investment advisor, and the client, must all be parties to the agreement. Consequently, the sub-broker is an agent of the broker, and legally the broker is liable under exchange and SEBI rules for failure of the sub-broker to comply with rules of fair practice. We understand that anyone selling mutual funds to clients must first be certified by the Association of Mutual Funds of India (AMFI), through a SEBI-recognized training program. Although AMFI is not an SRO, and is reluctant to become one, SEBI has accepted their examination as an appropriate certification method for sellers of mutual funds.

### C. Stabilizing Futures and Options Markets through Improved Regulatory Oversight, Risk Management, and Introduction of New Instruments

Because of the 2002 amendments to the securities laws, derivatives have been clearly established as “securities” that are subject to SEBI’s oversight. Consequently, derivatives-related trading rules and systemic credit risks have been addressed, as is the case with the underlying securities, through SEBI and exchange oversight of the broker dealer practices. As discussed below, however, Section 2 of the Securities Contracts (Regulation) Act of 1956, although amended to provide that derivatives are securities, has not been appropriately amended to allow for the introduction of new types of instruments. Correspondingly, the regulation of new instruments remains ambiguous presenting a risk and limitation in future capital market development. While we believe a significant improvement as a consequence of USAID’s assistance in this area of Phase II of FIRE-R exists, we note there is still a gap in the legislation that needs to be addressed, as noted in the Gaps and Vulnerabilities section below.

Related to the issue of introduction of new instruments, but not specifically a focus of the FIRE-R program, is an evolving regulatory risk relating to the Commodities Futures markets. This area is discussed more completely in the Gaps and Vulnerabilities section below. The regulation of the commodities futures markets is the responsibility of the Forward Market Commission (FMC). However, the FMC is widely reported as lacking

---

<sup>5</sup> Given the time constraints, Bankworld did not undertake a full examination of any of these systems. Consequently, our conclusions are based upon conversations with representatives of the exchanges. .

<sup>6</sup> We have been given estimates that there are somewhere between 800,000 and 2,000,000 of them working in India.

resources to be fully effective in regulating its futures markets in the near term. Brokerage firms currently trade in commodity futures, but only through a separate legal entity, with a corresponding separate balance sheet that is not consolidated with their securities operations.

In the last six months, commodities futures trading volume has grown suddenly and dramatically. Unfortunately, it appears that the growth may be mostly speculative rather than hedging. With little effective regulation, many market participants feel that there is scope for significant manipulation in the market, which could lead to a possible catastrophic adjustment in the commodities market. (See Commodities Regulation in the Gaps and Vulnerabilities section, below).

#### D. Increasing Investor Confidence in the Market through Improved Corporate Governance, Investor Education, and Disclosures, and Institutionalization of Securities Laws Education

In these aspects of Phase II of the FIRE-R program, we have seen some limited success. First, we note that the standards for disclosure and corporate governance have improved. Our examinations of prospectuses for public offerings of securities reveal that financial and qualitative disclosure is extensive and appears to be of high quality.<sup>7</sup> We also find that India has a sophisticated and internationally accepted set of standards for both corporate governance and financial reporting.

Similarly, it is common knowledge in the international financial community that the Indian capital markets have been successful in floating large issuances of equity securities, even when the securities represent a minority position in a single-shareholder dominated company. In August of 2004, Tata Consultancy Services (TCS), a division of Tata Sons, the holding company of \$13 billion Tata Group, was able to raise approximately \$1.2 billion in a single offering; the offering was oversubscribed by more than 10 times. Post-IPO, TCS stands as a separate company with Tata Sons still retaining an 86.7% stake in TCS. Clearly, the capital market has the ability to mobilize capital especially around well-established business houses.

We also note that trading volumes at the two major exchanges are enormous, especially given that only a few between 50 and 100, of the approximate 9,000 listed companies are heavily traded. Our assessment is that there is a certain degree of investor confidence developing in companies that are closely monitored by Qualified Institutional Bankers (QIBs), but among “second-tier” companies, a liquid market has been elusive. There is little consistent trading or liquidity in the securities of approximately 8,900 of the approximate 9,000 listed companies. We believe this lack of depth in the market is caused by several factors. The main cause for this we feel is a significant gap between the *standards* for corporate governance and financial reporting and *actual practices* with

---

<sup>7</sup> Bankworld reviewed only a handful of prospectuses, and our comments are based upon discussions with market participants, regulators, representatives of the Ministry of Company Affairs and representatives of a credit and corporate governance rating firm. Bankworld did not conduct an independent assessment of corporate governance and disclosure practices – a task outside the scope of this SOW.

regard to financial reporting and corporate governance on the part of these second-tier companies.

Related to this problem, we note that SEBI has not undertaken substantive reviews of either corporate governance practices or compliance with Indian GAAP, at either the initial public offering stage or subsequently after a company has been listed.<sup>8</sup> We have been told that Indian GAAP is “in conformance” with international standards and that, although Indian GAAP is a principles-based system (as opposed to the US GAAP rules-based system), there are few fundamental differences in the accounting standards between US and Indian GAAP. Bankworld’s developmental accounting experience, as well as our discussions with several market intermediaries and corporate rating institutions in India, leads us to believe there is little consistency in application of standards in India. As a consequence, we believe that the distrust in the private financial reporting system is a significant reason for the lack of broad-based investor confidence.

Issuer disclosure filings, including prospectuses, are checked by regulatory authorities only to determine whether necessary information has been provided, but the content of that information is not reviewed. Although we understand both the BSE and NSE have substantial listing requirements, we also note there is no institutional, systematic review of periodic issuer reports performed by any governmental agency or SRO.

We also note that certain legal impediments to enforcement of compliance with contract and corporate obligations, as well as financial and corporate governance regimes do arise. (See Gaps and Vulnerabilities below.) Consequently, among market participants, credit agency representatives, and even regulators, there is a high degree of distrust in the quality of most, approximately 97%, of the companies listed on the two major exchanges. Our analysis of media reports also confirms this. We conclude that while USAID, its consultants and counterparts have realized extraordinary accomplishments; in the area of standard development in corporate governance and financial reporting, we find that the efforts have not been as successful in creating the investor confidence needed for India’s private capital markets to be a reliable mechanism for effective mobilization of capital.

With regard to investor education, pension reform and insurance reform, as a consequence of the above-noted fundamental corporate governance and disclosure problems, we are skeptical that a widespread effort to encourage large amounts of investment in the private securities market is a wise initiative. Simply put, while the market infrastructure for trading may be ready to handle large transaction volume, and corresponding clearance and settlements may be low risk, we do not believe there is widespread compliance with corporate disclosure and governance standards. We do not believe fully integrated and operating legal mechanisms exist for restitution (i.e., correcting injustices) currently in place to avoid widespread and justifiable distrust in the capital market. We believe, the corporate governance and judicial reforms should precede any broad-based investor education program that might encourage investment in what we, most regulators, most market participants and the Indian financial press view as “poor value” or “vanishing” companies.

---

<sup>8</sup> We understand further that no governmental agency or SRO is performing this function.

With respect to training, we note significant successes in training regulators, market participants and SRO representatives. Bankworld met with trainees and discussed training efforts sponsored by the SEC, IBM and SEBI. Virtually all of the attendees highly praised the training programs and indicated that the programs seemed appropriate for Indian representatives at the time they were given. When solicited, however, several of the attendees had recommendations for improvement of the training. (See recommendations below for a full discussion.)

Finally, with regard to the institutionalization of securities law, we note that securities law curricula are being offered at the Government Law College in Mumbai. Further, SEBI plans to form a National Institute of Securities Markets (NISM) that will institutionalize and provide continuing professional education to regulators, representatives of SROs and also market intermediaries. We did not, however, find any evidence of broad-based “investor training,”<sup>9</sup> nor did we see evidence suggesting that securities law curricula was being widely disseminated and established in other areas besides Mumbai.<sup>10</sup>

#### E. Development of Bond Market

Bankworld notes that India has achieved dramatic success in terms of developing an active, transparent and systemically sound platform for trading in government issued securities. However, as we understand, there is very little activity, other than in private placement transactions, in the corporate bond market. To the extent that Phase II of FIRE-R was aimed at developing the latter, it has not really succeeded. There are many reasons for this. Certainly, the costs and paperwork for private placements are less than for an issuance that would be listed on an exchange. We understand this is one reason why corporate issuers have tended to go the cheaper and less cumbersome route of private placement. Additionally, because bank rates for loans are low (many banks are majority-owned by the GOI), and they compete directly with the capital markets, companies tend to seek bank financing as opposed to capital market debt financing.

One consequence of this lack of a publicly traded bond market (private placements are traded OTC, over a “telephone trading system”) is a debate among many about the existence and/or accuracy of media-reported yield curves. As a result, most professionals with whom we spoke, and even regulators at SEBI, felt that the market was subject to easy manipulation. Also, due to the lack of a liquid (and perhaps transparent) market for corporate debt, there is concern that daily net asset valuations (NAV) for mutual funds that hold these securities may be subject to manipulation.

---

<sup>9</sup> As noted above, we are generally skeptical of investor training agendas – especially given some of the significant gaps and vulnerabilities noted below. Thus, even though we feel this USAID objective has not been met, we believe that, because the market has significant remaining weaknesses, this may actually be an advantage.

<sup>10</sup> We were told, however, that securities law classes would soon be offered at a university in Bhopal.

### 3. GAPS AND VULNERABILITIES

As noted above, while there have been many successes, there are still several areas where goals of the FIRE-R Phase II have not been fully achieved. Some of the problems noted by Bankworld are reflective of deeper systemic problems within India's capital markets, and not easily curable. One such area is the inadequate long-term retail investor participation in the market. While we will explain this more fully below, we see this as a symptom of other systemic issues within the Indian capital market. In India, there has been a long and troubling cycle of widespread financial scandals that resulted from inadequate regulation and an inability to seek effective judicial redress. Additionally, private capital mobilization and investment is hampered by the government's long-standing policy of providing high returns on what are generically referred to as "fixed return schemes."<sup>11</sup> Another symptom of systemic problems in the market is a severe lack of liquidity, i.e., secondary market trading in all but about 100 of the approximately 9000 equity issues listed on the various exchanges in India. Although trading volume is very high,<sup>12</sup> most of the trading is done by those referred to as "day traders," who are either (1) indulging in short term speculation or (2) taking arbitrage positions (i.e., arbitrage between the two exchanges trading the same stock, or arbitrage between the cash market and the derivatives market for the same underlying stock). We understand that most trading positions are closed out daily at one of the approximate 4,000 trading terminals throughout India.

The following is a discussion of the various gaps and vulnerabilities we discovered during our work in India. Bankworld will herein provide advice regarding the areas we think are in most need of assistance, and the areas we feel USAID assistance would be most beneficial.

While some of the gaps and vulnerabilities noted involve SEBI, many do not, and are either outside of SEBI's jurisdiction, or political in nature. Nevertheless, they represent what we believe to be some of the most critical problems, or potential problems, facing the Indian capital markets.

#### 3.1 SEBI-Related Gaps and Vulnerabilities in Regulation

We have noted several SEBI-related institutional weaknesses that should be addressed. Specifically, we note that SEBI weaknesses include:

- (1) A lack of clear understanding in enforcement actions of making the "punishment fit the crime" when sanctioning members or listed companies found to be violating the laws and regulations. Although a detailed analysis in this area was outside of the scope of this project, we noted that approximately 40% of SEBI's recent decisions have been overturned by the Securities Appellate Tribunal (SAT, a SEBI oversight tribunal). This may be a consequence of a lack of understanding at the SAT level. In

---

<sup>11</sup> "Fixed return schemes" refers to a number of different government-sponsored plans through which an investor is guaranteed a percentage return by the GOI. The different vehicles include postal deposits, RBI bonds etc.

<sup>12</sup> According to the presentation given to us by SEBI officials, the NSE ranks third in the world in number of annual transactions, and the BSE ranks sixth in the world in number of annual transactions.

any case, there seems to be a need to have SEBI/SAT have parallel understandings of the nature of the violations as well as the fairness and consistency of the sanctions.

- (2) SEBI does not appear to utilize the SROs (i.e., the BSE and NSE) in partnering for regulatory needs. IOSCO is firm in its recommendations that a securities regulator cannot do everything necessary for regulation of and enforcement in the securities markets. Therefore, SEBI should use the existing SRO structures to its benefit and to thereby broaden its reach in regulating the markets.
- (3) SEBI does not review and make analysis of financials or prospectuses submitted to them for approval or licensing. (This is discussed in more detail below). We believe it is a significant weakness and a possible black hole as no other agency (e.g., Ministry of Finance) analyzes these documents either.
- (4) Section 3.1.F (below) states the current areas of SEBI non-compliance or shortfalls with IOSCO Principles: (a) creating and implementing liquid net capital adequacy norms; (b) regulating investment advisors, analysts, mutual funds, and fund managers; (c) implementing risk management systems for all intermediaries; (d) review of bankruptcy laws to ensure mitigation of systemic risks and for the protection of client assets; and (e) enforcement of corporate governance standards and practices, including those of periodic disclosures and financial information. These are all more-fully discussed below. A full description of the areas noted for greater adherence of IOSCO Principles is included in Annex IV.

#### A. Training for Regulators and Market Participants (NISM)

In any market, training for regulators and market participants is a constant and evolving process. Both US counterparts and Indian representatives universally believe the US counterparts should continue to be involved in training. Nevertheless, we find the training needed should be narrowly focused and aimed at specific complex issues. The Indian regulatory and legal régime for its capital markets has become highly advanced. Consequently, the training initiatives need to be structured in a manner different than in the past. Specifically, representatives of SEBI, representatives of the exchanges, and even representatives of the Government Law College all stated that training should be done less in the context of individuals explaining how the United States regulates securities markets, and more in the context of a forum on how to deal with regulatory issues as they evolve in India and in other markets.

We note that better training will result in the following objectives being achieved:

- (1) Market participants will be able to perform their duties more effectively and efficiently. Their services will be more beneficial to investors currently in the market and those looking to invest. Instead of the US SEC dictating the training platform for SEBI, for example, SEBI should state its needs (e.g., non-compliant areas of IOSCO Principles; review and analysis of financial statements and prospectuses) and hopefully, the US SEC can be more responsive with providing requested assistance and training. If the US SEC cannot meet these requests, we believe USAID contractors are a viable alternative.

- (2) With the knowledge and realization that the regulators and the intermediaries are better trained and more knowledgeable, investors will have more trust in the system and will be more apt to look at the capital markets as a viable option or opportunity for investment and deployment of savings. Investors must feel comfortable that the markets, the intermediaries, and the regulators are all performing optimally; that markets are transparent and efficient; that intermediaries are performing a true service to meet investors' needs; and that regulators are enforcing and sanctioning appropriately.

#### B. Licensing and Training of Financial Advisors (sub-brokers)

India has an estimated 800,000 to 2 million sub-brokers or non-broker financial advisors. Currently there are neither licensing requirements nor are there any training or certification requirements for individuals and firms falling in these categories. These types of financial advisors sell a range of different products including insurance, fixed return schemes, government securities, mutual funds, and private equity shares (the latter through a broker dealer). Retail investors often must depend on the depth of knowledge and professional quality of service from these advisors. We at Bankworld feel that lack of training and licensing procedures will hinder the growth of Indian capital markets. SEBI is making progress in this area because it has prepared appropriate new legislation covering this group, or has plans to prepare such legislation in the near future, which will be a major step in the right direction.

We note that, a licensing and training program provides some degree of education and understanding of markets and performance standards. Education is a key to a person's growth, to an industry's growth, and, ultimately, to economic growth. Additionally, with formal licensing, SEBI (or SROs) will have regulatory authority over the activities of financial advisors and intermediaries, meaning that if violations of laws or rules take place, and investors are harmed, the regulator will take appropriate measures not only to sanction the violator, but also to (hopefully) compensate the harmed parties. The securities industry is a highly regulated industry and, consequently, appropriate licensing and registration of all intermediaries dealing with the public or investors is a necessary component of its activities.

#### C. Surveillance System Deployment

In addition to the surveillance systems that are currently being employed by both the BSE and NSE, SEBI is planning to implement its own separate surveillance system that will continuously track trading, and enable SEBI to flag suspicious trading activities. SEBI has specifically asked for assistance in implementation of this surveillance system.

With the surveillance system installed and operating, as well as with basic training on the system, SEBI will be better equipped to perform a more comprehensive surveillance of markets and activities within these markets. SEBI appears to have a good understanding of surveillance; but currently, markets have not been fully integrated for surveillance purposes. We feel that with the installation of the new surveillance system, any needs for

surveillance will be met. We note that traditionally, it is the responsibility of the SROs/Exchanges to perform the day-to-day surveillance. When manipulation or fraud is determined, these cases would be referred to the securities regulator. Surveillance helps ensure that markets and activities are within compliance of norms, and, again, this adds to the confidence of investors when they know surveillance is taking place along with appropriate sanctioning of deficiencies or breaches.

#### D. Enforcement

We noted in discussions with legal representatives of SEBI, as well as in discussions with representatives of several other market participants, that there is need for institutional technical assistance with respect to the implementation of a consistent, fair, and measured enforcement program at SEBI. Several market participants have indicated that SEBI's enforcement program often results in erratic and improper penalties based upon the conduct at issue. Several participants noted that SEBI sometimes sanctions participants in very high amounts when the conduct violation is of an immaterial nature. Conversely, the penalties are sometimes too low in situations where conduct violations have broader market impact.

We have also noted that 40% or more of all cases appealed to the SAT are overturned either because the penalty amount is inappropriate or due to some procedural matter. SEBI has specifically asked for assistance in dealing with this problem.

We have not been able to accurately assess why an incongruity exists between SEBI and the SAT. A sample case-by-case analysis would be necessary – and we note that SEBI is perhaps best situated to perform such work. Nevertheless, we believe that consistency in the enforcement program is imperative (and something the US SEC also constantly wrestles with in its enforcement agenda). Several factors need to be studied to determine whether SEBI or the SAT has a good understanding of how the punishment in a particular case relates to the violations: Was the violation done with intent to harm or due to ignorance? Was there a large-scale financial harm? Were clients harmed? Was the violation isolated or part of a pattern?

We note that the NASD has sanctioning guidelines on dozens of types of violations, responding to frequency, damage, and intent, etc. These guidelines number over 200 pages electronically. Some US assistance may be helpful in this area, either on a case by case, consultative basis, or in the form of SEBI-based training that can be conducted to review various types of violations, looking at the damage to the market or investors, and analyzing what sanctions might be appropriate. We note that this problem is not a “black and white” situation, and consequently people who make decisions on these matters will have differing attitudes and understandings. Nevertheless, we do believe it is possible to document guidelines for sanctions based on certain activities.

#### E. Inspections and SRO effectiveness

As a general matter, Bankworld has found that SROs, specifically the exchanges, are actively inspecting, investigating and sanctioning members. Nevertheless, we noted that the inspection and enforcement activities, although coordinated in some ways between the two exchanges, do not appear to be as well coordinated with SEBI. Consequently, there may be some situations where the exchange and SEBI are either conducting concurrent, overlapping activities; or alternatively, may fail to detect and act upon a market participant misconduct. The inspection and enforcement would improve if there is greater coordination between SEBI existing SROs. Specifically, we believe coordination could improve in the areas of inspection, surveillance, follow up investigations, and disciplinary actions. As good corporate governance practices are becoming more important to the listed companies, especially for raising capital or issuing debt, the first line of responsibility for ensuring that appropriate standards are met lies at the exchange level. Thus, the exchanges on which the companies are listed should be the primary regulator is of the listing requirements, including financial reporting and corporate governance. Listed companies that are not meeting requirements must be dealt with by the SROs accordingly.

Generally, we suggest that the results or findings of enforcement activities, along with inspections and SRO efficiency/effectiveness, be communicated on public access networks, media, web sites, etc. This brings publicity not only to the violations and the violators, for better prevention, but also to the sanctions being assigned to the violations, which in turn bring confidence and a higher trust in the “system” to investors as well as to the listed companies whose shares or debt instruments are traded.

#### F. IOSCO Compliance

SEBI admits it is still not yet in full compliance with IOSCO principles could come before when IOSCO first members (internationally recognized principles for securities market regulation) and recommendations. The suggested areas in which SEBI could improve include (1) creating and implementing liquid net capital adequacy norms; (2) regulating investment advisors, analysts, mutual funds, and fund managers; (3) implementing risk management systems for all intermediaries; (4) reviewing bankruptcy laws to ensure mitigation of systemic risks and for the protection of client assets; and (5) enforcing corporate governance standards and practices, including those of periodic disclosures and financial information. A full description of the areas noted for greater adherence of IOSCO Principles is included in Annex IV.

IOSCO is the international organization that provides principles of standard activities within the securities market as well as principles of regulation of the market. It is important to investors to know that a country’s securities markets meet international standards, certainly for cross-border activities, for expansion of the markets, for transference within international markets, e.g., possible fungibility.

#### G. Financial Reporting

The Bankworld team noted the absence of a fully focused institution charged with the responsibility for ongoing monitoring of corporate governance and financial reporting by

issuers and companies listed on the exchanges. SEBI officials also recognize that even during the IPO process, the review performed by SEBI on the prospectus is perfunctory with regard to financial statement disclosures and corporate governance procedures. We understand that there are listing requirements at each of the major exchanges, and that the listing requirements and the IPO prospectus requirement each demand consolidated financial statements prepared in accordance with Indian Accounting Standards (standards that are in conformance with international accounting standards). We also understand that the listing requirements and the IPO prospectus requirements include requisite representations regarding compliance with very strict corporate governance standards. Nevertheless, discussions with market participants, regulators, and with representatives of market institutions indicate that although the standards may be appropriate, compliance with the standards is not consistent and widespread. Many have indicated that because Indian Accounting Standards are principle-based, and allow for a great deal of judgment, the likelihood of manipulation of financial information is high.

Financial reporting is the essence of transparency with regard to the financial and operating activities of traded companies. Perhaps more than anything else, the financial viability and reliability of a company is accepted and utilized for current and future investment choices. It is imperative that financial reporting is accurate, complete, timely, and up to date. Financial results should be reviewed and analyzed by regulators to ensure the highest levels of transparency and information utilization. Investors look to financial results as a basis for investing; banks look at financials as a basis for providing credit; and credit agencies use financial results to provide ratings for debt and corporate governance applications. The regulator should verify these financial results in order to continue the viability of the marketplace upon which the companies are traded. This is an essential practice and a fundamental principle of IOSCO. Without reliable financial information, securities markets cannot be an effective or efficient means of allocation of financial resources, nor will institutions or individuals who might otherwise participate be able to trust the market.

### **3.2 Other Gaps and Vulnerabilities**

In addition to gaps and vulnerabilities that relate to SEBI's functions, we have noted several other areas some of which could possibly come under SEBI's authority that create impediments to the development of India's capital markets. They are as follows:

#### **A. Corporate governance**

As noted above, there are significant weaknesses in the regulation of financial reporting and corporate governance. We see corporate governance in two major categories. The first category involves accurately reporting issuers' financial results and prospectuses to the market and to shareholders. The second is the empowerment of shareholders to effectively take action to monitor and/or change the professional management of traded companies. Each of these areas is discussed more fully below. We understand that many of the 9000 listed companies are not in compliance with related listing requirements, and therefore should be downgraded or delisted. BSE has a program that identifies non-

compliant listed companies. These companies are placed on the “Z” tier, meaning that these companies are not in compliance with listing rules and that the buyer of these securities must be aware of additional risks in owning these securities.<sup>13</sup>

#### B. Shareholder empowerment

Bankworld has discovered, through discussions with leading market participants and in review of business reporting, several instances in which companies have sold their shares to the public and, subsequent to the sale, have misappropriated business opportunities or assets of the issuer. We also noted, in our review of newspaper articles, control over the annual meeting of shareholders lies completely within the authority of the management. In this way, shareholders are precluded from effectively participating or overseeing the management of publicly traded companies. This, along with a lack of ability to redress corporate wrongs (see Judicial Training below), has been at least partially responsible for many of the large scandals involving publicly traded companies.

#### C. Financial Reporting

Similarly, as with shareholder empowerment issues, there is no governmental authority fully focused and charged with the responsibility for oversight of either periodic reporting or even financial reporting included within the prospectuses of companies that offer securities for sale in the public market. And, as is the case with shareholder empowerment issues, there seems to be no adequate and prompt means of legal redress when companies engage in fraudulent financial reporting occurs.

#### D. Judicial Training

We understand, it is common knowledge among attorneys and lay-people alike that the courts have not been very effective in resolving disputes in which shareholders have been harmed. This inadequacy of the court system has been attributed to two major factors. First, a backlog of cases creates an inability to resolve disputes within the legal system in a reasonable amount of time. Second, there exists a lack of full appreciation among judges and lawyers of the economic and financial impact of judicial decisions and interpretations of common law and statutes. Consequently, because courts cannot effectively enforce contract provisions, securities laws or fiduciary obligations, the economic risk of contract breach, fraud in the market or misappropriation often lays squarely on the counter-party who may have no means of redress.

#### E. Legislative Reform

Fortunately, market participants, regulators and senior members in the Cabinet of Ministers recognize many of the weaknesses that are being identified in this section. Consequently, a current agenda for legislative reform that would address many of the

---

<sup>13</sup> To clarify, we do NOT recommend “de-listing” shares unless there are no outside shareholders, the company does not exist, the company is in bankruptcy, or the company’s shares have not traded for the past 2-3 years. Widespread and unsupportable delisting would create discontent or harm to current shareholders.

problems identified is under way. In particular, the Ministry of Company Affairs (MCA) is currently working on a “Conceptual Framework” that would, among other things, provide for more effective oversight, regulation and enforcement with regard to corporate governance and financial disclosure matters. Additionally, we understand there is a current legislative initiative to again change the definition of a security so that securitizations of mortgage obligations, credit card debt, car loans etc. will clearly be delineated as securities. We note that all of these initiatives are steps in the right direction.

#### F. Governmental Commitment to Capital Markets

In many interviews, Bankworld representatives were told that one of the main reasons the private capital markets have not grown more robust was that governmental programs and policies either inadvertently compete for domestic savings, or limit the amount of investment that can be made into the capital markets by pensions, insurance companies, banks and foreign institutional investors. More specifically, we note that investment opportunities, commonly referred to as “fixed return schemes” offer comparatively high rates of return and consequently compete directly with the private capital markets and cause market distortions.

Fortunately, the rates for these schemes have been reducing in recent years, and we believe that the government is moving in the right direction in terms of offering rates that allow the capital markets to compete. These reductions help counter one of the many reasons why the capital markets may not be growing as fast as they otherwise might, fixed, risk free, high return investment schemes.

Similarly, we have found that nearly all of the pensions in effect in India are defined benefit plans (as opposed to defined contribution plans). Notably, the defined benefit plans are, for the most part, paying relatively high returns, and naturally there exists a great deal of resistance on the part of the Indian citizens to the lower rates paid on pension plans. The focus on defined benefit plans has meant, in part, that the government has been reluctant to allow funds collected for pensions to be invested in the capital markets. We also understand, there are statutory limitations on the amounts in pension plans that can be invested in the capital markets. Finally, while much liberalization has taken place, the government enforces restrictions with respect to total foreign investment that can be made in the capital markets in India. They limit the amounts that foreigners can invest in certain segments of the market, and they limit the amounts that foreigners can invest in specific companies.

#### G. Commodities Regulation

Recently, India allowed trading of commodities futures. The Department of Consumer Affairs in the Ministry of Consumer Affairs, Food and Public Distribution for the Government of India is the highest regulatory body governing all commodity exchanges. The Forward Markets Commission (FMC) was set up in 1953 to provide regulatory advice to the Government and have closer regulatory interaction with the commodity

exchanges. However, the GOI suspended trading in commodities trading for over 40 years. Commodities' trading has only recently been allowed to resume. Most of the regulatory powers of the Central Government have been delegated to the FMC. Although trading in these contracts is new (approximately six months), volumes have shot up to Rs. 3,000 crore a day.

The Bankworld team believes the commodities market remains for the most part under-regulated. We note that the firms trading in commodities are the same firms that are trading in securities. Even so, the commodities futures positions of these firms were not incorporated into the broker dealer financial capital rules. Consequently, we fear there is a potential financial risk of turmoil in the commodities futures market could “cross-over” into the SEBI-regulated capital market with unknown and adverse financial liquidity crises for the whole capital market.

We believe there is a need for fuller attention at the official level to the fundamental roles of commodities futures regulation, and how control of positions in the commodities futures market can impact the real economy for the underlying goods being produced and sold. There is also a need for emphasizing that the lack of transparency in the spot market for commodity sales is fertile ground for manipulation of the futures contracts.<sup>14</sup>

We understand that there is a current legislative initiative to put commodities futures regulation under the authority of SEBI. While we believe that such an initiative would be appropriate and officials of SEBI have a good understanding of financial systemic risk it is our conclusion that technical assistance for the fundamentals of commodities regulation will still be needed.

#### **4. AREAS FOR FUTURE INTERVENTION**

This section will include all recommended assistance, by issue, with an assessment of whether USAID should undertake the assistance, and, if so, what the most appropriate delivery mechanism would be. In the final portion of our report, we will list the suggestions where USAID technical assistance would be most appropriate and effective.

Our experience with the development of capital markets in different countries has shown us that markets grow in phases. The infrastructure of capital markets must be built initially in Phase I. This was largely accomplished during Phase I of FIRE-R. In Phase II, a system for strengthening the regulatory regime, adding product training intermediaries, and public awareness needs to be addressed. As noted above, it has largely been accomplished by FIRE-R Phase II. The third and most daunting phase of capital market development is related to building investor trust and confidence in the system as well as in the intermediaries in the market. Bankworld believes India currently finds itself at this stage. The following

---

<sup>14</sup> An American example of how this lack of regulation can have dramatic economic consequences is when the US Federal Energy Regulatory Commission deregulated energy trading without proper controls. By manipulating supply points and failing to accurately report spot market sales, large energy traders such as Enron, Reliant, Dynegy and others were able to manipulate the market to the point of nearly bankrupting the State of California.

recommendations will focus on technical assistance in areas that will help to broaden and deepen the capital market by building investor trust in the system and by addressing the gaps and vulnerabilities, noted in Section 3.2.

Overall, we recommend a substantially new focus for technical assistance to India's capital markets. Specifically, we suggest that minimal "maintenance" assistance be provided to SEBI in several specific areas to help improve or broaden their institutional effectiveness primarily in the areas of the imminent implementation of SEBI's surveillance system, training on enforcement, and improvement in SEBI's integration with SROs. We believe, however, by going forward, the emphasis of USAID's assistance should be on other areas that will better broaden the capital markets and make them a more efficient means for allocation of capital.

Our recommendations are as follows:

#### **4.1. Assistance to SEBI**

Over the past several years SEBI has developed into a viable and reliable regulator and enforcement agency. Only in a few areas, as mentioned below, do we at Bankworld believe there is a need for additional USAID assistance. Thus, we believe that USAID support in other areas would be of nominal or low value. Generally, continued training and support through SEC seminars and institutes may continue to support future development in an efficient manner. The results of SEBI's activities should be communicated in the public forum for publicity of the results of regulatory activities and education. Indian investors have a history of placing money in fixed income, guaranteed return government-sponsored vehicles and can benefit by learning of a viable marketplace for a balanced or alternative investment opportunities. Trust in the system is built upon knowledge that investments are made in an efficient market and not necessarily guaranteed.

##### **A. SEC Role**

SEBI has developed into a vibrant, knowledgeable, active, and experienced regulator. In addition to regulating the securities market, SEBI is vested with the development and promotion of the securities market. USAID has worked with SEBI since 1994 helping it to become a regulator and also an institution that promotes the growth of the securities market. We find that many, if not most, of the USAID goals regarding SEBI have been accomplished. With this in mind, we recommend that assistance to SEBI be reduced and redirected. We believe that USAID should continue to provide SEBI the benefit of the US SEC's rich and lively regulatory experience. We recommend, however, that the SEC's training be in highly specialized, specific areas, and that it be given in a collaborative nature, as opposed to a classroom forum, as requested by SEBI and coordinated by advisors.

We suggest the SEC be used only for short term, 1 to 2 week periods, as training needs and programs are identified and planned. Even though the SEC may not always be able

to spare the ideal personnel on the specific topical areas on a particular timetable requested by Indian counterparts, we recommend the SEC continue to invite SEBI and SRO personnel to its Institute and other training programs in the US. Preferably, as recommended by the trainees from past SEC programs, the SEC should consider “India only” training in the US. Also, in addition to other training programs, the SEC should ideally allow time for Indian officials to meet with counterparts with similar experience at the SEC.

Bankworld notes that the SEC can be helpful in supporting SEBI (and the Indian SROs) in strengthening areas of surveillance, inspection and investigation techniques, and in enforcement proceedings. The impact of these trainings would be to develop SEBI and the SROs as world-class regulators and would consequently help build the trust of investors and the respect and confidence of the intermediaries in the capital market.

Separately, when the IMSS (Integrated Market Surveillance System) is installed, the SEC (along with the NASD or USAID consultants) can assist in specific training in surveillance and investigation matters and techniques.

We also recommend that the SEC be used to approve the curriculum of the National Institute of Securities Markets (NISM), and along with the NASD, possibly, to develop a program for NISM for certifying intermediaries and instituting exams for brokers and eventually sub-brokers.

We have recently learned that SEBI has drafted a concept paper of rating of market intermediaries. We laud SEBI for this and hope that an effective and practical system to rat the market intermediaries can be put in place which will eventually serve investors interests and confidence in the market. This paper, dated 15 December 2004, is attached as Annex V.

## B. Consultant Assistance to SEBI

- National Institute of Securities Markets (NISM)

USAID has conducted training for regulators and market participants throughout the FIRE-R Program. Except as mentioned above in SEC assistance, the Bankworld assessment team does not feel participation in NISM should be a significant USAID focus. While we recognize training as an ongoing necessity in any market, we believe SEBI is sophisticated enough to manage its own training. As specific needs (e.g., previously mentioned investigation and interrogation techniques) arise, however, we believe that SEBI should request this specific training from the SEC.

- Licensing and Training of Financial Advisors

We believe that SEBI along with the SROs are capable of training the Financial Advisors (sub-brokers). The assessment team agrees that the certification or licensing of sub-brokers is a worthy cause; yet, the need for USAID assistance is minimal given the high

level of knowledge with current government and SRO officials. Additionally, the FIRE-R projects have already written papers and have given instruction as to appropriate applicable licensing and training procedures.

- Surveillance

USAID has been active in participating in the training and determination of the specifications for the Integrated Market Surveillance System. Once this system is implemented, the assistance offered by USAID can be in the form of training for the specific system. We anticipate that the amount of technical assistance necessary will be minimal and will perhaps be provided by the firm from which SEBI purchases the surveillance system. Since several memoranda regarding surveillance have already been provided to SEBI, we would expect that the amount of technical assistance necessary for implementation would be limited to perhaps three months of level of effort (LOE).

- Investigation and Enforcement

Additional assistance from USAID with regard to SEBI enforcement matters has been described above. Specifically, we recommend limited and specific US SEC assistance responsive to SEBI's requests for enforcement training. SEBI, as well as the SAT and SROs, understand that investigations and disciplinary actions are a very important process in building domestic and foreign investor trust and confidence. Virtually all agree that India could benefit from collaborative assistance in institutionalizing these Indian processes.

As previously discussed, that SEBI has received training regarding inspections, and SEC assistance in the future would be helpful to institutionalize and bring consistency to SEBI's processes. We have found, however, that USAID has not trained, or worked with, the SROs to any significant degree.

SROs are most effective as regulatory bodies when they are partnered with the regulator and are trained in accomplishing effective regulation of members and listed companies. In light of the recent absence of USAID training and technical assistance (TA) to SROs, the assessment team suggests three months of LOE of a USAID consultant (or perhaps an SEC representative, if available) for conducting joint training sessions in inspections, investigations, and enforcement activities for the SEBI along with the SROs.<sup>15</sup>

- IOSCO Compliance

Regarding IOSCO compliance, many of the deficiencies at SEBI have already been addressed in papers or in TA from USAID. In order to ensure an even greater compliance by SEBI to IOSCO Principles, however, USAID should consider 1 to 2 months of specific TA from consultants along with SEC support aimed specifically at the Principles,

---

15 Prior to this TA, the SROs should be polled to submit specific "need" requests to USAID for training in these specific issues.

which are not fully implemented. Annex IV specifies the areas of greater adherence to IOSCO Principles needed, according to SEBI's self-assessment.

- **Commodities Futures Regulation**

If and when the Commodities Futures regulatory authority is shifted to SEBI, additional assistance would be needed, not only in the intricacies of commodities and commodity futures regulation (the "real economy" issue), but also with a view toward mitigating participant and institutional credit risk through consolidation of securities positions. Bankworld believes that the training of the commodities regulator is a priority, yet effective and efficient training could only take place if SEBI is given jurisdiction as the regulator. Advisors from the CFTC or USAID consultants can provide TA as well as training. Since SEBI has experienced and knowledgeable personnel in trading regulation, the TA program (perhaps three months of LOE) could be focused upon the eccentricities of the commodities futures market. The training should be focused upon encouraging the "hedge" function of commodities futures, as opposed to the speculative aspect of commodities trading which appears to be emphasized in the current market.

#### **4.2. Assistance to Areas/Institutions Other than the SEBI**

##### **A. Financial Reporting and Corporate Governance**

As previously discussed, Bankworld has determined that there is no substantive review of the content of financial reports, either in the prospectus or in the periodic reporting. While the regulators, including the Ministry of Company Affairs (MCA), ensure that financial reports are submitted, no authority is charged with the responsibility of reviewing the content for compliance with financial reporting or corporate governance standards. Bankworld believes that a substantial training and TA program can be offered by USAID in this area. The training could be for institutions that are assigned the clear cut responsibility for financial reporting review such as the MCA, SEBI, or the SROs. To the extent that USAID has an appropriate and willing counterpart, Bankworld would recommend a long-term training/TA program that would 1) integrate the review of financial reporting and corporate governance reviews at MCA, SEBI and/or the SROs, and 2) help to institutionalize the review, investigation and prosecution of financial fraud and corporate governance malfeasance at the appropriate governmental body.

Related to the issue of financial reporting and corporate governance is the Indian accounting and external audit function. An examination of the applicable standards, and compliance therewith, was outside of our time constraints. We have not made an independent assessment of this issue, but believe that this area should be examined and if necessary, technical assistance provided as part of any assistance package relating to the financial reporting issue.

## B. Judicial Training

To the extent USAID can find a competent and responsive Indian counterpart, Bankworld recommends that USAID pursue a program aimed at improving the judicial system's effect on commercial activity in general and have a correspondingly positive impact the broader capital market.

Bankworld recommends that the judicial training effort be conducted with two specific goals in mind. First, we recommend that the judges and lawyers practicing in the commercial sphere be given greater exposure to the macroeconomic consequences of judicial decisions. This training would focus on both the use of common law causes of action as well as current statutory provisions and legislative initiatives that are aimed at capital markets reform. Second, we suggest a training effort aimed at increasing the judicial efficiency in the economy throughout India. We recognize that the judicial delays represent a systemic problem in India, as in most countries in the world. We assert, however, that any system in which adjudication can take as long as it takes in commercial disputes; the use of the court system for correcting central market malpractice and misconduct dwindles and becomes less relevant. Consequently, to the extent the court systems in India, especially the Supreme Court, or special commercial tribunals in Mumbai and Delhi, would be a willing counterparts, we suggest that USAID institute a high-level technical assistance program aimed at decreasing the judicial system's case backlog. Bankworld would expect that level of effort would be short term for a preliminary assessment of likelihood of success. To the extent the counterparts are accommodating, and the program is operating effectively, perhaps long-term assignment would be appropriate ranging from two to three years.

## C. Legislative Reform

In our meetings with officials in the MCA, we were informed that the Government of India is now engaged in a broad-based reform-oriented legislative agenda aimed precisely at many of the issues identified in this report. Specifically, we understand that a framework is currently circulating regarding legislative reform involving regulatory régimes that would cover both financial reporting and corporate governance. We understand that this reform initiative from framework, to legislation, to regulatory implementation will take several years and may be able to establish an entirely new corporate regulatory regime. Several important issues are being contemplated in the framework including jurisdictional authority for regulators; special courts for economic and financial issues, bankruptcy reform; régimes for investigation and imposition of fines and penalties, as well as defining certain criminal activities in the economic sphere. The proposed laws will have an enormous impact on regulation and development of the capital markets. Consequently, we strongly urge that USAID provide technical assistance with regard to this legislative initiative, to the extent a proper counterpart can be developed. We understand a framework has already been developed, and in our meetings with representatives of MCA, our opinions were solicited regarding the propriety of the current draft framework. Bankworld believes that this is a high priority item and one in which long-term technical assistance should be provided.

#### D. Pension Reform and Insurance

Bankworld recognizes both pension and insurance systems can greatly influence and support the growth of capital markets. The USAID experience in Kazakhstan during the late 1990s and early 2000s has shown that a robust pension system brings tremendous growth to the capital markets, including the issuance of corporate bonds. Pension funds are sources of great wealth, and the pensioners deserve to share in domestic opportunities as well as in world opportunities in the capital markets. Insurance companies have short-term as well as long-term needs in risk management and in investments. These can be addressed through a robust capital market. USAID has offered and delivered several worthwhile and successful Pension and Insurance Reform programs; and as the GOI considers different policy options, and the markets in India broaden, USAID should consider technical assistance and training programs (2-4 years of LOE). Nevertheless, because Bankworld recognizes that there are still some fundamental weaknesses in India's capital markets specifically the lack of depth in the market, and the lack of adherence to consistent, sound financial reporting and corporate governance standards we believe that technical assistance from USAID in these areas should be deferred; at least as regards the participation of pension funds in the equity or private debt markets.

Conversely, we acknowledge there are active trading, liquidity and ascertainable valuation methods with regard to government debt instruments. In this regard, perhaps a model pension fund program could be developed that would both be safe in the near term, and could be useful institutionally, as the private debt and equity markets become more reliable.

### 5. CONCLUSIONS AND RECOMMENDATIONS

While we believe that all the items listed in Section 4 above (Areas for Future Interventions) are relevant to the ultimate goal of making the Indian capital markets world class, given the limits of USAID interventions, we list below, in order of priority, the items that we feel are appropriate and most cost effective for USAID assistance.

#### 5.1 Support of SEBI

We recommend that USAID continue to assist SEBI in training and technical assistance in the areas in which they still need training and technical assistance as listed below:

- Short-term TA from SEC to SEBI and SROs, subject to the availability of SEC personnel. Alternatively, SEBI personnel could come to the US for specific technical assistance from the counterparts at the SEC particularly in the areas of:
  - Surveillance;
  - Inspections and investigation techniques;
  - Enforcement proceedings;
  - Review of training curriculum of NISM;
- Training during the implementation of the IMSS surveillance system that follows on previously supplied USAID technical assistance.
- Investigation and Enforcement: In addition to possible help from US SEC as mentioned above, USAID assistance to SEBI and SROs responsive to specific requests for enforcement training. Specifically, assistance should be provided regarding the problem of assessing “penalties to fit the crime” as noted above.
- IOSCO Compliance: Short term TA to help SEBI in ensuring that SEBI is able to act in accordance with IOSCO Principles. This would be assistance aimed at areas where SEBI has identified lack of compliance in implementation of IOSCO Principles.

Generally, we note that officials at SEBI, officials at the SROs, and market participants as a whole are sophisticated. India has passed the stage in which it needs general technical assistance. Simply put, the regulators and participants in the Indian capital markets no longer need to attend classes to learn about the fundamentals of securities regulation. Their current needs are very specific. As opposed to training, we find they need a counterpart with whom they can discuss complex developmental and implementation issues.

## **5.2 Regulatory and Legal Frameworks**

Bankworld recommends an immediate refocus of resources to assist in the development of the framework now being created to deal with regulation, investigation, enforcement and sanction for financial statement fraud and corporate governance malfeasance. As we were told by representatives of MCA, now is the time to get involved in this process, as it is during the framework development phase that advice and technical assistance will have its greatest impact. Representatives of MCA have asked for assistance on the framework to be provided before the end of October 2004. Nevertheless, they have indicated that technical assistance would be helpful throughout the legislative initiative that they expect to take several years.

## **5.3 Commodities Regulation**

As soon as an appropriate counterpart can be established (or alternatively the authority for regulation of commodities futures is established under SEBI) USAID should provide TA and training programs aimed at regulating the commodities futures trading. Ideally, if the authority rests with SEBI, this should be a short-term project in which professionals involved in commodities futures regulation would import the requisite technical know-how to SEBI.

We found that the commodities market, which has grown tremendously in volume of trades, remains unregulated and the regulator is largely ineffective, as noted earlier. Although the firms trading in commodities are the same firms that are trading in securities, the commodities futures positions were not incorporated into the broker dealer financial capital rules. Consequently, there may be a risk of turmoil in the commodities futures market could “cross-over” into the SEBI-regulated capital market with unknown, and perhaps devastating, financial liquidity crises for the whole capital market.

#### **5.4 Judicial Training and Reform**

Bankworld recommends USAID undertake an effort to assist in the improvement of India's judicial system, particularly as it relates to economic issues. We perceive the lack of ability to obtain timely legal redress for wrongs committed in the capital markets as an enormous impediment to the development of the capital markets as well as the development of commercial activity in general.

Consequently, to the extent an appropriate counterpart can be found, we recommend a two-pronged USAID effort to improve the judicial system. First, we recommend high exposure of judges and lawyers to commercial aspects and importance of capital markets. Second, we recommend training and/or a framework initiative at the Indian Supreme Court level that would help implement a more efficient and effective judicial system; one that would be relevant and useful for both commercial purposes in the broader sense, and capital markets development in the narrower.

## Annex I

### Bankworld's Approach and Methodology

#### 1. SOW Request

The SOW provides that Bankworld perform an assessment of the FIRE-R project with the following specific objectives:

- a. Assess the extent to which the USAID has contributed to the development of SEBI into a robust regulator and the Indian securities market.
- b. Identify vulnerabilities and gaps in regulatory oversight competence, market systems and practices that undermine SEBI.
- c. Identify the areas where SEBI would need international expertise via USAID and USAID-FIRE is best positioned to intervene.
- d. Identifying areas for future effective and efficient USAID technical assistance, and
- e. Evaluate the technical assistance and training being provided by the SEC and suggest ways of making SEC support to SEBI more responsive and results-oriented.

#### 2. Refocus at USAID Mission in New Delhi

Upon meeting with representatives of the USAID Mission in New Delhi, our team was instructed that the key aspects of this SOW were prospective. That is, the Mission was not as concerned with assessment of the prior success of the FIRE-R as they were concerned with gaps and vulnerabilities in the capital markets regulatory regime. We were to focus on the Mission's strategic objective of mobilizing capital in the private securities markets, determine whether and to what extent the current program is accurately aimed at fulfilling this objective, and finally recommending what, if any, effective and efficient mechanisms might be implemented by USAID in achieving the Strategic Objective. Consequently, this report has elaborated on prospective developmental issues that we have identified, and it advises on practical means by which USAID may achieve its Strategic Objectives in the capital markets area.

#### 3. Methodology

Bankworld's methodology has been to review key market fundamentals from a developmental perspective, identifying impediments, assessing USAID's current approach for assisting in capital markets development (focusing on SEBI), and recommending areas where USAID may provide needed – and domestically unavailable – prospective assistance. Our specific way of doing this was to conduct interviews with key representatives of:

- a. Securities and Exchange Board of India (SEBI)
- b. The Ministry of Finance
- c. The Ministry of Company Affairs
- d. The Association of Mutual Funds of India (AMFI)

- e. The Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE)
- f. Investor Associations
- g. Brokerage firms
- h. Credit rating agencies
- i. Clearance and settlement organizations
- j. Sub-brokers
- k. Financial planners
- l. The US Embassy
- m. Law firms practicing in capital markets Mumbai
- n. Students of USAID-sponsored training programs
- o. The Government Law College, and
- p. Issuers of securities traded on the BSE and NSE.<sup>16</sup>

Bankworld also performed a review of institutional reports and third-party assessments of market development. Specific documents relating to the relevant period (2001-2004) reviewed and available upon request<sup>17</sup> include:

- a. Previously issued reports and recommendations of IBM and the US SEC
- b. Key capital market-related Indian laws, rules and regulations
- c. Various issuer prospectuses and periodic reports
- d. Reports of the various capital markets institutions, including but not limited to, Securities and Exchange Board of India (SEBI), Bombay Stock Exchange (BSE), National Stock Exchange (NSE), Reserve Bank of India (RBI), National Securities Depository Limited (NSDL), and
- e. Indian journalist reports.

---

<sup>16</sup> See detailed list of meetings and attendees at Annex B.

<sup>17</sup> Because of the volume of documents accumulated and selectively reviewed (10's of thousands of pages), and because much of the information is available in an electronic format, they have not been appended to this report. A list of the documents is, however, included as Annex C, and the underlying document is available upon request.

## Annex II

## Bankworld's Meetings

Date September 2004	Name, Title, Institution, Place
7	Tom Torgerson, International Economist, Department of Treasury, Office of International Banking and Securities Markets, Virginia
	Constantin Abarbiertei, Associate Partner; Maria Goravanchi, Business Consulting Services; IBM Global Services, Virginia; Tom Torgerson
8	Ester Saverson; Bob Strahota; Sean Watterson; International Affairs, SEC; Washington DC
8	John Crihfield, Economist and Financial Sector advisor; Chris Barltrop, Senior Financial Markets Advisor; David Dod, Georgia Sambunaris, Capital Markets Specialist; USAID; Washington DC
12	Shlok Kapoor, Manager, Sales Global Markets (Currency Trader), Standard Chartered Bank, New Delhi
13	Ashok Jha, Manager, FIRE-R Program, USAID, New Delhi
	Ashok Jha; Rebecca Black, Director, Office of Economic Growth; Christian Hougen, Deputy Office Director, Program Support; N. Ramesh, Project Development Specialist, Office of Program Support; USAID; New Delhi
	Ashok Jha; Rebecca Black; William Martin, Deputy Director, USAID; New Delhi
	Ashok Jha; Rajiv Bajaj, CFP, Managing Director, Bajaj Capital; Uttam Agarwal, Vice President, Institutional Advisory Group, Bajaj Capital; New Delhi
14	Ashok Jha, Parthapratim Mitra, Director of Capital Markets, Ministry of Finance; Piyush Srivastava, Deputy Director of Capital Markets, Ministry of Finance; New Delhi
	Ashok Jha, U.K. Sinha, Joint Secretary, Ministry of Finance; James Soriano, First Secretary (Economics), US Embassy; Akorlie A. Nyatepe-Coo, International Economist, US Department of the Treasury; Parthapratim Mitra, Piyush Srivastava; New Delhi
15	P.R. Ramesh, General Manager, SEBI; Ankit Sharma, Assistant General Manager, SEBI; C.S. Kahlon, Executive Director (Investigations and Surveillance), SEBI; R.S. Loona, Executive Director (General Council), SEBI; M.S. Sahoo, Chief General Manager (Registrations), SEBI; Mumbai
16	Don Hart, Chief of Party, IBM Business Consulting Services; Kate Hathaway, Consultant, IBM; Paritosh Sharma, Consultant, IBM; Tom Keyes, IBM; Mumbai
	Meeting with 12 Trainees (from SEBI and the exchanges) who attended various USAID/SEC training programs in the US and in India over the past 3 years; Mumbai
17	R. Ravimohan, Managing Director and CEO, CRISIL (Credit Ratings Agency of India,

Date September 2004	Name, Title, Institution, Place
	Subsidiary of S&P), Mumbai
	A.P. Kurian, Chairman, AMFI (Association of Mutual Funds in India), Mumbai
20	P.R. Ramesh, General Manager, SEBI; Ankit Sharma, Assistant General Manager, SEBI; Mumbai
	G.N. Bajpai, Chairman, SEBI; Mumbai
	Cyril S. Shroff, Managing Partner; Nimisha S. Rau, Senior Associate, Amarchand & Mangaldas & Suresh A. Shroff & Co.; Mumbai
	Professor Parimala R. Rao; Sunita Masani, Attorney; Abhay Ahuja, Attorney; Government Law College, Mumbai
	N.L. Bhatia, President; Rahul Goel, Associate; Ghatkopar Investors' Welfare Association, Mumbai
21	P.J. Nayak, Chairman, UTI Bank, Mumbai
	Sanjay Sachdev, Conutry Manager, Principal Financial Group, Mumbai
	Angus Simmons, Consul General; Krishna Mani, Senior Economic Advisor; American Consulate General, Mumbai
	J. Ravichandran, Director, Legal and Secretariat, Finance and Accounts, Compliance and Inspection, National Stock Exchange of India Limited (NSE), Mumbai
	A.K. Sridhar, Chief Investment Officer; Ashutosh Bishnoi, Chief Marketing Officer; Rathin Lahiri, Head of Marketing; UTI Mutual Funds, Mumbai
22	Rajnikant Patel, Chief Operating Officer, BSE, Mumbai
	P.K. Advani, Director, Advani Share Brokers; R. Krishnamurthy, Managing Director, Centrum Finance Limited; Mumbai
	Gagan Rai, Executive Director, National Securities Depository Ltd. (NSDL), Mumbai
23	Ashok Jha, Rebecca Black, Christian Hougen, N. Ramesh, USAID; New Delhi
	Walter E. North, Director, Ashok Jha, Rebecca Black, Christian Hougen, N. Ramesh, (plus 3 others of USAID), USAID, New Delhi
24	Jitesh Khosla, Joint Secretary, GoI, Ministry of Company Affairs; R. Vasudevan, Director of Inspection and Investigation, Ministry of Company Affairs, New Delhi
	Lee Brudvig, Mister Counselor for Economic Affairs, Embassy of the United States of America; Jim Soriano; Ashok Jha; New Delhi

### Annex III Documents Reviewed by Bankworld

#### A. IBM Material

No.	Title	Author	Dated
1	Assistance to Ministry of Finance in Developing a Model to Improve the Quality of Financial Advice to Indian Retail Investors-Draft Business Plan for the Proposed Regulatory Organization.	Tom Keyes, International Consultant. Paritosh Sharma, Capital Markets Consultant	April 2004
2	Assistance to SEBI in the Institutionalization of Securities Law Education: Assistance in Implementing SEBI's Strategic Action Plan to Institutionalize Securities Law Education and Training in India's Law Schools and Universities		June 2004
3	Broadening Investor Participation in the Markets: Assistance to Ministry of Finance of the Government of India in Developing a Strategy for Improving "Financial Literacy" in India.	Tom Keyes, International Consultant Paritosh Sharma, Capital Markets Consultant	April 2004
4	Assistance to SEBI: Review of the Progress of SEBI's Certification Program for all Market Intermediaries, including the Current Status of the Certification Program of AMFI, BSE and NSE	Tom Keyes, Int'l Consultant Paritosh Sharma, Capital Markets Consultant	June 2004
5	Assistance to SEBI in Establishment of a National Institute for Securities Markets (NISM): a) Continued assistance in Development of the NISM Business Revenue Model and the Provision of a High Level Assessment of Project Costs and Outlay b) Assistance in Negotiation with Financial Times-Knowledge (FTK)	Tom Keyes, International Consultant Paritosh Sharma, Capital Markets Consultant	June 2004

6	Assistance to SEBI in Design and Development of a Comprehensive, Integrated Securities Market Surveillance System, including Assistance in Determination of Technical and Functional Specifications and Criteria for required Operating Systems for Development of a Request for Proposal (RFP) to Select Systems Developers and Suppliers for Design and Development of an Integrated Surveillance System, including Assistance in the Comparative Analysis Process for Review and Evaluation of Technical Proposals received from bidders in response to the RFP	Kate Hathaway, International Consultant Prakash Srivastava, Arun Swamy	June 2004
7	Implementation of a Comprehensive Surveillance System Envisaged to be Accomplished with Design and Development Support from NASD: Field Visit for SEBI PMU to NASD	Kate Hathaway, International Consultant Prakash Srivastava, Arun Swamy	June 2003
8	Assistance in Implementation of the Central Registration Database for market participants	Tom Keyes, International consultant Paritosh Sharma, Capital Markets Consultant	September 2003
9	High Level Design and Recommendations for the Deployment of Systems to Support the SEBI's Market Surveillance Goals and Priorities:	NASD, Inc	August 2003
	Review of NASD Final Report and Recommendations concerning Proposed Market Surveillance System for SEBI	Kate Hathaway, International Consultant	September 2003
10	Assistance to Association of Mutual Funds in India (AMFI) in development of a framework of Disaster Recovery (Business Continuity) Planning for Registrar and Transfer Agents	Nitish Idnani and Manish Sarswat, Consultants, Capital Markets	September 2003
11	Assistance in Implementation of an Integrated Registration and Certification program for market intermediaries, including Investment Advisors	Tom Keyes, International Consultant Paritosh Sharma, Capital Markets Consultant	September 2003
12	Assistance to the National Law School (NLS) Bangalore in a "Train-the-Trainer" Program for the		September 2003

Teaching of Securities Regulation in India			
13	Assistance to SEBI in the Establishment of a National Institute for Securities Market (NISM): Assistance in Establishment of NISM		June 2003
14	Reorganization of SEBI: Implementation Plan for SEBI's Restructuring		June 2003
15	Recommendations for a uniform code for intermediaries	Tom Keyes, International Consultant Paritosh Sharma, Capital Markets Consultant	September 2003
16	Assistance in areas involving Capital Adequacy of market intermediaries	Tom Keyes, International Consultant Paritosh Sharma, Capital Markets Consultants	September 2003
17	Institutionalization of Securities Law Education: Launch of Government Law College Securities Laws Diploma		June 2003
18	Assistance to SEBI in Establishing Procedures for "No-Action" Letters	Cliff Kennedy, International Consultant	June 2003
19	SEBI- Comments on Kania Report		November 2002
20	SEBI Organizational Restructuring	USAID/PWC Financial Institutions Reform and Expansion Project	June 2002
21	Advisory Committee on Derivatives' Report on the Development and Regulation of Derivatives Markets in India, September 2002	Barry J. Bird, MSI, International Consultant Kate Hathaway, International Consultant Stephen Grimwood, MSI, MBA, International Consultant	December 2002
22	Progress Report: The Proposed Government Law College Post Graduate Certificate/Diploma Course in Securities Laws	Lewis J. Mendelson, International Consultant	June 2002

23	Comparative Assessment of Legal Information Available in the Electronic Medium, with Action Plan for Further Development	Lewis J. Mendelson, Team Leader: Securities Law Education	March 2002
24	Assessing Indian Derivatives Exchange Market Surveillance with Recommendations for Enhancement	Kate Hathaway, International Consultant	March 2002
25	Review and Assessment of the Certification Program of Association of Mutual Funds in India	Tom Keyes, International Consultant Paritosh Sharma, Consultant, Indian Capital Markets	March 2002
26	Survey of Risk Management Practices in the Indian Mutual Fund Industry	Kavita Savur, Jesal Sanghvi, Sandhya Bhate, Consultants, Indian Capital Markets	March 2002
27	Recommendations for Institutionalizing the Teaching of Securities Regulation at India's Law Schools	Lewis J. Mendelson, International Consultant	March 2002
28	Recommendations for the Indian Corporate Bond Market	Patrick Collins, International Consultant	March 2002
29	Recommendations for Eliminating Jurisdictional and Regulatory Gaps and Overlaps in the Indian Derivatives Market	Kate Hathaway, International Consultant	March 2002
30	"Issues in Certification of Financial Intermediaries: The Way Forward"	Tom Keyes and Paritosh Sharma	March 2002
31	Assessment of Clearing and Settlement Practices in the Indian Derivatives Markets	Stephen F. Grimwood, International Consultant Kate Hathaway, International Consultant Monika Jashani, Consultant	December 2002
32	Analysis and Report on Integration and Harmonization of Disclosure Systems Reader-Friendly Disclosures Offer Integration Confidential Information	William Archerd, International Consultant	December 2002
33	US Securities Markets Training Program	Neill McConnell, International Consultant	December 2002
34	Review of Proposal to Establish the Systems	Susan Hertel,	December

	Inspection and Management Audit (SIMA) Division	International Consultant	2002
35	Review and Comments on the report of the Justice Kania Group on Corporatization and Demutualization of Stock Exchange in India	Cliff Kennedy, International Consultant	November 2002
36	Road to STP in India	Sanjay Vatsa, International Consultant	December 2002
37	SEBI-US Capital Markets and Regulatory Tour (September 28- October 8, 2002)	Donald R. Hart, Chief of Party	December 2002
38	Review and Assessment of Development Progress of AMFI since FIRE I, with Action Plan for Further Development	Kavita Savur, Consultant, Indian Capital Markets	September 2001
39	Survey and Assessment of the Indian Bond Market	Patrick Collins, International Consultant	December 2001
40	Indian Securities Markets: Cash Settlement Framework	Susan Hertel, International Consultant	December 2001
41	Review of Existing Corporate Disclosure Mechanisms within India	Mary E. Beach, International Consultant	September 2001
42	Teaching Securities Regulation in India: A Comparative Assessment	Lewis J. Mendelson, Team Leader, Securities Law Education in consultation with William P. Fallon, Team Leader, Training	December 2001
43	Review of the Regulation of Indian Derivatives Markets with Recommendations for Market Enhancement	Kate Hathaway, International Consultant with Monika L. Jashani, Consultant	December 2001
44	India Securities Law Comparison: Analysis of Market Regulation Surveillance and Enforcement	Cliff Kennedy, International Consultant	September 2001
45	A Study on the Feasibility of the Establishment of an SIA Type Securities Industry Organization in India	Jonathan Bulkley, International Consultant and Paritosh Sharma, Consultant, Indian Capital Markets	December 2001
46	SEBI- Recommendations for Strengthening	Cliff Kennedy,	December

	Surveillance and Enforcement Policies and Procedures	International Consultant, Regulatory Expert and Team Leader Richard Symonds, International Consultant, Legal and Regulatory Susan Hertel, International Consultant, Regulatory Organizational Structuring	2001
47	Training of Trainers (TOT) Workshop	William P. Fallon, International Consultant	September 2001
48	Review of Licensing and Certification of Indian Brokers and other Retail Financial Intermediaries: 1998 to Present	Tom Keyes, International Consultant Paritosh Sharma, Consultant, Indian Capital Markets	December 2001
49	Workshop on Detailed Evaluation of Trading Mechanisms Based on International Standards	Andy Wilson, International Consultant with Barry Bird Kate Hathaway Monica Jashani	December 2001
50	Indo-US Financial Institutions Reform and Expansion Project- Capital Markets FIRE II	Cc: C.S. Kahlon, Executive Director, SEBI Ashok Jha, USAID Constantin Abarbieritei, PWC	Sept 26, 2001
51	The Ahmedabad Municipal Bond Issue India's First without a Guaranty		July 1999
52	Municipal Accounting and Financial Reporting Standards in India		Sept 1998

## b. News Articles and Editorials

No.	Title	Author	Dated
1	Listing authority high on agenda	Shaji Vikraman	Dec 30, 2002
2	SEBI empowered to call for probe records	Bureau	Nov 25, 2002
3	SEBI granted powers for search & seizure	Bureau	Oct 29, 2002
4	When laws wait for the word	Shaji Vikraman	Oct 21, 2002
5	Sinha, Jaitley to decide on additional powers to SEBI	Shaji Vikraman	May 27, 2002
6	Will SEBI Chairman's powers be defined?	Shaji Vikraman	Jan 21, 2002
7	Dalmia, DSQ Soft Banned From Mkt For 10 Years	Markets Bureau	Sept 11, 2004
8	Adjudication Proceedings Against Shapoorji, Others		Sept 4, 2004
9	Gellis Sold GTB Shares Between June 30 & July 29'	Investor Bureau	Aug 25, 2004
10	Sebi Throws New Light On Manic Monday	Sucheta Dalal	Aug 23, 2004
11	Sebi Debars Samir Arora For Five Years	Markets Bureau	Apr 2, 2004
12	SAT Reduces Penalty On 9 Companies	Markets Bureau	Sept 4, 2004
13	Sebi To Probe ONGC Share Muddle	Economic Bureau	Apr 1, 2004
14	Sebi Bars Trident From Accessing Mkt For 5 Yrs	Markets Bureau	Apr 8, 2004
15	Sebi Bars 2 CSE Brokers, Scraps Registration Of Vikash Somani	Markets Bureau	Mar 6, 2004
16	Sebi Watches Unusual Market Movement, Warns Stern Action	Markets Bureau	Feb 27, 2004
17	NSE Disabled 190 Terminals On May 17	Yagnesh Kansara	May 21, 2004
18	Sebi Confirms Debarring Aastha Pref Shareholders	Market Bureau	June 16, 2004

19	Sebi Warns JM Morgan Stanley, Asks For More Diligence		June 4, 2004
20	Sebi can't protect investors	Editorial	Feb 13, 2004
21	Sebi on the prowl	Editorial	Jan 20, 2004
22	They aren't enough to safeguard investors	Vinod Jain	June 30, 2003
23	Don't over-reach, Sebi	Editorial	Mar 27, 2003
24	Sebi sees light	Editorial	Mar 17, 2003
25	Two cheers, Sebi	Editorial	Jan 8, 2003
26	Advantage, Sebi	Editorial	May 3, 2002
27	Overcautious Sebi		Apr 9, 2002
28	About time, Sebi	Editorial	Jan 15, 2002
29	Sebi's amnesia	Editorial	Sept 23, 2002
30	Sebi set to probe badla resurrection in 3 bourses		
31	Sebi begins probe into fraud deal via pool		

## c. SEC Reports under FIRE-R

No.	Title	Author	Dated
1	The Indian Capital Market: An Assessment of Technical Assistance and Training Needs	Ester Saverson, Jr. Assistant Director Office of International Affairs U.S Securities and Exchange Commission	Dec 20, 2001
2	Memorandum Re: SEBI's Guidance Manual for Inspection of Stock Exchanges		Feb 8, 2002
3	Memorandum Re: SEBI's Guidance Manual for Inspection of Broker-Dealers		Apr 21, 2002
4	Annual Work Plan Under the PASA between USAID/INDIA and SEC	SEC's Office of International Affairs	July 1, 2001-June 30, 2002
5	Annual Work Plan Under the PASA between USAID/INDIA and SEC	SEC's Office of International Affairs	July 1, 2004-June 30, 2005
6	India Annexure to the Written Submission Table: SEBI Registered Market Intermediaries		
7	India Presentation, BSE	Kevin Desouza	
8	Written Submission of SEBI for the Country Presentation India		
9	Report on Financial Markets in India	Yatrik Vin, Vice President, National Stock Exchange of India Ltd.	2004
10	Training Provide Under PASA Between USAID/ India and SEC	To Ashok Jha from Ester Saverson	Dec 18, 2003

## d. IBM Material given in Mumbai

No.	Title	Dated
1	The Indian Capital Markets Reform Agenda: Areas of Required Assistance from the USAID FIRE Project	Sept 7, 2004
2	Distribution of Financial Products	Jan 22, 2004
3	IPO Distribution	Jan 22, 2004
4	Assessment of Impact of USAID Support to SEBI and its Future Technical Assistance Needs	Sept 15, 2004
5	FIRE: Training Database	June 30, 2004
6	Indo-US Financial Institutions Reforms and Expansion Project- Capital Markets List of FIRE II Deliverables	Sept 15, 2004
7	USSEC India Training Database	June 30, 2004
8	Update on Design and Development of SEBI's Integrated Market Surveillance System (IMSS)	Sept 10, 2004
9	Concept and definition differences	Sept 15, 2004
10	Assessment of Clearing and Settlement Practices in the Indian Derivatives Markets	
11	Developing a Corporate Bond Market in India	Sept 15, 2004
12	Stabilizing Futures and Options Markets through Improved Regulatory Oversight, Risk Management, and Introduction of New Instruments	Sept 14, 2004
13	Gaps and Vulnerabilities in regulatory oversight competence, market systems and practices that undermine SEBI's capacity to function as a world-class regulatory body	Sept 15, 2004
14	List of FIRE II Deliverables According to Assessment of T/A Focus Areas	Sept 15, 2004
15	FIRE-R Project Achievements	Sept 15, 2004

16	USAID FIRE II Capital Markets Project Deliverables		Period of Performance: Jan 2003-June 2004
17	Small is not yet Beautiful -- Article	Sumit Gulati	

e. Regulator Material

No.	Title	Author	Dated
1	SEBI Annual Report		2003-2004
2	Review of Markets Annual Review of Financial Markets	The Stock Exchange, Mumbai	2004
3	SEBI Manual An Authorized Publication of SEBI	Published by Taxmann Allied Services (P) Ltd.	2004

f. Market Participants Information

No.	Title	Author	Dated
1	Association of Mutual Funds in India 9 <sup>th</sup> Annual Report		2003-2004
2	Investors India	A Bajaj Capital Publication	September 2004
3	National Electronic Settlement and Transfer (NEST) Update		Sept 2004

## g. Other Materials

No.	Title	Dated
1	Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation	October 2003
2	Definitions from 1956 Regulation	
3	SEBI Annual Report	2003-2004
4	SEBI Annual Report	2002-2003
5	SEBI Annual Report	2001-2002
6	SEBI Annual Report	2000-2001
7	RBI Annual Report	2003-2004
8	RBI Annual Report	2002-2003
9	RBI Annual Report	2001-2002
10	National Securities Depository Limited 8 <sup>th</sup> Annual Report	2002-2003
11	National Securities Depository Limited 7 <sup>th</sup> Annual Report	2001-2002
12	National Securities Depository Limited 6 <sup>th</sup> Annual Report	2000-2001

## Annex IV

### Areas of Greater Adherence to IOSCO Principles

- a. Principle 5: “The staff of the regulator should observe the highest professional standards including appropriate standards of confidentiality.” In particular, SEBI needs to (1) monitor and review staff use of information; (2) monitor staff’s keeping confidentiality and protection of personal data; and (3) ensure staff’s observance of ‘fairness’ in performance of their functions. SEBI, if not already implemented, must institute a Code of Ethics for its staff and directors, as well as prohibit trading of securities by its staff and immediate reporting of trades (if any) by its directors.
  
- b. Principle 19: “Regulation (of Collective Investment Schemes, i.e., mutual funds) should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor’s interest in the scheme.” In particular, the SEBI must ensure that the mutual funds are using internationally acceptable accounting standards.

SEBI should pay particular attention to assure that the regulatory framework is structured to prevent investors being misled by inappropriate presentation of elements such as risks associated with the investment policies and trading strategies of the scheme, reference to past performance, and fees and other charges that may be levied under the scheme.

In order to ensure use of IAS, the annual financial reports of these mutual funds should state this. SEBI may require this statement to be included in the annual reports and otherwise, to have the auditors state the reasons or areas of deficiency. Certainly, SEBI may (and should) perform its own audit of the financial records and accounting standards of the mutual funds.

- c. Principle 20: “Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.” In particular, (1) the calculation of NAV is not necessarily done in a transparent and fair manner, nor in accordance with accepted accounting standards on a consistent basis; (2) independent auditors are *not* required to check the valuation of CIS assets; and (3) there are no regulatory requirements or reviews of pricing errors. Some equity assets may be illiquid and therefore priced inappropriately or inaccurately. As well, pricings of corporate bonds, which were purchased through a private placement or in the over the counter market (i.e., via telephone, in a totally opaque environment) may be priced inaccurately as well. As these corporate bonds are not trading on an exchange, there is also an issue of liquidity for trading or meeting redemption needs.

Proper valuation of collective investment scheme assets is critical to ensure investor confidence in CIS as a reliable and robust investment vehicle and for proper investor

protection, especially in cases where a market price is unavailable. The regulatory framework should permit the responsible authority to ensure compliance with the relevant rules.

- d. Principle 21: “Regulation should provide for minimum entry standards for market intermediaries.” In particular, SEBI does not regulate investment advisors. IOSCO recommends that (1) capital adequacy and other operational controls apply to investment advisors, (2) the regulator ensure the protection of client assets of investment advisors, (3) the regulator implement record keeping requirements, clear and complete disclosures, and rules preventing investment advisor *guarantees* of future investment performance, misuse of client assets, and potential conflicts of interest.

Relating to Investment Advisors, IOSCO recommends that if an investment advisor deals on behalf of customers, the capital and other operational controls applicable to other market intermediaries should apply to that advisor. However, if the advisor does not deal, but is permitted to have custody of client assets, regulation should provide for the protection of client assets, including segregation and periodic or risk-based inspections (either by the regulator or an independent auditor). Yet, there are investment advisors who neither deal on behalf of clients nor hold or have custody of client assets nor manage portfolios but who only offer advisory services without other investment services. In this case, separate licensing of the investment advisor may not be required.

SEBI does not require certification of most intermediaries (except for those selling mutual funds) and does not require registration of sub-brokers. The authorization, licensing or registration of market intermediaries should set minimum standards of entry that make clear the basis for authorization and standards that should be met on an ongoing basis. It is agreed that SEBI should initiate requirements and a procedure for proper registration and certification of all intermediaries, prioritizing for those intermediaries who sell securities to clients. SEBI should also have the ability to refuse licensing of an intermediary, subject to administrative or judicial review, if authorization requirements have not been met. Alternatively, SEBI may decide to designate the registration and licensing responsibilities to the SROs, with proper authority to register, license, and/or refuse or de-license intermediaries under the SRO’s jurisdiction.

- e. Principle 22: “There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.” In particular, IOSCO recommends that capital adequacy requirements be imposed on market intermediaries, which reflect their respective market, credit, liquidity, operational, and legal risks. Additionally, IOSCO recommends that the capital standards are sufficient enough to allow the intermediary to wind down business without loss to its customers or disrupting the orderly functions of the market.

The establishment of an adequate initial and ongoing capital requirement increases the protection of investors and the integrity of financial systems. A brokerage firm should be required to ensure that it maintains adequate financial resources to meet its business commitments and to withstand the risks to which its business is subject. Risk may result from the activities of unlicensed and off-balance sheet affiliates. Therefore, regulation should consider the need for information about the activities of these affiliates. As well, the need for consolidated balance sheets is most apparent.

Currently, there are no *net* (i.e., liquid) capital requirements implemented, only capital requirement, and for brokers, deposits made to reflect their trading capacities. On a real time basis, if the exchanges discover that a broker has positions in excess of the coverage of the deposit, the exchange will *immediately* cut off that broker from trading, including closing out positions. That broker must then deposit additional money into its account. In the meantime, clients of the broker or sub-broker are frozen, until the broker makes a sufficient additional deposit. Therefore, the capital adequacy requirements should be structured to result in needed capital addressed to the full range of risks to which market intermediaries are subject, e.g., market, credit, liquidity, operational, and legal, risks. Most important for brokers is that they have sufficient *liquid* capital to liquidate assets in order to meet client liabilities.

Other deficiencies in SEBI's current regime relating to intermediaries include (1) no sufficient reporting standards for the deterioration in capital adequacy of intermediaries (including no early warning reporting requirements); (2) no assessment of financial risks undertaken by intermediaries performed by the independent auditors; and (3) no review and monitoring of capital levels.

- f. Principle 23: "Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, insure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters." In particular, SEBI does not require intermediaries to have supervisory procedures and practices, nor are intermediaries required to perform self-assessments (or assessments by independent auditors) of their own internal controls. Additionally, intermediaries are not required to have mechanisms in place to ensure fair treatment of its clients. At the very least, SEBI should ensure that all intermediaries investigate and resolve all customer complaints, and keep these investigations and resolutions in a "customer complaint file", to be presented to the regulator upon request. The regulator may also require all intermediaries to report customer complaints, as well as to report the resolution to these complaints.

Market intermediaries should conduct their businesses in a way that protects the interests of their clients and helps preserve the integrity of the market. Regulation should require that market intermediaries have in place appropriate internal policies and procedures, including those for supervision, for observance of securities laws and appropriate internal controls and risk management systems to prevent misconduct or negligence. Generally accepted principles require each intermediary to keep and

adhere to written supervisory procedures...and a delegated Compliance Officer to ensure that these procedures, as well as laws, regulations, and rules, are adhered to.

- g. Principle 24: “There should be a procedure for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.” In particular, SEBI does not require early warning systems or reporting by intermediaries who may be in a potential default position. Additionally, SEBI does not have clear plans for dealing with the eventuality of an intermediary’s failure.

The failure of a market intermediary can have a negative impact on customers and counterparties and may have systemic consequences. The regulator must have a clear and flexible plan in place to deal with the eventuality of failure by market intermediaries. The regulator should attempt to minimize damage and loss to the investor.

For the most part, SEBI’s deficiencies relating to full compliance with IOSCO’s recommended principles deal with the supervision and operations of Collective Investment Schemes and Intermediaries. While it is important for SEBI to correct these deficiencies, it will not require a great deal of work. SEBI would have to adopt stronger and more specific rules as well as have the SROs (i.e., the Exchanges) adopt strong reporting and operational rules for its members. Additionally, SEBI and the SROs would need some amount of training and possibly some technical assistance, and the intermediaries as well as the Collective Investment Schemes need to be educated in the procedures necessary for compliance. Practically speaking, SEBI can implement necessary changes, yet a 3-month TA from USAID could fulfill the SEBI’s compliance with IOSCO principles.

## Annex V

### SEBI Concept Paper on Professional Rating of Intermediaries

December 2004

Professional Rating of market intermediaries, as a concept, is a matter of debate and discussions. The need for rating is felt not only from the point of view of greater disclosure requirements for investor's interests, considering the important role such intermediaries play, being an interface between investors and exchanges/SROs but also from the point of view of measuring the adequacy of systems and controls to meet internal as well as external compliance requirements.

Market Intermediaries Regulation and Supervision Department, Division of Policy and Supervision-1 has prepared a draft concept paper on rating of market intermediaries (brokers). The paper is placed below for eliciting public comments. It may be noted that the concept paper is only at the draft stage and does not necessarily reflect the views of SEBI on the issue. SEBI would be considering the comments received from different sources before taking a view on the matter.

Public comments may be sent to SEBI, Division of Policy and Supervision-1, Market Intermediaries Regulation and Supervision Department, World Trade Centre, 29<sup>th</sup> Floor, Cuffe Parade Mumbai 400 005 or e-mailed to [ashishk@sebi.gov.in](mailto:ashishk@sebi.gov.in) or faxed to 91-22-22164482/22164494 latest by December 10, 2004.

#### **A. Need for Intermediaries Rating Services (Brokers)**

In view of the developments that are taking place in the capital markets, the need to constantly upgrade and improve systems and procedures in operation as well as skill sets has gained considerable importance. Besides compliance with regulatory requirements both in letter and spirit has assumed significance so as to mitigate risk and ensure adequate protection of investors' interest.

In light of these developments, quality, competence, professionalism and standards of ethics being adopted by market intermediaries have become all the more necessary. These developments underpin the need to measure and compare the relative competencies and standards of services of the intermediaries on these and other parameters in order to provide investors necessary information to compare the intermediaries.

One of the tools with which these parameters can be measured and indexed is the professional rating of intermediaries by independent rating agencies. The rating index would measure these intermediaries on laid down criteria and will be an indication of the relative strength of the financials and other parameters of the intermediary. It must however be mentioned that rating of intermediaries has not been tried in many countries. A few of the rating agencies in India

have already begun the exercise. SEBI would be discussing the methodology with them to refine it further and intends to encourage market intermediaries to get themselves rated.

## **B. Rating Objectives/Benefits**

The intended objectives of rating as well as benefits accruing from the exercise are thought of as below:

- 1) It is expected to spur growth of professionally managed entities as business development and opportunities would result from such an exercise.
- 2) Investors interest may gain more importance, as this would be a factor to be considered while taking a rating decision. Investors would be knowledge investors and will be informed about the standing of the entity.
- 3) Rated entity would be in a position to brand its image and capitalize the same for generating more business.
- 4) Benchmarking with others in the field is expected to constantly improve and upgrade the performance.
- 5) Risk management systems and procedures are expected to improve as this will be a vital rating criteria.
- 6) Process of consolidation of entities is expected to start, as focus would be either to shape up or ship out.
- 7) Overall compliance standards are expected to improve as a result.
- 8) In a nutshell, the product may accrue significant benefits to all stakeholders including the investors, stockbrokers themselves, the regulator and others who will benefit from the transparency and the consequential focus on efficiency.

## **C. Role of Credit Rating Agencies**

Rating of intermediaries based on well-defined parameters would be done by the credit rating agencies registered by SEBI under SEBI (Credit Rating Agencies) Regulations, 1999. Rating agencies interested in doing rating exercise would be required to develop suitable rating process, methodology and parameters in this regard. Rating parameters are expected to cover the entire process flow and operations of the rated entities so as to take a holistic view while awarding a particular rating.

## **D. Rating- Optional or Mandatory**

While the product for rating of intermediaries would be encouraged to be introduced in the markets, it is felt that the demand for the product should come from the market itself instead of any imposed obligation on the intermediaries to go for it. Further with the relative maturity of the markets and self imposed code of discipline, which arises out of such maturity, the demand for product is expected to rise as more and more intermediaries would like to get themselves rated and measured, both for internal evaluation and introspection and for giving an insight into its affairs to the outside world and for marketing its services.

It is further observed that a similar approach has been followed by the rating agencies while introducing Corporate Governance and Wealth Creation and Management Index. While the

index has not been mandated, companies in their pursuit to achieve higher and higher levels of governance standards are on their own getting themselves rated. Similarly, for market intermediaries also, as the process of consolidation and need to shape up gains momentum, the role and significance of such an index would be felt more and more by them. The rating product is also expected to shore up the interests of investors in the capital markets' as a highly rated entity is expected to be more concerned with protection of investors' interests in all its dealings.

### **E. Rating Approach/Components of Rating**

It is expected that rating methodology should invariably cover the following points while taking a rating decision:

#### 1. Organization structure:

Legal structure of the firm, ownership pattern, organization structure which would include physical and technological infrastructure, adequacy and competence of personnel, qualification and professionalism of the top management who are at the helm of affairs, checks and balances built into the system, flow pattern of information, clear definition of job profiles, proper delegation of authority and well laid down accountability and responsibility statement.

#### 2. Risk Management Policy and System:

The risk management practices and risk appetite of the entity, systems and procedures for managing different types of risk including market risk, systemic risk, credit risk, operational risk, policy on giving exposure to and collection of margin and pay-ins from clients, sub brokers etc. This would also include analysis of clients mix (retail/institutional), extent of proprietary trading, day trading, etc.

#### 3. Policy on Investors interest:

The Management policy on ensuring fair dealing for clients, time taken to make pay- out of money as well as securities to clients including the end clients of sub brokers, policy on handling investors grievances, time taken to settle the complaints and steps taken to ensure non repetition of the same, dealing with arbitration matters, promptness in attending to such matters, quantitative assessment of the organization's approach towards investors protection.

#### 4. Organization process and procedures:

The flow of work pattern in the organization, possible bottlenecks which may affect the performance of functions, procedures adopted by the entity in dealing with different facets of operations including opening of new accounts, executing trades, issuance of contract notes/bills to clients, executing agreements, obtaining clients information, operating bank accounts, DP account, dealing with sub brokers etc.

#### 5. Management policy on compliance:

The importance attached to the concept of compliance in the organization, role and relative importance of the compliance officer, information flow from/to compliance officer, actual

compliance with various rules/regulations/circulars/bye laws of SEBI/stock exchanges etc., steps taken by the management to ensure that problematic areas are addressed promptly etc.

#### 6. Financials:

The financial strength of the entity as judged from its net worth, capital structure, gearing and other operating ratios, exposure taken by the entity based on financials, policy on short term and long term borrowing, extent of leveraging for proprietary trading, transparency and quality in disclosures relating to operations, quality of disclosure in directors reports, any adverse reporting by the auditors and steps taken to rectify the same etc.

#### 7. History/Background:

Factors would include an analysis of factors like imposition of fines/penalties etc. by regulators/stock exchanges/other SROs, action taken by government authorities, repetition of violations which resulted in such imposition/action etc.

#### 8. Firm's Positioning:

Factors which may be analyzed would include the market structure, size of the market and level of competition, number of players in the field, core competence of the entity, dominance of players, market share, trend in market size and market share, comparative analysis with others firms on different parameters.

It may be noted that the above factors are only illustrative and not exhaustive and rating industry may devise their own models and methodologies for rating a broker. Further appropriate weightages may be given to these and other factors as may be deemed fit to provide for a level playing field to smaller as well as big brokers while undergoing rating exercise.

### **F. DISSEMINATION OF RATING**

The rating awarded by the rating agency to the intermediary may be disseminated by such intermediary on its website and advertisements subject to necessary approvals, for business promotion and to brand its image. However disclosure of rating obtained would be optional for the intermediary. Rating agencies would also need to obtain prior approval from the rated entity before disclosure of rating awarded to the entity.

### **G. ACTION PLAN**

- Ratings may be made optional and not compulsory. Growth in demand and greater maturity and understanding of the issue would automatically spur interest to go for the rating in due course of time.
- Ratings should invariably cover all the memberships of the entity so as to present a holistic picture.
- If the entity is also registered as an intermediary in other capacities, suitable rating exercise may need to be carried out to measure the overall level of performance across different activities and hence rating product would need to be evolved over a period of time to cover the entire gamut of activities being undertaken by the rated entity.

- Initially ratings may be given for a period of one year and then revised. However if required ratings may be kept under surveillance/reviewed earlier also.
- Rating agencies would draw out a detailed rating criteria, methodology and process for evaluating brokers.
- Rating instruments and symbols should make it amply clear that rating is not intended to induce people to trade through a particular entity. It is only a reflection of the performance of the entity.
- Rating rationale and rating process may be disseminated to general public.