

## Reforms in Capital Market in India and the role of SEBI

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### Abstract

Prior to the 1991 reforms, a comprehensive system of State controls assured the State's almost complete domination of the financial or capital markets. In 1991 with the announcement of the economic reforms package, the volume of business in both primary and secondary segments of the capital market of our economy increased enormously. But after the multi-crore securities scandal in 1992, the SEBI (Securities and Exchange Board of India) to come into existence with a lot of powers conferred on it, to monitor and regulate the capital market. The work done by the SEBI so far is promising for the progress of our stock market. There are few instances existed when in spite of having a well formulated legal framework scandals emerged in our capital market. However, the regulatory system is needed to be revised.

**Key Words: Capital Market, SEBI, Regulation**

### Introduction:

Prior to the 1991 reforms, a comprehensive system of State controls assured the State's almost complete domination of the financial markets. Under the Capital Issues (Control) Act, the Ministry of Finance (MoF) controlled the price and quantity of initial public offerings through the powers of the Controller of Capital Issues (CCI) and set interest rates on fixed income products, which limited access to capital and financial services. There were few private banks and those faced significant limitations on business expansion. Interest rates were administered by the Reserve Bank of India (RBI). Entry barriers throughout the financial sector limited opportunities to start banks, mutual funds, securities exchanges, brokerage firms, insurance companies and pension funds. State-owned banks had only minimal equity capital and lacked prudential norms of accounting, asset classification, and provisioning. Government controls funneled insurance funds and pension funds to Government bonds and bank deposits. In 1991 with the announcement of the economic reforms package, the volume of business in both primary and secondary segments of the capital market of our economy increased enormously. But after the multi-crore securities scandal in 1992, which rocked the

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Indian Financial System, a requirement for an autonomous, statutory and legally powerful integrated regulatory framework was sensed because the then existing authority was found to be inadequate to ensure the smooth functioning of the capital market and give proper protection to the investors. This was the breeding ground of the SEBI (Securities and Exchange Board of India) to come into existence to monitor and regulate the capital market. Securities and Exchange Board of India (SEBI) that was already in existence since April, 1988, was conferred on powers to protect the interests of the investors. SEBI got its legal entity through an ordinance issued on 30<sup>th</sup> January, 1992. SEBI was conferred powers on various dimensions including the power to prohibit “*Insider Trading*”, “*Takeover of Business*”, and “*Regulation of Substantial Acquisition of Shares*”, etc. The objectives to issue such an ordinance were (i) to provide the investors the shield of protection, and (ii) to regulate the functioning of the securities market for its promotion and development. The ordinance was repealed by the SEBI Act on April 4, 1992. Though SEBI is an autonomous body it actually functions under the governance of the Ministry of Finance. SEBI enjoys the status of an independent organization and its activities are accountable to the Parliament. “*The Securities and Exchange Board of India Act, 1992 (the SEBI Act) was amended in the years 1995, 1999 and 2002 to meet the requirements of changing needs of the securities market and responding to the development in the securities market. Based on the Report of Joint Parliamentary Committee (JPC) dated December 02, 2002, the SEBI Act was amended to address certain shortcomings in its provisions. The mission of SEBI is to make India as one of the best securities market of the world and SEBI as one of the most respected regulator in the world.*” However, despite the regulation of SEBI “Ketan Parekh Scam” broke out in 2001, which necessitated the review of the regulation and function of SEBI. In December, 2002, a report, prepared by the Joint Parliamentary Committee (JPC) on securities market scam of 2001, had also recommended several issues that were needed to be included in the regulatory framework. Some of the recommendations included are provisions for compensation to aggrieved investors, the concept of Ombudsman in the capital market, establishment of special courts for financial crimes, regulation of listed companies by SEBI, shifting of Investor Education and Protection Fund established under section 205C of the Companies Act to SEBI, etc. To give effect to these recommendations SEBI Act was required to be amended. Following the recommendations the SEBI Act was amended in 2002 that sought “*to address certain shortcomings in the provisions of the SEBI Act, 1992, particularly with respect to matters relating to inspection, investigation and enhancement of penalties to serve as effective deterrents.*” However, some ambiguities were required to be removed in order to give effect to the amendments to the then existing SEBI Act.

### **Objectives of the Study:**

The objectives of the study are as follows:

- (1) to give an overview of the legal framework of the Indian Financial Regulatory Mechanism both in the pre-reforms and post-reforms periods;
- (2) to study the development in the capital market in India;
- (3) to evaluate the performance of SEBI in various aspects of its activities that promise to provide investor's protection.

### **Legal Framework in the Pre-reforms Period:**

Prior to 1992, the regulatory system of India's planned economy was marred by dispersed and uneven regulatory responsibilities, obsolete definitions, regulatory gaps and lack of accountability. The major elements of legal framework in pre-reforms period are depicted below:

#### ***Capital Issues (Control) Act of 1947 (CICA)***

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

#### ***Chartered Accountants Act of 1949 (CAA)***

The Chartered Accountants Act of 1949 placed governance of the accounting profession, including standards setting and discipline, under the Institute of Chartered Accountants of India (ICAI). However, compliance with the standards was not mandatory, and the ICAI lacked the power to enforce them.

#### ***Companies Act of 1956***

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

#### ***Securities Contracts (Regulation) Act of 1956 (SCRA)***

The objective of Securities Contracts (Regulation) Act of 1956 (as stated in its preamble) was "to prevent undesirable transactions in securities by regulating the business of dealing

therein.” It governed stock exchanges, securities contracts, and listing of securities. It also declared options in securities illegal, and, until 1999, its definition of “securities” was limited to listed stocks and debentures and “exchange” referred only to the “trading floor,” without including an electronic trading platform.

***Unit Trust of India Act of 1963 (UTI Act)***

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

***SEBI: The Board***

SEBI was formed in 1988, but was not granted the statutory powers until speculative price rises in the secondary market confirmed the need for a stronger regulator. The regulations of SEBI would expectedly shape much of the institutional structure of India’s capital markets.

**The Major Reforms in Capital Market:**

**Phase: I (From 1992 to 1996):**

- (i) The Securities and Exchange Board of India, which was set up under an administrative arrangement, given statutory powers with the enactment of the *SEBI Act, 1992*. *Capital Issues (Control) Act, 1947* was repealed and the Office of Controller of Capital Issues was abolished. Companies were given the freedom to raise funds from securities market after filing letter of offer with *SEBI*.
- (ii) Listing agreements of stock exchanges were amended that required the listed companies to furnish annual statement to the stock exchanges showing variations between financial projections and projected utilization of funds in the offer document and to enable shareholders to make comparisons between performance and promises.
- (iii) Governing boards of the stock exchanges were reconstituted by the *SEBI* by introducing capital adequacy norms for brokers and issuing rules for making the client-broker relationship more transparent, in particular, segregating client and broker accounts.
- (iv) *National Stock Exchange of India (NSE)* was set up with computerized online screen based nationwide electronic trading.
- (v) *Over the Counter Exchange of India (OTCEI)* was set up with computerized mechanism with the facility of online electronic trading.

- (vi) Incentives were given to *Foreign Institutional Investors (FIIs)* by allowing them access to Indian capital market on registration with *SEBI*.
- (vii) Indian companies were allowed access to international capital markets through Euro issues.

***Book-Building Mechanism:***

To keep pace with the globalization and liberalization process, the government of India was very keen to bring the capital market in line with international practices through gradual deregulation of the economy. An important mechanism named as Book Building in the system of initial public offerings (IPOs) was recognized by SEBI in India after having the recommendations of the committee under the chairmanship of Y. H. Malegam in October, 1995. SEBI guidelines recognized book building as an alternative mechanism of pricing. Under this approach, a portion of the issue is reserved for institutional and corporate investors.

***Phase: II (From 1996 & Onwards):***

***Promoter's Contribution and Lock-in:***

To ensure promoters' association and commitment to company and to increase investors' confidence in public issues of unlisted companies, the minimum promoters' contribution of 20% for unlisted companies was required to be locked in for 3 years.

***Dematerialization Method:***

In order to eliminate problems relating to loss of allotment letters, share certificates, etc., and to induce the investors to opt for allotment of dematerialised shares, the trading for IPOs in dematerialised form had been made compulsory with an option available to the investors for physical shares.

***Internet Trading:***

To give more facilities to investors in the form of convenience, transparency and real time trading, the internet based trading had been allowed.

***Educating the Investors:***

To educate the investors the working group had been appointed that recommended application of information booklets on dematerialization, secondary and primary market operations and imparting education through radio and media.

***Derivative Trading:***

To provide liquidity to the market and to enable market to absorb larger stocks derivative products were expanded subsequently to include options on indices and thereafter to option on individual stocks.

***Incentives for Foreign Institutional Investors:***

In order to attract more foreign investments in stock markets FIIs, foreign corporate bodies and foreign individuals were permitted to invest up to 5% of the total issued capital of the company.

**Evaluation of Performance of SEBI:**

The purpose for which the SEBI was established was to ensure the protection of the interests of the investors, to monitor or regulate and stimulate the growth of the securities market. There are a number of actions taken by the Board on persons, intermediaries for violating or contravening the rules or guidelines that might endanger the development of the securities market. The work done by the SEBI so far is promising for the progress of our stock market. A part of the role that SEBI plays, since its inception in the Indian financial system, evolved dual approaches i.e. Proactive Approach and Reactive Approach.

**1 Proactive Approach:**

This approach signifies the SEBI's role as an educator. The concept of awareness about the security markets by the investors had been given the major emphasis. SEBI has been taking different steps all directed towards investors education. The initiatives taken by the Board include Securities Market Awareness Campaign (SMAC), display of various audio-visual and printed educative materials, organizing workshops, introduction of investor's website (<http://sebi.investor.gov.in>), introduction of the electronic grievance lodging system and various other types of advertisements like Newspapers/Magazines, TV Campaign, etc. All these steps were taken as a recognition of the concept :“*An Educated Investor is a Protected Investor*”

**1 Reactive Approach :**

The reactive approach is, however, regulatory in nature. This actually serves as a grievance redressal mechanism. After receiving the complaints from the investors the Board then takes action against intermediaries or any one who has violated the rules or guidelines prescribed by the SEBI. The following are the types of the grievances the SEBI takes up.

## Types of Grievances

|           |  |
|-----------|--|
| Type I    | Refund Order/Allotment Advice  |
| Type II   | Non-Receipt of Dividend  |
| Type III  | Non-Receipt of Share Certificates after transfer   |
| Type IV   | Debentures   |
| Type V    | Non-Receipt of letter of offer for right   |
| Type VI   | Collective Investment Schemes  |
| Type VII  | Mutual funds/Venture capital funds/ Foreign Ventures/ Capital Investors/<br>Foreign Institutional Investors/ Portfolio managers, Custodians  |
| Type VIII | Brokers/ Securities Lending Intermediaries/ Merchant Bankers/ Registrars and<br>Transfer agents/ Debenture Trustees/ Bankers to Issue/ Credit Rating Agencies<br>Underwriters/ Depository Participants |
| Type IX   | Securities Exchanges/ Clearing and Settlement Organization/ Depositories   |
| Type X    | Derivative Trading   |
| Type XI   | Corporate Governance/ Corporate Restructuring/ Substantial Acquisition and<br>Takeovers/ Buyback/ Delisting/ Compliance with Listing conditions  |

### 1 Inspection:

As per the Annual Report 2006-07, published by the SEBI, during the year 2006-07 the total number of grievances received was 26,473 and the total number of grievances redressed during the year was 17,899. The rate of the grievances redressed is 67.6%. The total number of grievances received from 1991-92 to 2006-07 was 29,07,053 and the total number of grievances redressed up to 2006-07 was 27,40,959. SEBI's response to investor complaints in 1991-92 was only 21.6% whereas in 2006-07 this rate was 67.6%. The overall rate of response to investors' grievances was 94.28% and it was still increasing. This indicates that SEBI had made a handsome progress towards meeting with the investors' protection mechanism. The picture is shown below.

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**Table : 1**

| Year    | Grievances Received |            | Grievances Redressed |            | Cumulative Redressal Rate (%) | Year-wise Redressal Rate(%) |
|---------|---------------------|------------|----------------------|------------|-------------------------------|-----------------------------|
|         | During the Period   | Cumulative | During the Period    | Cumulative |                               |                             |
| 1991-92 | 18794               | 8794       | 4061                 | 4061       | 21.6                          | 21.6                        |
| 1992-93 | 110317              | 129111     | 22946                | 27007      | 20.9                          | 20.8                        |
| 1993-94 | 584662              | 713773     | 339517               | 366524     | 51.4                          | 58.0                        |
| 1994-95 | 516080              | 1229853    | 351842               | 718366     | 58.4                          | 68.2                        |
| 1995-96 | 376478              | 1606331    | 315652               | 1034018    | 64.4                          | 83.8                        |
| 1996-97 | 217394              | 1823725    | 431865               | 1465883    | 80.4                          | 100.0                       |
| 1997-98 | 511507              | 2335232    | 676555               | 2142438    | 91.7                          | 100.0                       |
| 1998-99 | 99132               | 2434364    | 127227               | 2269665    | 93.2                          | 100.0                       |
| 1999-00 | 98605               | 2532969    | 146553               | 2416218    | 95.4                          | 100.0                       |
| 2000-01 | 96913               | 2629882    | 85583                | 2501801    | 95.1                          | 88.0                        |
| 2001-02 | 81600               | 2711482    | 70328                | 2572129    | 94.9                          | 86.0                        |
| 2002-03 | 37434               | 2748916    | 38972                | 2611101    | 95.0                          | 100.0                       |
| 2003-04 | 36744               | 2785660    | 21531                | 2632632    | 94.5                          | 59.0                        |
| 2004-05 | 54435               | 2840095    | 53361                | 2685993    | 94.5                          | 98.0                        |
| 2005-06 | 40485               | 2880580    | 37067                | 2723060    | 94.5                          | 91.5                        |
| 2006-07 | 26473               | 2907053    | 17899                | 2740959    | 94.2                          | 67.6                        |

Source: Annual Report 2006-07, Published by SEBI

**1 Investigation:**

SEBI is empowered to call for any investigation into the affairs of any persons or intermediaries, who or which it believes, have violated any rules or regulations under the SEBI Act. This power is conferred on SEBI under section 11C of the Act. Investigations are undertaken to examine alleged or suspected violations, to gather evidence, and to identify persons/entities behind irregularities and violations, such as: price manipulation, creation of artificial market, insider trading, etc. Table: 2 shows the cases taken up for investigation and completed from the year 1992-93 to 2006-07.

**Table : 2**

| Year                  | Cases taken up For investigation | Cases Completed | %of Cases completed |
|-----------------------|----------------------------------|-----------------|---------------------|
| 1992-93               | 2                                | 2               | 100                 |
| 1993-94               | 3                                | 3               | 100                 |
| 1994-95               | 2                                | 2               | 100                 |
| 1995-96               | 60                               | 18              | 30                  |
| 1996-97               | 122                              | 55              | 45                  |
| 1997-98               | 53                               | 46              | 87                  |
| 1998-99               | 55                               | 60              | 100                 |
| 1999-00               | 56                               | 57              | 100                 |
| 2000-01               | 68                               | 46              | 67                  |
| 2001-02               | 111                              | 29              | 26                  |
| 2002-03               | 125                              | 106             | 85                  |
| 2003-04               | 121                              | 152             | 100                 |
| 2004-05               | 130                              | 179             | 100                 |
| 2005-06               | 165                              | 85              | 49                  |
| 2006-07 (provisional) | 127                              | 102             | 80                  |
| <b>Total</b>          | <b>1200</b>                      | <b>938</b>      | <b>78</b>           |

Source : Annual Report, 2006-07, Published by SEBI



### 1 Inspection of Brokers and Sub-Brokers:

SEBI apprehends the power to inspect the affairs of the brokers and sub-brokers when it thinks it is required. In 2005-06 period the total number of inspection of stock brokers is 7 whereas in 2006-07 this figure goes up to 30. Apart from this, surprise inspection had been conducted on 32 Stock/Sub-brokers in 2005-06 and 37 in 2006-07. Table:3 shows this picture.

**Table : 3**

| Particulars  | 2005-06 | 2006-07 |
|--|---------|---------|
| Regular Inspections completed – Stock Brokers                    | 7       | 30      |
| Regular Inspections completed– Sub Brokers                       | Nil     | Nil     |
| Surprise/Limited Purpose Inspections – Stock Brokers/Sub-brokers | 32      | 37      |

Source: Annual Report, 2006-07, Published by SEBI.

### 1 Initiating Prosecution:

Prosecutions were launched under the Companies Act, SEBI Act, Depositories Act, the Indian Penal Code, and SC(R) Act, The total number of cases up to March 31, 2007 was 1,026. Of the 1,026 cases, the 930 prosecution cases were launched under the SEBI Act. followed by 42 cases under different sections of the Companies Act, 1956 and 13 under Depositories Act, 1996. Table: 4 shows the picture of the prosecution launched by SEBI.

**Table : 4**

| Year                | No. of cases in which prosecution has been launched | No. of persons/ entities against whom prosecution has been launched |
|---------------------|---|---|
| Up to and including |   |   |
| 1995-96             | 10  | 58  |
| 1996-97             | 13  | 63  |
| 1997-98             | 11  | 81  |
| 1998-99             | 15  | 145   |
| 1999-00             | 23  | 121   |
| 2000-01             | 20  | 98  |
| 2001-02             | 115   | 613   |
| 2002-03             | 229   | 848   |
| 2003-04             | 458   | 2377  |
| 2004-05             | 84  | 410   |
| 2005-06             | 27  | 81  |
| 2006-07             | 21  | 149   |
| <b>Total</b>        | <b>1026</b>   | <b>5044</b>   |

Source: Annual Report, 2006-07, Published by SEBI.

The nature of prosecution launched by SEBI is as follows:

**Table : 5**

| <b>Nature of Prosecution Launched</b>            | <b>Number of Cases</b> |
|--|------------------------|
| Securities and Exchange Board of India Act, 1992 | 930                    |
| Secs.73, 77 and 113 of Companies Act, 1956       | 42                     |
| Secs.63, 68 of Companies Act, 1956               | 20                     |
| Securities Contracts (Regulation) Act, 1956      | 16                     |
| Depositories Act, 1996                           | 13                     |
| IPC  | 05                     |
| <b>Total</b>                                     | <b>1026</b>            |

*Source: Annual Report, 2006-07, Published by SEBI.*

**Conclusion:**

Success and failure are two sides of a coin. Throughout its more than 15 years of existence as a statutory body, SEBI has sought to balance its objectives i.e. constant revision of its present rules and programs, formulating new rules, prescribing new guidelines and lastly implementing all these norms or regulation effectively so that the growth of the securities market can be ensured. To achieve the desired target by the SEBI, as a regulatory body, it has initiated some future plans to:

- 1 empower investors to make informed decisions and achieve fair dealings in their pecuniary transactions in the securities market;
- 1 make corporate houses to understand and realize their regulatory obligations;
- 1 inform market participants and make them believe that they are provided with favourable, efficient, and orderly market where they can safely deal in;
- 1 educate investors by conducting workshops, publishing advertisement in a consistent manner.

Our capital market is more than 100 years old and our regulatory mechanism, SEBI, is only 15 years old. There are few instances when in spite of having a well formulated legal framework, scandals emerged in our capital market, for example : in 1991-92 Harshad Mehta Scam and in 2001 Ketan Parekh Scam. The scandals broke out in the post-economic liberalization period which might lead to believe that Scam and liberalization are inter-connected phenomena. Howsoever, unwarranted that belief may be in reality. There should be no doubt that the regulatory systems are needed to be revised continuously as per requirements. Since the technological changes and the integration of Indian financial market with that of the world

market posed a greater challenge to SEBI, it was in the interest of the market investors that SEBI must be given more power to supervise the market with due diligence. SEBI has now more powers to regulate the securities market. Additional search and seizure powers will strengthen SEBI's investigative procedures and imposition of more penalties will act as an impediment to those activities by which corporates and entities indulge in unwarranted malpractices. Lastly, if SEBI's existing and future perspectives can ensure a fair and free market environment then the days are not far when India will be amongst the league of the major global capital market in the next round of reforms.

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