Problems of SEBI in Regulating Capital Management

Md. Zafar Alam*

Abstract

The functioning of the SEBI reformed Indian regulatory structure is examined in the context of the basic principles of regulation, the special regulatory requirements of capital markets management and the features of Indian markets. The regulator's aim was to achieve international best practices, and encourage market integrity through clear and self-enforcing rules of the game while encouraging the game itself. It contributed to implementing world class technology and processes in the markets. Following general principles allowed flexible response to arbitrage and change. Insider groups lost power as the liquidity advantage tipped in favour of automated systems, but there were imperfections in monitoring due to structural defects which are being addressed. Thinness of participation and in depth of securities may be overcome as markets revive with growth.

Key words: regulations, capital markets, technology, information, implementation

Introduction

With internationalization, the entry of new entities and technology, the old-style self regulation of stock exchanges breaks down, and government controls become ineffective. Regulatory structures have to be similar across countries in order to minimize regulatory arbitrage yet encourage capital movements. Successful regulation follows general principles adapted to the specific market and context; this gives it the flexibility to work with the market and respond to changing particulars. Regulators have a hard time keeping up with constant innovation. Liberalization requires de-regulation.

Capital markets provide effective intermediation of savings, allocation of investment, price discovery, pricing and hedging of risk; but they are subject to information imperfections, excess volatility, and market manipulation. The regulator has to be something like a policeman, but a smart one, who preserves market integrity through clear and self-enforcing rules of the game while encouraging the game itself.

We start with the basic principles of regulation, then extend them to the special requirements of capital markets, in order to develop the principles against which we go on to examine Sebi's functioning in the Indian context.

***Research Scholar Deptt.of commerce, B. R. A. B. University, Muzaffarpur**

Principles of regulation

Regulation can be defined as government intervention in markets to influence those decisions of private agents that would otherwise not fully consider public interest. Intervention is justified by market failure due to monopoly or market power, asymmetric or imperfect information, and the existence of externalities or of public goods (Lee, 2003). All three categories of market failure occur in financial markets, and we will examine their implications one by one.

Regulators should aim to encourage efficiency, and only prevent price or anti entry collusion. The transaction costs perspective adds that the tendency towards opportunism should be minimized but vertical integration may be necessary to save transaction costs under asset specificity. The Austrian School emphasizes that dynamic monopoly profits may be necessary for innovation. Waves of creative destruction destroy these in time. These perspectives on preventing collusion, encouraging entry and innovation are particularly relevant for the regulation of financial markets.

Special features of regulation in capital markets

The basic principles of regulation combined with the special features of capital markets, indicate the major issues for regulation in capital markets. The public interest approach suggests that financial regulation should ensure that finance serves the needs of the real economy, through efficient intermediation of savings, price discovery, allocation of investment, and the pricing and hedging of risk. Informational imperfections are inherent in financial markets. Therefore enhancing the revelation of information and preventing the misuse of asymmetric or insider information is the most basic task of a financial regulator.

Financial markets are pervaded by asymmetric information that creates deep frictions and imperfections (Wilhelm, 2001). For example, borrowers know more about their own credit risks than lenders do, leading

to adverse selection (as borrowers select transaction terms that favour them), and under-provision of credit by lenders. Moral hazard may also occur with borrowers undertaking riskier actions than the lender had agreed to in the loan terms. Issuers of equity know more than institutional investors, each of whom has a heterogeneous information set. Retail investors have the greatest relative information disadvantage. Regulatory agencies add value by reducing these disadvantages, through measures such as transparency, disclosure of price sensitive information and conflicts of interest, and encouraging organizational forms that reduce or offer protection from these hazards.

Changes in technology have had fundamental effects on each of these aspects, on the nature of financial markets, the possibility of regulation, and the organization of stock exchanges. The latter were always subject to network effects because of liquidity–the exchange with more liquidity could tip in customers and lock them in because of lower transaction costs. In the days of floor trading the advantage went to the greatest geographical clustering of financial intermediaries. But with ICT geographically dispersed intermediaries can provide liquidity. The exchange with the best technology will be able to attract the most customers.

Special features of regulation in the Indian context

It is important that regulatory practices be derived from more general principles, since then they can more easily adapt to financial innovations. Regulatory practices also need to be attuned to country specific features, but not at the expense of deviations from general principles. For example in European jurisdictions disclosure of price sensitive information is mandated as a general principle, not as a response to specific events as was the case in US. The Sarbanes-Oxley Act passed after the wave of corporate and securities scandals, has changed the US in this respect (Spaventa, 2003). The scandals revealed regulatory gaps such as insufficient enforcement of disclosure requirements, excessive reliance on peer review for auditors, and inability to keep brokerage and investment banking activities separate. Brokerage firms took fees for offering a preferred list of firms. For example, Morgan Stanley had failed to inform investors of the compensation it received for selling certain funds3. Under diffuse shareholding and independent managers, as prevail in the US, the information asymmetries between the principal and their agent become acute and require active regulatory intervention. Under concentrated European shareholding, additional

measures are required to protect minority shareholders, such as rights to appoint directors, and checks on preferential allotment and promoter holdings. We turn next to the Indian regulatory structure and context.

A) Sebi: History, objectives, powers

Late comers have the advantage that they can adopt best practices, but this is easiest done when a new institution is created, since changing old well established institutions is difficult. The Capital Issues (Control) Act 1947, administered by the Controller of Capital Issues (CCI), governed capital issues in India. As part of liberalizing reforms CCI was abolished, and Sebi set up in1988, was made a statutory body in 1992. Its objectives are to protect the interests of investors, ensure the fairness, integrity and transparency of the securities market, and reach best international regulatory practices. But flexibility was required to respond to market arbitrage, and to emerging requirements in the Indian context. There has been a constant attempt to improve regulatory practices and contribute to the ongoing capital market reforms. Once the policy decision had been taken to open out and reach and exceed international standards and practices, the direction of change was clear and Sebi contributed to progress along it in a major way.

But the regulatory and market microstructure reforms were unable to revive the stock markets over this extended period (see Table 1). Among the reasons were the periodic financial scams that deepened the lack of confidence in the effectiveness of the regulator’s monitoring, surveillance and implementation of the new world class rules, the industrial slowdown that persisted over 1997-2000, and shallow markets with a relative neglect of the retail investor.

B) Information

Disclosure: Strict norms regarding disclosure of price sensitive information, and conflicts of interest, contribute to reducing asymmetries of information and aid the markets in price discovery. Companies issuing capital in the primary market are required to disclose the facts and specific risk factors associated with their projects; they should also give information on the procedure for the calculation of premium, but they can fix the premium. Sebi permitted companies to determine the par value of shares issued by them, and allowed issues of Initial Public Offers (IPOs) to go for “Book-Building”, that is get bids within an announced band to help discover market demands and price. Measures continue to be taken to improve transparency in markets. In 20133 the

National Stock Exchange (NSE) prohibited any cash transaction. In 2014 Sebi asked brokers to reveal details of transactions involving more than 0.5 percent of the listed shares of a company, and banned them from trading with each other on the same exchange.

C) Technology and Transactions costs

India has reached and sometimes exceeded international benchmarks in disclosure norms, trading volume, settlement cycle, and low transaction costs. In the order driven system, each investor can access the same market and order book, at the same price and cost, irrespective of location. Dematerialization of securities had been introduced to reduce bad paper risk. Settlement of trades in the depository is compulsory except for sales by small investors.

Political economy: The rapid dominance of the Indian for-profit, fully automated NSE promoted by leading banks and financial institutions (mainly public sector), over the powerful traditional Bombay Stock Exchange (BSE), which was also forced to automate, and the collapse of all other small stock exchanges through the country, demonstrates the tipping equilibria discussed in section. The government ability to sponsor a new technology had a powerful effect in an industry with network effects. Moreover, technology affects the governance structure chosen. NSE is a company incorporated under the Companies Act (1956), and makes a profit. Unlike the other broker run exchanges the management is independent of the broker members. The official view is that this allows a fair, equitable and efficient market to develop, free of the conflict of interest experienced in broker run exchanges (NSE, 2003), but our analysis suggests that governance structure follows from technology.

Badla, the old system of carry forward trade without delivery that was popular with brokers, was another contentious issue. Those for badla said that removing this would seriously hurt liquidity, those against that it was responsible for excess volatility and scams. But replacing it by modern forward and future derivatives was quite smooth. A phased program of T+5 rolling settlement introduced in 2000, for eligible compulsorily dematerialized scrips with a daily turnover of above 1 crore, was expanded to cover more scrips having the facility of ALBM*/BLESS (automated lending and borrowing mechanism) or MCFS (modified carry forward system) in any stock exchange. The settlement cycle was shortened smoothly to reach T+1 in 2014. Trading

in future contracts based on BSE Sensex index and on S&PCNX nifty index began in June, 2000, and exchange traded interest rate and currency derivative contracts were to follow.

D) Volatility

Price bands, complex value at risk (VaR) margining systems, circuit filters, exposure limits and suspension are all used to curb volatility. These allow adjustment for risk to be individual specific and therefore less inefficient than a common margin, while achieving the desired result of putting concave boundaries on convex returns, thus reducing one way price movements. Margins that vary with liquidity are required in response to the externalities that follow from herd behaviour in capital markets. Moreover, such margins reduce deposit requirements and therefore lower costs of trade. A daily mark-to-market margin system prevents large risks from building up, and lowers the possibility of a payments crisis.

E) Flexibility

A principles-based stance gives flexibility to adjust to emerging trends. An example is Sebi tightening the norms for private placement in 2003. With the stock markets in the doldrums, many firms turned to these. But the absence of disclosure increased risk. Apart from the stick Sebi also offered the carrot of reduction in the cost of open offers. In 2014 all listed companies were required to have a minimum 25 percent non-promoter holding, but since earlier companies had been allowed to list with less, they were given time to adjust. Other examples of flexibility in action are:

Conclusion:

As growth revives and markets become more active, the tight norms Sebi has established and the deep steady capital market reforms to which it has contributed, will payoff. The paper has enumerated the pluses and minuses of regulation in the context of capital market development in India; the many achievements and further potential improvements. Following general principles allowed Sebi the flexibility to adjust as required. With respect to technology, automation, disclosure, risk containment and reduction in transaction costs Indian bourses have outperformed those in developed countries. More participation and depth of instruments is required. This will happen with a revival of growth and greater confidence in the improved monitoring systems.

There are gaps between perception and reality. Because of a history of speculation in thin markets, there is a misperception that insider dominance is a feature of Indian capital markets. But it turns out to be a feature of open outcry and geographically concentrated capital markets. Technology and the geographical dispersion it brings about decreases their power. The latter has happened in India while it is still resisted in the US. Once the government decided to back new technology these forces tipped trade in favour of modern systems. Imperfections in monitoring and surveillance were also due not so much to insider collusion as to imperfections in the structure of incentives and penalties.

A lacuna important in the Indian context was the neglect of the small investor, the small firm and start-ups. The small investor, who tends to buy and hold, lends stability to the market. Capital market regulation has shown flexibility in India, helped markets to evolve and evolved with them. If transparent, principle based yet flexible regulation encourages innovation and learning it can effectively continue the process.

References:

- Encaoua, D., and A. Hollander, 2002,"Competition Policy and Innovation", *Oxford*
- *Review of Economic Policy*, 18, 63-79.
- Glaeser E. L. and A. Schleifer, 2003, "The rise of the regulatory state", *Journal of*
- *Economic Literature*, XLI, 401-425.
- Haldea, G., 2004, "Crisis of credibiltiy: Laws must regulate the regulator", *Times of*
- *India*, Mumbai Edition, 22 January.
- Hall, B., 2002, "The Assessment: Technology Policy", *Oxford Review of Economic*
- *Policy*, 18, 1-9.
- Hantke-Domas, M., 2003, "The public interest theory of regulation: non-existence or
- misinterpretation?" *European Journal of Law and Economics*, 15:165-194.
- Kane, E. J., 2002, Using Deferred Compensation to Strengthen the Ethics of Financial
- Regulation, Journal of Banking and Finance, 26(9): 1919-33.

- Lee, 2003, "Regulation and the New Economy", in Jones D.C. (ed.) *New Economy*
- *Handbook* USA: Elsevier.
- Miller, M., 1986, "Financial Innovation: The last twenty years and the next", *Journal of*
- *Financial and Quantitative Analysis* 21, 459-471.
- Nageswaran V. A. and S. Krithivasan, 2004, "Capital market reforms in India and
- ASEAN: avenues for co-operation", paper presented at the *1st ASEAN-India Roundtable*,
- February 9-10, Singapore.
- NSE (National Stock Exchange), 2003, Indian Security Markets: A Review, and earlier
- issues, available at www.nse-india.com
- RBI (Reserve Bank of India), 2003, *Handbook of Statistics on the Indian Economy*,
- Mumbai: RBI.
- Sebi (Securities and Exchange Board of India), 2003, *Annual Report2002-03*, and
- Earlier reports available at
- http://www.Sebi.gov.in/Index.jsp?contentDisp=SubSection &sec_id=41&sub_sec_id=41
- Shah, A. and S. Thomas, 1997, "Securities markets: Towards greater efficiency", *India Development Report 1997*, Kirit S. Parikh (ed.), New Delhi: IGIDR and Oxford University Press.
- Spaventa, L., 2003, "Incorporating a scam-free Europe", *Economic Times*, Mumbai
- Edition, May 22, available at
- Wilhelm, W.J., 2001, "The Internet and Financial Market Structure", *Oxford Review of*
- *Economic Policy, 17, 2, 235-247.*