



BSE
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SPECIAL CONTRIBUTION

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Regional Stock Exchanges

As in several other fields, technology drives today the stock markets the world over. India is no exception. Establishment of National Stock Exchange of India Ltd., (NSE) in 1994 with an all-India spread and expansion of operations of Bombay Stock Exchange (BSE) throughout the country, both of which have their trader work stations at over 400 centres in the country today, have led to the virtual extinction of all the 19 Regional Stock Exchanges (RSEs) spread across the length and breadth of the country.

The share of 19 RSEs, which was as much as 45.6 per cent of the total all-India turnover of Rs. 2.39 lakh crore in 1995-96, declined progressively year after year and in 2001-02, it was just 8.4 per cent of the total volume of Rs. 8.96 lakh crore. At present, there is virtually no trading at any of the RSEs. Trading in the cash segment is thus confined to NSE and BSE only, with the share of the latter, which used to account for over 70 percent of the all-India volume of trading till 1995, is also progressively declining. Currently, BSE accounts for about 30 per cent of the aggregate volume of trading on NSE and BSE in the cash segment. In the derivatives segment, while NSE clocks in about Rs. 2000 crore daily, the turnover on BSE has been progressively declining virtually to the zero level. The RSEs of the country and their members had spent over Rs. 200 crore in automating their trading, clearing and settlement systems, largely driven by regulatory compulsions, sadly to witness them lying idle at present.

Indian securities market has large number of stocks. With the recent reforms in securities settlement in the Indian securities markets, regional stock exchanges lost their business making it harder for them to provide the liquidity. How to overcome this problem has been engaging the attention of regulators and the national level stock exchanges. Several rounds of discussions have also taken place among the representatives of regional stock exchanges on the best form of business model they should design in order to make them more relevant in the background of intense competition and heavy focus on technology. Two major views that emerged in this regard are the consolidation of the stock exchange. We present here the views; one from Shri P. V. Mayya, Chairman, Inter Connected Stock Exchange of India and Shri S. T. Gerela, Director, Business Development, The Stock Exchange, Mumbai (BSE)

Causes for the Decline

Abolition of badla with effect from July 2, 2001, which acted as the backbone of trading at the Calcutta, Delhi, Ahmedabad and Ludhiana Stock Exchanges and also at a few other exchanges, which conducted badla trading but in a clandestine manner, dealt a serious blow to trading at the RSEs. Introduction of uniform trading cycles at all the stock exchange, also effective from July 2, 2001, reduced further the volume of trading at the RSEs due to diminished opportunities for arbitrage transactions. Introduction of compulsory rolling settlements, initially in a few securities and subsequently in all securities effective from December 31, 2001 on a T+5 basis accelerated the reduction in turnover at the RSEs. The switch over of the rolling settlement to T+3 effective from April 1, 2002 and to T+2 with effect from April 1, 2003 sealed the fate of the RSEs.

Yet another major reason for the absence of trading at the RSEs is that all the major operators are all these exchanges acquired memberships of either NSE or BSE or of both, while most others acquired the sub-brokerships of members of NSE/BSE and all of them switched over their operations completely to NSE and BSE.

In spite of the fact that trading at the RSEs has ground to a halt, RSEs have managed to survive so far because of the annual listing fees that are being received from the listed companies. The circulars issued by the Ministry of Finance on April 23, 2003 withdrawing its earlier circulars which required all companies including existing listed companies, to be listed on the stock exchanges located in the State where the registered office or the main works/fixed assets of the company are situated, has driven the last nail into the coffin of RSEs as companies have started lining up one after the other to get themselves delisted from the RSEs. With the incomes drying up almost completely, RSEs will soon wear a totally deserted look with no activity whatever.

Inter-connected Stock Exchange of India Ltd.

It was the dwindling fortunes of RSEs that brought them together to establish the Inter-connected Stock Exchange of India Ltd. (ISE). At a meeting of the Federation of Indian Stock Exchanges held in October 1996, a Steering Committee was formed to evolve an Inter-Connected Market System. As a result, ISE, which was promoted by 14 regional stock exchanges of the country (excluding Calcutta, Delhi, Ahmedabad, Ludhiana and Pune Stock Exchanges, apart from NSE, BSE and OTCEI) was incorporated on ISE by SEBI under the Securities Contracts (Regulations) Act, 1956 on November 18, 1998, ISE commenced trading on February 26, 1999.

ISE was launched with the laudable objective of converting small, fragmented and illiquid markets into a large, efficient and liquid national-level markets. This was a unique experiment, with a highly automated trading, clearing and settlement systems backed by state-of-the-art computers, virtually first of its kind in the world. ISE is also a professionally managed stock exchange with the Chairman of the Exchange being also a Public Representative Director right from its inception.

Unfortunately for the RSEs, particularly small brokers, the ISE experiment did not succeed. The daily turnover, which used to be Rs. 1 to 2 crore in the first six months, gradually declined to

virtually zero level. Failure of ISE is, to a large extent, due to the bigger brokers of the participating RSEs failing to evince any interest in trading on ISE due to commercial considerations. As a result, it became virtually impossible for ISE to create any worthwhile liquidity in its markets in competition with the breadth and depth of NSE and BSE. Markets continued to be fragmented as the participating RSEs did not close down their regional segments. The, while the small fragmented and illiquid market failed to emerge.

ISE has also not succeeded in getting companies listed on it despite the stipulation by SEBI that the State of Maharashtra

A host of factors like low capital base of listed companies, (there are about 2,000 listed companies with a paid-up capital of Rs.3 crore and below), progressive reduction in public offer from 60 percent of the issued capital to 25/10 percent for eligibility for listing, switch-over to proportionate allotment of securities, free pricing of shares, introduction of book-building in respect of IPOs, introduction of order-driven system and of rolling settlement etc., have all cumulatively been responsible for the present state of illiquidity in the Indian stock markets.

constituted the regional area for ISE due to lack of regulatory support for making it applicable to over 3,000 already listed companies in the State of Maharashtra.

Revival of Small Stock Exchanges

With a view to reviving small stock exchanges, SEBI permitted these exchanges in 1999 to float subsidiary companies to acquire membership rights of other exchanges to provide the members of these exchanges access to the wider market for improving the trading volume. Pursuant to this, almost all the RSEs, including Delhi Stock Exchange, floated subsidiaries and acquired membership rights of both NSE and BSE.

Although the subsidiaries of RSEs have been functioning fairly satisfactorily, the volume of turnover by almost all of them are not upto the expected levels, varying from about Rs. 10 crore to about Rs. 60 crore a day. These subsidiaries have by and large not been able to register any significant volume of trading in the derivative instruments, although the volume of trading in the derivatives segment of NSE is generally higher than in the cash segment. The regulatory insistence of maintenance of base minimum capital at the RSEs despite zero volume of trading amounting to over Rs. 300 crore has hindered the growth of

subsidiaries. As a result, several of these subsidiaries have not been able to be financially viable. Subsidiaries of RSEs, strictly speaking, are members of stock exchanges to reconstitute the governing boards of the subsidiaries to provide for at least 50 percent of the Directors to be Public Representatives to be appointed with the approval of SEBI, the Chief Executive Officer of the subsidiary or be a Director on the Board of the subsidiary, etc., almost on the lines of constitution of a stock exchange. These additional regulatory burdens cast on the subsidiaries-oriented, privately-run stock-broking house.

While subsidiaries of RSEs have no doubt provided an avenue to the members of RSEs to survive for the present, there is a lurking fear of even this avenue grinding to a halt as it is likely that the subsidiaries may not be allowed to continue to function, if they incur losses, as quite a few of them do. Moreover, recognition of the RSEs may not be renewed due to absence of any trading and consequently the subsidiary route presently available for members of RSEs to trade on NSE and BSE would also automatically close down.

Should these apprehensions result into realities, the country will soon be faced with the spectre of most of the members of RSEs being forced to either close down their operations completely or to relegate themselves to working as sub-brokers of major brokers as they will not be able to acquire the memberships of NSE/BSE directly. NSE requires the Dominant Promoter Group of an applicant corporate entity to consist of not more than four individuals holding at least 51 percent of the paid-up equity capital of the company. Efforts made by SEBI for revival of small stock exchanges through the route of subsidiaries will willy nilly grind to a halt. This is no longer so in respect of small stock exchanges only but also in respect of bigger stock exchanges like Calcutta Stock Exchanges, whose turnover in 1995-96 had actually exceeded that of BSE, and Delhi Stock Exchange.

Growing Illiquidity in Listed Stocks

The real issue of concern is not so much as the fate of RSEs and their members but of the growing illiquidity in listed stocks on the Indian stock exchanges. Top 10 scrips account for over 75 percent of the trading volume while the top 100 scrips account for about 99 percent of the trading volume. Out of about 10,000 scrips of about 5,350 companies listed on the BSE, not more than 2,500 scrips were traded in 1999-00, while the number of scrips traded during 2000-01 and 2001-02 came down further to about 1,800 and 1,600 respectively. In the year 2002, the number of scrips traded for more than 100 days was just 691, while about 1,900 scrips were not traded even on a single day. Even in respect of the 691 scrips worth Rs. five lakh a day, is applied, the yearstick of say, five trades a day or trades worth Rs. five lakh a day, is applied, the number will come down drastically to just about 100. Even at the NSE, which has been permitting trading in big cap and mid cap companies only, in 2001-02, out of about 1,000 scrips, the number of scrips listed only on the RSEs and there is virtually no trading whatever at present in all these scrips.

A host of factors like low capital base of listed companies, (there are about 2,000 listed companies with a paid-up capital of Rs.3 crore and below), progressive reduction in public offer from 60 percent of the issued capital to 25/10 percent for eligibility for listing, switch-over to proportionate allotment of securities, free

pricing of shares, introduction of book-building in respect of IPOs, introduction of order-driven system and of rolling settlement etc., have all cumulatively been responsible for the present state of illiquidity in the Indian stock markets.

Indonext Exchanges is the Solution

With all the RSEs having already virtually ground to a halt and with the growing illiquidity at the NSE-BSE in respect of a vast number of shares, it is imperative that a solution needs to be evolved in the larger interest of millions of investors of the country.

A feasible solution can be to create one single trading platform for all the RSEs, shutting down completely their local trading platforms, on the lines of Euronex of Europe. Threatened by the growing concentration of business on London Stock Exchange and Deutsche Bourse, the Paris Bourse, Amsterdam Exchange and Brussels Exchange established in 1999 Euronext by creating a single Euronext cash market for equities and bonds, a single Euronext derivatives market and a single Euronext commodity market with a single set of trading rules. While trading takes place in a multi-jurisdictional setting, clearing of transactions takes place under a single jurisdiction in France.

It is important to note that while the three Exchange organizations have merged, there is no merger of their official exchange status. There are three subsidiary companies of the holding company in the three member countries, with each of them holding an exchange licence for the local capital market. This enables companies to choose their entry point for listing and consequently, their preferred jurisdiction, either France, or Belgium or the Netherlands. Euronext is a growing organization. Lisbon Stock Exchange of Portugal has recently joined Euronext. The monthly turnover on Euronext at present is about \$150 billion, much higher than that of about \$90 billion on Deutsche Bourse and about 60 percent of about \$250 billion on the London Stock Exchange. Indonext Exchange can be ISE or OTCEI or any one of the RSEs that may be chosen by the Participating Stock Exchanges (PSEs). Indonext Exchange can become a success if all eligible members of PSEs are freely permitted to become its trading members with the SEBI stock broker registration on Indonext Exchange being automatic and membership of PSEs being taken into account while reckoning payment of turnover fees to SEBI by the trading members. Besides, base minimum capital varying from Rs. 4 lakh to Rs. 7 lakh lying with the various RSEs to the credit of each of their members and being totally not put to any use, should be permitted to be transferred to Indonext Exchange.

All the steps mentioned above, necessary as they are, would not be sufficient to make Indonext Exchange a success. NSE and BSE, having already emerged as giants controlling fully the total volume of trading in the country, Indonext Exchange can succeed only if there is exclusivity of trading. This can be done by providing for trading in respect of all companies with a paid-up capital upto say, Rs. 20 crore, which currently account for a daily turnover of about Rs. 350 crore, only on Indonext Exchange, while companies with a paid-up capital upto Rs. 20 crore coming out with IPOs in future may be permitted to be listed only on Indonext Exchange. Companies with a paid-up capital of Rs. 20 crore already listed on NSE/BSE may be delisted from these stock exchanges and listed on Indonext Exchange.

Indonext Exchange to Focus on Liquidity

Establishment of Indonext Exchange is only a step towards a solution to the larger issue of lack of liquidity, the extent of which has been detailed above.

Indonext Exchange has to focus to ensure that lack of liquidity should not be a problem any longer. A host of issues need to be addressed in this behalf.

Broadly, there are four categories of shares, viz (i) liquid, (ii) thinly traded, (iii) marginally traded, and (iv) illiquid, while there is no need to do anything in respect of liquid shares, the question of evolving a suitable exit route to the illiquid shares mainly by way of transfer of these shares to the recently set up Asset Reconstruction Company of India Ltd. or some other similar organizations at a nominal value of say, one paise per share, so as to enable the holders of these shares to book losses needs to be considered.

With regard to thinly traded and marginally traded shares, trading may be permitted only through the quote-driven system with market makers, who should mandatorily be required to be appointed by companies on the lines of the provisions already contained in SEBI guidelines in respect of IPOs, but rarely implemented. Market makers need to be offered proper facilities for borrowing of funds at a concessional rate of interest in order to enable them to hold stock of shares and to finance their working capital and for supply of stocks from promoters to enable the market makers to fulfil their commitments against sales. Besides, market makers need to be offered financial incentives by way of waiver of levy on transactions relating to market-making, stock exchanges to share with market makers the income earned by way of levy on the transactions in the shares in which market makers make a market, profits made by market makers on a short-term basis to be treated as long-term capital gains and taxed accordingly, as in the United States, etc. In respect of marginally traded shares, instead of market makers, specialists may be appointed for each share on the line of the system in vogue in the New York Stock Exchange, so that all orders for purchase and sale get concentrated at one point.

In such cases where market makers and specialist are not appointed, a separate trade matching engine, called "Cal Auction System" (which has been successfully implemented in the recently established Arizona Stock Exchange in the United State) can be introduced. In this system, matching of all buy and sell offers takes place at the end of a day or a week, as may be specified.

Liquidity cannot really be generated unless the basic maladies which have conscripted liquidity referred to earlier are addressed. Some of the measures that need to be taken immediately include increasing the capital base of listed companies to at least Rs. 3 crore with a public shareholding of at least 25 percent of the expanded capital base, enhancing the minimum percentage of public offer to at 40 percent of the issued capital of a company for being entitled for listing, modifying the system of proportionate allotment of shares and grant of weightage in allotment to those applying upto 10 tradeable lots, particularly to those applying upto 5 tradeable lots, modifying the free pricing policy substantially so as to prevent post-listing erosion, suspending at least for some time the book-building mechanism and re-introduction of weekly account period settlement in respect of thinly traded and marginally traded shares, etc.

Conclusion

Decadence of RSEs has not affected the brokers of these exchanges to the extent it has hurt the millions of shareholders of the regionally listed companies who have awoken to find that there is no market for their holdings. To add to this, there are other disturbing developments like several of the flourishing companies going abroad to raise capital, some of the thriving companies, particularly multinational companies, delisting their shares, etc. Indian stock markets do not any longer attract the rising levels of savings in the economy. The shareholding population has virtually investment in stock market instruments by over 50 percent of the households in the United States. The various remedies suggested above need serious consideration by the authorities concerned so that the benefits of fruits of development have a wider reach.

**Tandem Himalaya
S86016 Fault
Tolerant System**

**Response Time of
Less than a Second**

**Capacity for
4 million trades
a day**

TECHNOLOGY

BSE
The Stock Exchange, Mumbai