## Secondary market

4.6 In the secondary market, the uptrends continued in 2006-07 with BSE Sensex and NSE Nifty indices closing above 14,000 (14,015) and 4,000 marks (4,024) for the first time, respectively on January 3, 2007. After a somewhat dull first half, conditions on the bourses turned buoyant during the later part of the year with large inflows from Foreign Institutional Investors (FIIs) and larger participation of domestic investors. During 2006, on a point-to-point basis, Sensex and Nifty Indices rose by 46.7 and 39.8 per cent, respectively. The pick up in the stock indices could be attributed to impressive growth in the profitability of Indian corporates, overall higher growth in the economy, and other global factors such as continuation of relatively soft interest rates and fall in crude oil prices in international markets.

4.7 Amongst the NSE indices, both Nifty and Nifty Junior delivered strong positive returns, appreciating by 39.8 per cent and 28.2 per cent, respectively during the calendar year 2006. While Nifty gave compounded returns of 28.3 per cent, Nifty Junior recorded compounded returns of 27.8 per cent per year between 2004 and 2006 (Table 4.3).

4.8 The NSE indices (Nifty and Nifty Junior), on a climb since November 2005,

**Table 4.3 : Movements of the index of NSE (end of period)**

| | Calendar Year | | | | | |
|---|---|---|---|---|---|---|
| **Month** | **2004** | **2005** | **2006** | **2004** | **2005** | **2006** |
| | **Top 50 Stocks** | | | **Nifty Junior** | | |
| January | 1,810 | 2,058 | 3,001 | 3,368 | 4,248 | 5,883 |
| February | 1,800 | 2,103 | 3,075 | 3,331 | 4,338 | 5,967 |
| March | 1,772 | 2,036 | 3,403 | 3,392 | 4,275 | 6,412 |
| April | 1,796 | 1,903 | 3,558 | 3,640 | 4,024 | 6,856 |
| May | 1,484 | 2,088 | 3,071 | 2,847 | 4,365 | 5,827 |
| June | 1,506 | 2,221 | 3,128 | 2,905 | 4,393 | 5,264 |
| July | 1,632 | 2,312 | 3,143 | 3,082 | 4,919 | 5,335 |
| August | 1,632 | 2,385 | 3,414 | 3,199 | 5,053 | 5,941 |
| September | 1,746 | 2,601 | 3,588 | 3,504 | 5,304 | 6,510 |
| October | 1,787 | 2,371 | 3,744 | 3,482 | 4,714 | 6,823 |
| November | 1,959 | 2,652 | 3,955 | 3,885 | 5,342 | 6,967 |
| December | 2,081 | 2,837 | 3,966 | 4,453 | 5,541 | 7,106 |

**Source: NSE**

dipped in May and June 2006 owing to bearish sentiments and selling by FIIs. But there was a rapid recovery thereafter and an uptrend in the indices. Similarly, BSE Sensex (top 30 stocks) which was 9,398 at end-December 2005 and 10,399 at end-May 2006, after dropping to 8,929 on June 14, 2006, recovered soon thereafter to rise steadily to 13,787 by end-December 2006 (Table 4.4).

4.9 The BSE Sensex has continued its movement upwards in 2007 so far. It closed at 14,652 on February 8, 2007. The journey from 13,000 to 14,000 mark, achieved in just 26 trading sessions, was one of the fastest-ever climbs. The Sensex gained 4,389 points and appreciated by 46.7 per cent during 2006. It recorded compounded returns of 33.2 per cent per year between 2004 and 2006. BSE 500 recorded a gain of 38.9 per cent during 2006 to close at 5,271. The compounded returns of BSE 500 between 2004 and 2006 were 30.6 per cent per year.

4.10 According to the number of transactions, NSE continued to occupy the third position among the world's biggest exchanges in 2006, as in the previous three years. BSE occupied the sixth position in 2006, slipping one position from 2005 (Table 4.5). In terms of listed companies, the BSE ranks first in the world.

4.11 With the stock indices soaring, investors' wealth as reflected in market capitalisation also increased significantly by over 45 per cent during 2006. The year under review saw increased daily volatility (as measured by standard deviation of returns) in the Indian markets partly due to a sharp sell off in the market during the month of May in line with global markets in reaction to the trend in global interest rates. The market soon recovered thereafter to touch new highs reflecting the underlying strength of the fundamentals of the Indian economy. The price-to-earnings (P/E) ratio, which partly reflects investors' expectations of corporate income growth in future, was higher at a little over 20 by end-December 2006 as compared to 17-18 at end-December 2005 (Table 4.6).

**Table 4.5 : Biggest exchanges by number of transactions**

| | Rank by number of transactions during calendar year | | | |
|---|---|---|---|---|
| **Exchanges** | **2003** | **2004** | **2005** | **2006** |
| NASDAQ | 1 | 1 | 2 | 1 |
| NYSE | 2 | 2 | 1 | 2 |
| NSE | 3 | 3 | 3 | 3 |
| Shanghai | 4 | 4 | 6 | 4 |
| Korea | 7 | 6 | 4 | 5 |
| BSE | 5 | 5 | 5 | 6 |
| Shexzhen | 8 | 8 | 7 | 7 |
| Taiwan | 6 | 7 | 8 | 8 |
| Deutsche Borse | 9 | 9 | 9 | 9 |
| London/euronet | 11 | 10 | 10 | 10 |

**Source: NSE**

**Table 4.4 : Movements of the index of BSE (end of period)**

| | Calendar Year | | | | | |
|---|---|---|---|---|---|---|
| **Months** | **2004** | **2005** | **2006** | **2004** | **2005** | **2006** |
| | Top 30 Stocks | | | BSE 500 | | |
| January | 5,696 | 6,556 | 9,920 | 2,247 | 2,726 | 4,005 |
| February | 5,668 | 6,714 | 10,370 | 2,228 | 2,826 | 4,130 |
| March | 5,591 | 6,493 | 11,280 | 2,244 | 2,735 | 4,517 |
| April | 5,655 | 6,154 | 12,043 | 2,321 | 2,611 | 4,830 |
| May | 4,760 | 6,715 | 10,399 | 1,892 | 2,829 | 4,158 |
| June | 4,795 | 7,194 | 10,609 | 1,924 | 2,928 | 4,030 |
| July | 5,170 | 7,635 | 10,744 | 2,081 | 3,125 | 4,029 |
| August | 5,192 | 7,805 | 11,699 | 2,126 | 3,273 | 4,424 |
| September | 5,584 | 8,634 | 12,454 | 2,277 | 3,522 | 4,740 |
| October | 5,672 | 7,892 | 12,962 | 2,319 | 3,199 | 4,957 |
| November | 6,234 | 8,789 | 13,696 | 2,548 | 3,568 | 5,228 |
| December | 6,603 | 9,398 | 13,787 | 2,780 | 3,796 | 5,271 |

**Source: BSE**

| Table 4.6 : Equity returns, volatility, market capitalisation and price earnings (P/E) ratio | | | | |
|---|---|---|---|---|
| | Calendar Year | | | |
| **Indices** | **2003** | **2004** | **2005** | **2006** |
| ***Nifty*** | | | | |
| Returns (per cent) | 71.9 | 10.7 | 36.34 | 39.83 |
| End-year market capitalisation *(Rs. cr.)* | 634,248 | 902,831 | 1,350,394 | 1,975,603 |
| Daily volatility | 1.23 | 1.73 | 1.11 | 1.64 |
| End-year P/E | 20.73 | 15.32 | 17.07 | 21.26 |
| **Nifty Junior** | | | | |
| Returns (per cent) | 141.0 | 30.8 | 24.43 | 28.24 |
| End-year market capitalisation (Rs. cr.) | 132,409 | 165,444 | 218,575 | 333,693 |
| Daily volatility | 1.37 | 1.94 | 1.22 | 1.96 |
| End-year P/E | 15.73 | 14.19 | 17.11 | 21.78 |
| **BSE Sensex** | | | | |
| Returns (percent) | 72.9 | 13.1 | 42.3 | 46.7 |
| End-year market capitalisation *(Rs. cr.)* | 635,015 | 735,528 | 1,213,867 | 1,758,865 |
| Daily Volatility | 1.2 | 1.6 | 1.1 | 1.6 |
| End Year P/E | 18.9 | 17.1 | 18.6 | 22.8 |
| **BSE 500** | | | | |
| Returns (percent) | 101.1 | 17.5 | 36.6 | 38.9 |
| End-year market capitalisation *(Rs. cr.)* | 1,189,620 | 1,580,762 | 2,281,579 | 3,336,509 |
| Daily Volatility | 1.2 | 1.8 | 1.1 | 1.6 |
| End Year P/E | - | - | 17.5 | 20.2 |

**Source: NSE and BSE**

4.12 In terms of volatility of weekly returns, uncertainties as reflected by the Indian indices were higher than that depicted by indices outside India such as S&P 500 of United States of America and Kospi of South Korea. The Indian indices recorded higher volatility on weekly returns during the two-year period January 2005 to December 2006 as compared to January 2004 to December 2005 (Table 4.7).

| Table 4.7 : Volatility of weekly returns on the equity market | | |
|---|---|---|
| | Period | |
| **Class of stocks** | **Jan '04 - Dec '05** | **Jan '05 - Dec '06** |
| India | | |
| Top 50 (Nifty) | 2.85 | 3.21 |
| Next 50 (Nifty Junior) | 3.47 | 4.07 |
| Sensex | 2.81 | 2.96 |
| BSE 500 | 3.07 | 3.23 |
| Outside India | | |
| U.S (S&P 500) | 1.41 | 1.26 |
| Korea (Kospi) | 2.81 | 2.73 |

**Source: NSE and BSE**

4.13 The market valuation of Indian stocks at the end of December 2006, with the Sensex trading at a P/E multiple of 22.76 and S&P CNX Nifty at 21.26, was higher than those in most emerging markets of Asia, e.g. South Korea, Thailand, Malaysia and Taiwan; and was the second highest among emerging markets. The better valuation could be on account of the good fundamentals and expected future growth in earnings of Indian corporates (Table 4.8).

| Table 4.8: P/E ratios in the emerging markets | | |
|---|---|---|
| **Index/Market** | **March 2006** | **Dec. 2006** |
| South Korea KOSPI | 10.86 | 12.21 |
| Thailand SET | 9.97 | 9.40 |
| Indonesia JCI | 21.68 | 25.10 |
| Malaysia KLCI | 15.33 | 17.35 |
| Taiwan TWSE | 14.62 | 20.85 |
| BSE SENSEX | 20.92 | 22.76 |
| S&P CNX Nifty | 20.26 | 21.26 |

**Source: SEBI**

4.14 Market capitalisation in terms of GDP indicates the relative size of the capital market, besides investor confidence and discounted future earnings of the corporate sector. As on January 12, 2007, market capitalisation (NSE) at US$834 billion was 91.5 per cent of GDP. India's market capitalisation compares well with other emerging economies and shows signs of catching up with some of the mature economies (Table 4.9).

**Table 4.9 : Market capitalisation**

| Country | Market Capitalisation (US$ billion) end 2006 | Market Capitalisation as a per cent of GDP |
|---|---|---|
| China | 1,000 | 33.3 |
| India (NSE) | 834* | 91.5 |
| Japan | 4,800 | 96.0 |
| Malaysia | 251 | 181.3 |
| South Korea | 754 | 94.1 |
| Thailand | 141 | 72.7 |
| USA | 17,400 | 133.8 |

Note: GDP for India relates to 'advance estimate' for 2006-07, while those for other countries relate to calendar year 2006.

* As on January 12, 2007.

Source: Derived from various country sources

4.15 Liquidity, which serves as a fuel for the price discovery process, is one of the main criteria sought by the investor while investing in the stock market. Market forces of demand and supply determine the price of any security at any point of time. Impact cost quantifies the impact of a small change in such forces on prices. Higher the liquidity, lower the impact cost. The impact cost for purchase or sale of Rs.50 lakh of the Nifty portfolio and that of Rs. 25 lakh of Nifty Junior portfolio remained constant at 0.08 per cent and 0.16 per cent, respectively, over 2005 and 2006 (Table 4.10).

**Table 4.10 : Equity spot market liquidity**

| | Calendar year | | | |
|---|---|---|---|---|
| Portfolio | 2003 | 2004 | 2005 | 2006 |
| **Nifty** | | | | |
| NSE impact cost at Rs.50 lakh (%) | 0.10 | 0.09 | 0.08 | 0.08 |
| **Nifty Junior** | | | | |
| NSE impact cost at Rs. 25 lakh (%) | 0.32 | 0.31 | 0.16 | 0.16 |

Source: NSE

4.16 The turnover in the spot and derivatives market, both on the NSE and BSE, has shown steady growth in the recent years. NSE and BSE spot market turnover more than doubled between 2003 and 2006. In respect of derivatives, the turnover on NSE nearly doubled in a single year between 2005 and 2006 (Table 4.11).

**Table 4.11: Growth of turnover**

| | Calendar Year | | | |
|---|---|---|---|---|
| Markets | 2003 | 2004 | 2005 | 2006 |
| NSE Spot | 907,882 | 1,170,298 | 1,888,112 | 1,916,227 |
| BSE Spot | 409,373 | 533,483 | 701,024 | 961,653 |
| NSE Derivatives | 1,350,610 | 2,586,738 | 3,926,843 | 7,046,665 |
| BSE Derivatives | 4,006 | 4,008 | 4,010 | 4,012 |

Source: NSE and BSE

4.17 NSE and BSE spot market turnovers adding up to Rs. 2,877,880 crore and NSE and BSE derivatives turnover adding up to Rs. 7,050,677 crore in 2006 showed significant growth over the previous year. At the end of 2006, as a proportion of GDP (advance estimate for 2006-07), the turnover in the spot market was 70.2 per cent, while that in the derivatives market was 171.9 per cent.

4.18 In terms of the composition of market participants, the stock market continued to be dominated by retail investors. The average transaction size of the spot market indicated its continued accessibility to small investors (Table 4.12).

**Table 4.12 : A predominantly retail market**

| | Calendar year | | | |
|---|---|---|---|---|
| Markets | 2003 | 2004 | 2005 | 2006 |
| *Average trade size (Rupees)* | | | | |
| NSE spot | 26,993 | 27,716 | 24,293 | 25,657 |
| BSE Spot | 22,794 | 23,995 | 27,307 | 29,574 |
| NSE derivatives | 425,077 | 488,790 | 501,946 | 635,241 |

Source : NSE and BSE

**Table 4.13: Transactions of FIIs**

*(Rs. Crore)*

| Transactions | Calendar year | | |
|---|---|---|---|
| | 2004 | 2005 | 2006 |
| **End-year number of FIIs** | 637 | 823 | 1,044 |
| **End-year number of sub accounts** | 1,785 | 2,273 | 3,045 |
| **1. Equity market activity** | | | |
| **a. Spot** | | | |
| Gross Buy | 185,672 | 286,021 | 475,623 |
| Gross Sale | 146,706 | 238,839 | 439,083 |
| Net (Buy-Sale) | 38,965 | 47,182 | 36,540 |
| **b. Derivatives activity** | | | |
| Gross Buy | 84,205 | 254,322 | 564,887 |
| Gross Sale | 86,133 | 249,875 | 564,182 |
| Net (Buy-Sale) | -1,928 | 4,447 | 705 |
| **c. Total equity (a+b)** | | | |
| Gross Buy | 269,877 | 540,343 | 1,040,510 |
| Gross Sale | 232,839 | 488,714 | 1,003,265 |
| Net (Buy-Sale) | 37,037 | 51,629 | 37,245 |
| **2. Debt** | | | |
| Gross Buy | 13,812 | 7,015 | 11,061 |
| Gross Sale | 10,729 | 12,533 | 7,012 |
| Net (Buy-Sale) | 3,083 | -5,518 | 4,049 |
| **3. Total FII investment (1+2)** | | | |
| Gross Buy | 283,689 | 547,358 | 1,051,571 |
| Gross Sale | 243,568 | 501,247 | 1,010,277 |
| Net (Buy-Sale) | 40,120 | 46,111 | 41,294 |
| Total FII Investment (Net) in US $ million^ | 8,763 | 10,467 | 9,031 |

**^ Includes dollar equivalents of FII investment in equity spot and debt segments as published by SEBI and their investment in derivatives converted from Rupees to dollars using annual average rates.**

**Source: SEBI**

4.19 Both FIIs and mutual funds as institutional investors remained active in the equity market during the year. Though the net investment by FIIs in the equity spot market fell by around 22 per cent to Rs. 36,540 crore in 2006, there was a quantum increase in gross value of buying and selling (Table 4.13).

4.20 The number of FIIs rose by 27 per cent to 1,044 at the end of 2006. The number of sub-accounts too increased by 34 per cent to 3,045. Domestic participants accounted for the major part of the transactions in the Indian equity market with the gross turnover (including both buy and sale) by FIIs at Rs. 20.6 lakh crore accounting for only 10.4 per cent of total gross (two-way) turnover of Rs. 198.6 lakh crore in spot and derivatives markets in 2006.

4.21 In tandem with an increase in resource mobilisation, assets under management of mutual funds increased by about Rs. 1.24 lakh crore to reach Rs. 3.24 lakh crore in 2006 (Table 4.14). The transactions of mutual funds in the equity segment of Indian stock exchanges, which amounted to net sales of Rs. 1,164 crore in 2004, turned to net purchase of Rs. 13,436 crore in 2005 and further to Rs. 15,384 crore in 2006.

| Table 4.14 : Assets under management of mutual funds (Rs. Crore) | | | | |
|---|---|---|---|---|
| | Calendar year (Year end) | | | |
| **Schemes** | **2003** | **2004** | **2005** | **2006** |
| Money Market | 32,424 | 59,447 | 64,711 | 97,757 |
| Gilt | 6,917 | 4,876 | 3,730 | 2,057 |
| Income | 71,258 | 47,451 | 52,903 | 86,350 |
| Growth | 22,938 | 31,551 | 67,144 | 119,538 |
| Balanced | 4,663 | 5,472 | 6,833 | 9,170 |
| ELSS | 1,893 | 1,740 | 3,927 | 8,726 |
| Total | 140,093 | 150,537 | 199,248 | 323,598 |

**Source : NSE**

## Secondary market for debt

4.22 In the secondary market for debt, Government of India (GOI) securities continued to account for the major part of activity. In terms of market size of GOI bonds, the gross issuance of GOI dated securities in 2006 amounted to Rs.147,000 crore as compared to Rs. 129,350 crore in 2005. The end of the year market capitalisation of GOI securities increased by 7.6 per cent from Rs.1,051,521 crore in 2005 to Rs.1,131,558 crore in 2006.

4.23 The interest rates on GOI bonds have been on the rise in the past three years. The zero-coupon rate on a 1-year bond has shown an upward trend, rising from 6.09 per cent in 2004 to 8.03 per cent in 2006. Likewise, the zero-coupon rate on a 10-year bond has increased from 6.78 per cent in 2004 to 7.22 per cent in 2005 and further to 7.57 per cent in 2006. Due to the increase in interest rates, the returns to GOI bond index continued to be negative during 2006. Further, the volatility of GOI bond market during 2006 was higher than that during 2005.

## Policy developments

4.24 In the Securities Market, several initiatives were taken by the Government during 2006-07. Apart from initiatives in respect of primary market (Box 4.1), several measures were undertaken during the year which concern the secondary market (Box 4.2).

**Box 4.1 : Policy developments in primary market**

In the Primary Market the following policy initiatives were undertaken during 2006-07:

- SEBI notified the disclosures and other related requirements for companies desirous of issuing Indian Depository Receipts in India. It was mandated that the issuer must be listed in its home country, must not have been barred by any regulatory body, and should have a good track record of compliance of securities market regulations. SEBI stipulated the requirements of issue size, subscription to the issue and disclosures to be made in the prospectus of the issue such as general information, disclaimer clause, offering details, risk factors and financial information among other requirements.
- As a condition of continuous listing, listed companies have to maintain a minimum level of public shareholding at 25 per cent of the total shares issued. The exemptions include companies which are required to maintain more than 10 per cent, but less than 25 per cent in accordance with the Rule 19 2(b) of the Securities Contracts (Regulation) Rules, 1957 and the companies, that have two crore or more of listed shares and Rs. 1,000 crore or more of market capitalisation. SEBI has also provided a transparent mechanism to graduate to compliance of the continuous listing requirements for companies which are currently non-compliant or companies which might become non-compliant in future.
- SEBI has specified that shareholding pattern will be indicated by listed companies under three categories, viz., “shares held by promoter and promoter group”, “shares held by public” and “shares held by custodians and against which Depository Receipts have been issued”.
- In accordance with the guidelines issued by SEBI, the issuers are required to state on the cover page of the offer document whether they have opted for an IPO grading from the rating agencies. In case the issuers opt for a grading, they are required to disclose the grades including the unaccepted grades in the prospectus and abridged prospectus.
- SEBI facilitated a quick and cost effective method of raising funds termed as Qualified Institutional Placement (QIP) from the Indian securities market by way of the private placement of securities or convertible Bonds (but not warrants) with the Qualified Institutional Buyers. Listed companies having equity shares of same class listed on a stock exchange having nation-wide trading terminals and complying with the minimum public shareholding under continuous listing requirement are eligible to raise funds through the QIP route.
- SEBI stipulated that the benefit of ‘no lock-in’ on the pre-issue shares of an unlisted company making an IPO, currently available to the shares held by Venture Capital Funds (VCFs)/Foreign Venture Capital Investors (FVCIs), shall be limited to : (a) the shares held by VCFs or FVCIs registered with SEBI for a period of at least one year as on the date of filing draft prospectus with SEBI and (b) the shares issued to SEBI registered VCFs/FVCIs upon conversion of convertible instruments during the period of one year prior to the date of filing draft prospectus with SEBI provided that the period of holding such convertible instruments as fully paid-up, together with the period of holding shares resulting from conversion by the VCFs and FVCIs is at least one year as on the date of filing the draft prospectus with SEBI.
- In order to regulate pre-issue publicity by companies which are planning to make an issue of securities, SEBI amended the Disclosure and Investor Protection Guidelines to introduce “Restrictions on Pre-issue Publicity” from the time the issuer company’s Board approves the issue till the actual allotment of shares of the issue. The restrictions, *inter alia,* require an issuer company to ensure that its publicity is consistent with its past practices, does not contain projections or estimates or any information extraneous to the offer document filed with SEBI.

**Box 4.2 : Measures undertaken in the area of secondary market**

- In continuation of the comprehensive risk management system put in place since May 13, 2005 in T+2 rolling settlement scenario for the cash market, the stock exchanges were advised to update the applicable Value at Risk (VaR) margin at least 5 times in a day by taking the closing price of the previous day at the start of trading and the prices at 11:00 a.m., 12:30 p.m., 2:00 p.m. and at the end of the trading session. This has been done to align the risk management framework across the cash and derivative markets.
- In order to strengthen the 'Know Your Client' norms and to have sound audit trail of the transactions in the securities market, PAN has been made mandatory with effect from January 1, 2007 for operating a Beneficiary Owner account and for trading in the cash segment similar to transactions in the futures and options segment of the stock exchanges.
- In order to implement the Union Budget proposal on creation of a unified platform for trading of corporate bonds, SEBI stipulated that the BSE Limited would set up and maintain the corporate bond reporting platform. The reporting shall be made for all trades in listed debt securities issued by all institutions such as banks, public sector undertakings, municipal corporations, corporate bodies and companies. Also, SEBI and RBI have set up an internal Working Group to implement the Budget 2006-07 announcement of creating a single, unified exchange-traded market for corporate bonds **(Box 4.3)**.
- In line with the Government of India's policy on foreign investments in infrastructure companies in the Indian securities market, the limits for foreign investment in stock exchanges, depositories and clearing corporations, have been specified as follows: a) Foreign investment up to 49 per cent will be allowed in these companies with a separate Foreign Direct Investment (FDI) cap of 26 per cent and cap of 23 per cent on FII investment; b) FDI will be allowed with specific prior approval of FIPB; c) FII will be allowed only through purchases in the secondary market; d) FII shall not seek and will not get representation on the Board of Directors; and e) No foreign investor, including persons acting in concert, will hold more than 5 per cent of the equity in these companies.
- The application process of FII investment was simplified and new categories of investment (insurance and reinsurance companies, foreign central banks, investment managers, international organizations) were included under FII.
- GOI raised the cumulative debt investment limits from US$1.75 billion to US$2 billion and US$0.5 billion to US$1.5 billion for FII/sub account investments in Government securities and corporate debt, respectively. RBI, in its mid-term review of monetary policy, further enhanced the limit of FII investment on Central and State Government Securities to US$2.6 billion by December 31, 2006 and further to US$3.2 billion by March 31, 2007.
- Initial Issue Expenses and Dividend Distribution Procedure for Mutual Funds were rationalised.
- In compliance with the proposal made in Budget 2005-06, Mutual Funds were permitted to introduce Gold Exchange Traded Funds.
- Pursuant to the Union Budget 2006-07, the aggregate ceiling for the mutual fund industry to invest in ADRs/GDRs issued by Indian companies, equity of overseas companies listed on recognised stock exchanges overseas and rated debt securities was raised from US$1 billion to US$3 billion.
- In the Government Securities market, the RBI ceased to participate in primary issues of Central Government Securities from April 1, 2006 in line with the provisions of FRBM Act. Intra-day short sale in Government Securities was also permitted with effect from February 28, 2006. 'When Issued' transactions in Government Securities have been allowed with effect from August 1, 2006.
- Demutualisation of BSE, the oldest stock exchange in Asia, is well under way in accordance with the provisions of SEBI scheme for demutualisation. The exchange ceased to be an Association of Persons and became a company under the Companies Act in August 2005. A public issue in the first half of 2007 will ensure that at least 51 per cent of equity is held by public other than trading members. The change in the ownership structure is in keeping with the evolution of BSE as a modern, professionally managed, transparent, competitive and efficient stock exchange.
- Foreign institutional investors have been allowed to invest in security receipts.
- The report submitted by the Committee on Fuller Capital Account Convertibility (Chairman, Shri S.S. Tarapore) while considering fuller capital account convertibility, incidentally observed that though the overall regime had undergone a significant degree of liberalisation, in practice, some regulations relating to an earlier period of tight controls continued to remain, giving rise to a disconnect between the regulatory intent and the procedure in use. As a follow up action of the Committee's recommendations, an RBI task force has been set up to identify the anomalies in the present regulatory framework for current and capital accounts and that rectification should be undertaken within a period of three months (Box 4.4).

**Box 4.3 : Recommendations of R.H.Patil Committee report on corporate bonds and securitisation**

Corporate debt in India suffers from certain shortcomings: investment cult is confined to large cities; corporate debt market is lesser developed as compared to G-sec market; small issuer base; major issuance of corporate papers is through private placements with scanty disclosures; corporate debt market does not have a structured clearing and settlement mechanism in place. Addressing the above-mentioned issues, a high-level committee headed by Shri R.H.Patil gave the following main recommendations:

- The stamp duty on partly secured (including partly secured by registered mortgage) and unsecured debentures should be made uniform across all States and be linked to the tenor of the securities, with an overall cap;
- TDS rules for corporate bonds should be similar to the ones applicable to Government Securities;
- In order to incentivise corporates to raise a part of their requirements through bonds, the time and cost for public issuance and the disclosure and listing requirements for private placements should be reduced and made simpler;
- Banks should be allowed to issue bonds of maturities of over 5 years for asset-liability management (ALM) purpose and not only for the infrastructure sector as at present;
- A suitable framework needs to be put in place that incentivises efficient market-making and considers support mechanisms that market-makers need for this purpose, including permission to undertake repos in corporate bonds;
- For unlisted companies issuing bonds to institutional investors/Qualified Institutional Buyers (QIB), rating rationale should form the basis of listing;
- SEBI should issue suitable guidelines for providing wide dissemination of information/reports including compliance reports filed by companies and debenture trustees, defaults, if any, and all other relevant information that are required to be brought to the knowledge of the investors;
- The scope of investment by provident/pension/gratuity funds and insurance companies in corporate bonds should be enhanced and rating should form the basis of such investments rather than the category of issuers;
- Retail investors should be encouraged to participate in the market through stock exchanges. Such investors should also be encouraged to participate in the corporate bond market through mutual funds;
- There should be a guideline limiting the number of fresh issuances that would include re-issuance of the existing bonds by a corporate in a given time period (say over a quarter);
- The immediate creation of a centralizedsed database of all bonds issued by corporates is an absolute necessity. This database should also track rating migrants;
- There is a need to develop a transparent and efficient secondary market for corporate bonds, incorporating the global best practices and systems to the extent they are relevant and consistent with the Indian securities market. SEBI, being charged with the responsibility of development and regulation of corporate bonds market, should provide the necessary regulatory framework;
- Steps should be taken to immediately establish a system to capture all information related to trading in corporate bonds as accurately and as close to execution as possible, and disseminate it to the entire market in real time;
- The clearing and settlement of trades in this market must follow the International Organisation of Securities Commission (IOSCO) standards and the global best practices by way of well established clearing and settlement procedures through recognised clearing and settlement agencies;
- In order to improve secondary market trading, repos in corporate bonds may be permitted by RBI to be operated by the proposed clearing entities for corporate bonds;
- As market participants gain experience with trade reporting and the first phase of clearing and settlement systems, efforts should be made to develop online order matching platforms for corporate bonds. Such trading platforms can be set up by the stock exchanges or jointly by regulated institutions like banks, financial institutions, mutual funds, insurance companies, etc. SEBI would frame specific guidelines for setting up such trading platforms. Any platform, other than the one offered by a stock exchange would effectively be performing the functions of an exchange to a limited extent and as such would need the specific approval of SEBI;
- Currently, the interest rate derivatives market is confined to the over-the-counter (OTC) market with only a handful of participants. Large corporates are active participants in this market. There is no mechanism for dissemination of trades and prices. Steps may be taken to introduce reporting system in the market and ensure real time dissemination of information. Simultaneously steps may be taken to immediately introduce the revised and approved exchange traded derivative products which have been pending for a long time.

## Box 4.4 : Recommendations of Committee on Fuller Capital Account Convertibility (Tarapore Committee II) — Development of Indian debt market

***Government Securities Market***

(i) Over time, it would be preferable to progressively increase the share of mark-to-market category.

(ii) Promoting a two-way market movement would require permitting participants to freely undertake short-selling. Currently, only intra-day short-selling is permitted. This would need to be extended to short-selling across settlement cycles; this would, however, require adequate regulatory/supervisory safeguards.

(iii) To stimulate retail investments in gilts, either directly or through gilt mutual funds, the gilt funds should be exempted from the dividend distribution tax, and income up to a limit from direct investment in gilts could be exempted from tax.

(iv) In line with advanced financial markets, the introduction of Separate Trading of Registered Interest and Principal of Securities (STRIPS) in G-secs should be expedited.

(v) Expanding investor base would be strengthened by allowing, *inter alia*, entry to non-resident investors, especially longer term investors like foreign central banks, endowment funds, retirement funds, etc.

(vi) To impart liquidity to government stocks, the class of holders of G-secs needs to be widened and repo facility allowed to all market players without any restrictions on the minimum duration of the repo; this would, however, necessitate adequate regulatory/supervisory safeguards. This will improve the incentive for a wide range of economic agents to hold G-secs for managing their liquidity needs through repos.

(vii) A rapid debt consolidation process that is tax neutral, by exempting the gains arising from exchange of securities from all taxes, may be taken up. If necessary, a condition may be stipulated that gains arising from such an operation cannot be distributed to the shareholders.

(viii) The limit for FII investment in G-secs could be fixed at 6 per cent of total gross issuances by the Centre and States during 2006-07 and gradually raised to 8 per cent of gross issuance between 2007-08 and 2008-09, and to 10 per cent between 2009-10 and 2010-11. The limits could be linked to the gross issuance in the previous year to which the limit relates. The allocation by SEBI of the limits between 100 per cent debt funds and other FIIs should be discontinued.

***Corporate Bond and Securitised Debt Market***

(i) GOI, RBI and SEBI should be able to evolve a concerted approach to deal with the complex issues identified by the High Level Committee on Corporate Bond Market.

(ii) Institutional trading and settlement arrangements need to be put in place and investors should have the freedom to join any of the trading and settlement platforms they find to be convenient.

(iii) The issuance guidelines have to be changed so as to recognize the institutional character of the market. Since issuers may like to tap the bond market more frequently than the equity market and since subscribers are mainly institutional investors, issuance and listing mechanisms in respect of instruments being placed with institutional investors should be simplified by relying more on the assessment of a recognised rating agency rather than on voluminous and tedious disclosures as required by the public issues of equities.

(iv) Until transparent trading platforms become more popular, reliable trade reporting systems should be made mandatory. Clearing and settlement arrangements like those offered by CCIL in the case of G-secs should be in place to ensure guaranteed settlement.

(v) Stamp duty at the time of bond issues as also on securitised debt should be abolished by all the state governments.

(vi) The FII ceiling for investments in corporate bonds of US$1.50 billion should in future be linked to fresh issuances and the present absolute limit should be retained for the year 2006-07 and be fixed at 15 per cent of fresh issuances between 2007-08 and 2008-09 and at 25 per cent between 2009-10 and 2010-11. The allocation by SEBI of the limits between 100 per cent debt funds and other FIIs should be discontinued.

(vii) Corporate bonds may be permitted as eligible securities for repo transactions subject to strengthening of regulatory and supervisory policies.

(viii) In the case of the securitised debt market, the tax treatment of special vehicles that float the securitised debt has to be materially different. Government should provide an explicit tax pass-through treatment to securitisation Special Purpose Vehicles (SPVs) on par with tax pass-through treatment granted to SEBI-registered venture capital funds.

(ix) Securitised debt should be recognised under the Securities Contract and Regulation Act (SCRA), 1956 as tradable debt. The limitations on FIIs to invest in securities issued by Asset Reconstruction Companies should be on par with their investments in listed debt securities.