

# 4

## Capital and Commodity Markets

### I. Capital market

Progress on developing India's capital market, which is already more competitive, deep and developed by international markets standards, continued. Business in the country's oldest stock exchange, namely the Bombay Stock Exchange (BSE) dating back to 1875, which is also one of the oldest stock exchanges in the world, continued to thrive. The National Stock Exchange (NSE), which emerged in the mid-1990s and catalysed improvements in trading systems to provide the necessary depth and choice to investors, made sustained progress. With the BSE and NSE emerging as the two apex institutions of the country's capital market, restructuring of other stock exchanges went apace. Overseen by Securities and Exchange Board of India (SEBI), an independent statutory regulatory authority, the country's capital market dealt in scrips of a large number of listed companies with a wide geographical outreach, providing a world class trading and settlement system, a wide range of product availability with a fast growing derivatives market, and well laid down corporate governance and investor protection measures.

4.2 As a part of the on-going financial and regulatory reforms of the primary and secondary market segments of the capital market, a number of initiatives were taken in 2005-06 and the current year so far. These measures, together with accelerated economic growth and macroeconomic stability, sustained the confidence of investors (both domestic and foreign) in the country's capital market. The stock market scaled new peaks year after year since 2003, with the BSE

and NSE indices crossing the 14,000 and 4,000 marks, respectively, in January 2007.

### Primary market

4.3 The primary capital market has remained upbeat during 2006-07 so far. The aggregate resource mobilisation in the market, especially through Initial Public Offerings (IPOs) and private placements, was much higher in calendar year 2006 than during the previous year (Table 4.1).

**Table 4.1 : Resource mobilisation through primary market**

(Rs. crore)

Mode	Calendar year			
	2003	2004	2005	2006
1. Debt	5,284	2,383	66	389
2. Equity	2,891	33,475	30,325	32,672
Of which, IPOs	1,708	12,402	9,918	24,779
Number of IPOs	12	26	55	75
Mean IPO size	142	477	180	330
3. Private				
Placement	59,215 <sup>^</sup>	93,506	83,812	117,407
4. Euro Issues (ADR/GDR)	2,153	2,029	9,788	11,301
Total (1 to 4)	69,543	131,393	123,991	161,769

<sup>^</sup> For April 2003 to March 2004  
Source : SEBI and RBI (for Euro Issues)

4.4 Out of Rs. 161,769 crore mobilised in the primary capital market, Rs. 117,407 crore, or 72.5 per cent of the total resources mobilised, was raised through private placement. Seventy five IPOs raised Rs. 24,779 crore, which accounted for 76 per cent of resources raised through equity. The number of IPOs showed a steady rise to 75

during 2006; on an average, there were around 6 IPOs per month.

4.5 Net mobilisation of resources by mutual funds increased by more than four-fold to Rs. 104,950 crore in 2006 from Rs. 25,454 crore in 2005. The sharp rise in mobilisation by mutual funds was due to buoyant inflows under both income/debt oriented schemes and growth/equity oriented schemes. After suffering negative inflows in 2003 and 2004, inflows turned positive for public sector mutual funds in 2005 and accelerated in 2006. The share of UTI and other public sector mutual funds in the total amount mobilised was around 22.5 per cent in 2005 and 17.8 per cent in 2006 (Table 4.2).

Sector	Calendar Year			
	2003	2004	2005	2006
1. UTI	762	-1,487	1,273	6,426
2. Public Sector	-1,331	-1,262	4,446	12,229
3. Private Sector	35,646	7,524	19,735	86,295
4. Total (1 to 3)	35,077	4,775	25,454	104,950

Source: SEBI

## 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,

Month	Calendar Year					
	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

<b>Table 4.5 : Biggest exchanges by number of transactions</b>				
<b>Exchanges</b>	<b>Rank by number of transactions during calendar year</b>			
	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
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
Shenzhen	8	8	7	7
Taiwan	6	7	8	8
Deutsche Borse	9	9	9	9
London/euronet	11	10	10	10

**Source: NSE**

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).

<b>Table 4.4 : Movements of the index of BSE (end of period)</b>						
<b>Months</b>	<b>Calendar Year</b>					
	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
	<b>Top 30 Stocks</b>			<b>BSE 500</b>		
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**

Indices	Calendar Year			
	2003	2004	2005	2006
<b>Nifty</b>				
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
<b>Nifty Junior</b>				
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
<b>BSE Sensex</b>				
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
<b>BSE 500</b>				
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		
Class of stocks	Period	
	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).

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).

Portfolio	Calendar year			
	2003	2004	2005	2006
<b>Nifty</b>				
NSE impact cost at Rs.50 lakh (%)	0.10	0.09	0.08	0.08
<b>Nifty Junior</b>				
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).

Markets	Calendar Year			
	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).

Markets	Calendar year			
	2003	2004	2005	2006
<b>Average trade size (Rupees)</b>				
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
<b>End-year number of FIIs</b>	637	823	1,044
<b>End-year number of sub accounts</b>	1,785	2,273	3,045
<b>1. Equity market activity</b>			
<b>a. Spot</b>			
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>b. Derivatives activity</b>			
Gross Buy	84,205	254,322	564,887
Gross Sale	86,133	249,875	564,182
Net (Buy-Sale)	-1,928	4,447	705
<b>c. Total equity (a+b)</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
<b>2. Debt</b>			
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
<b>3. Total FII investment (1+2)</b>			
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 <sup>^</sup>	8,763	10,467	9,031

<sup>^</sup> 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)*

Schemes	Calendar year (Year end)			
	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).

### II. Commodity futures market

4.25 As compared to 59 in January 2005, 94 commodities were traded in the commodities futures market as of December 2006, and these included major agricultural commodities (rice, wheat, jute, gur, cotton, coffee, major pulses like urad, arahar, chana, edible oilseeds like mustard seed, coconut oil, groundnut oil and sunflower), spices (pepper, chillies, cumin seed and turmeric), metals (aluminium, tin, nickel and copper), bullion (gold and silver), crude oil, natural gas and polymer, among others. Gold accounted for the largest share (31 per cent) of trade in terms of value, followed by silver (19 per cent), guar seed (11 per cent) and chana (10 per cent). A temporary ban was imposed on futures trading in urad and tur dal in January 2007 to ensure orderly market conditions. An efficient and well-organised commodities futures market is generally acknowledged to be helpful in price discovery for the traded commodities (Box 4.5).

4.26 The growth in the commodity derivative trading witnessed in 2005-06 continued during 2006-07. Total volume of trade rose sharply from Rs. 1.29 lakh crore in 2003-04 to Rs. 27.39 lakh crore in 2006-07 (till December 2006) (Table 4.15). In the first nine months of 2006-07, the volume of trade was already more than Rs. 21.55 lakh crore achieved in the twelve months of 2005-06. Turnover as a proportion of GDP increased from only 4.7 per

#### 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.

cent in 2003-04 to 18.3 per cent in 2004-05 and further to 76.8 per cent in 2005-06. The growth in the volume of trading has been primarily propelled by Multi Commodity Exchange, Mumbai (MCX) and National

Commodity Derivatives Exchange, Mumbai (NCDEX) (Figure 4.1), with these two exchanges also accounting for a large share of the number of contracts traded on the exchanges (Table 4.16).



#### 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 centralized 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**

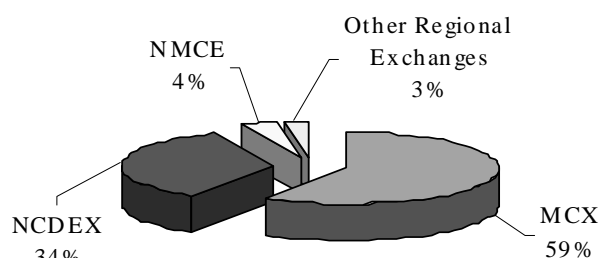
- (i) Over time, it would be preferable to progressively increase the share of mark-to-market category.
- (ii) Promoting a two-way market movement would require permitting participants to freely undertake short-selling. Currently, only intra-day short-selling is permitted. This would need to be extended 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.

**Fig. 4.1**

**Indian commodity exchange market share  
(in terms of turn-over) in 2006-07 (till December 2006)**



■ MCX ■ NCDEX □ NMCE □ Other Regional Exchanges

**Table 4.15 : Turnover on commodity futures markets**

(Rs. Crore)

Exchanges	2004-05	2005-06	2006-07*
Multi Commodity Exchange, Mumbai (MCX)	165,147	961,633	1,621,803
National Commodity Derivatives Exchange, Mumbai (NCDEX)	266,338	1,066,686	944,066
National Multi Commodity Exchange, Ahmedabad (NMCE)	13,988	18,385	101,731
National Board of Trade, Indore (NBOT)	58,463	53,683	57,149
Others	67,823	54,735	14,591
<b>All Exchanges</b>	<b>571,759</b>	<b>2,155,122</b>	<b>2,739,340</b>

\* Till December 31, 2006

Source: Forward Markets Commission.

**Table 4.16: Number of contracts traded in national exchanges**

(in lakh)

Exchange/ Year	2004-05	2005-06	2006-07*
<b>MCX, Mumbai</b>	33.38	152.45	255.26
<b>NCDEX, Mumbai</b>	109.95	274.17	236.55
<b>NMCEX, Ahmedabad</b>	9.56	9.95	28.51

\* Till December 31, 2006

Source: Forward Markets Commission

raw jute, and in NCDEX, guar seed, chana and soy oil had the highest volumes of trade. MCX emerged as the largest commodity futures exchange during 2006-07 both in terms of turnover and number of contracts. The growth of MCX during 2006-07 is comparable with some of the international commodity futures exchanges like Goldman Sachs Commodity Index (GSCI), Dow Jones AIG Commodity Index Cash Index (DJAIG) and Reuters/Jefferies Commodity Research Bureau (RJCRB) (Figure 4.2).

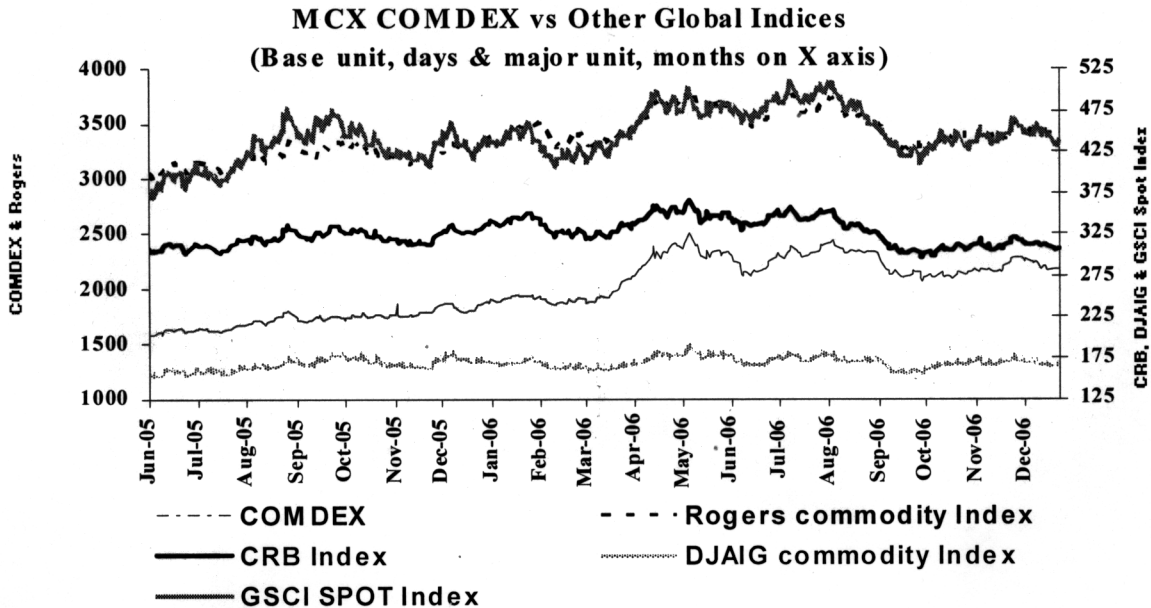
## Outlook

4.27 The daily average volume of trade in the commodity exchanges in December 2006 was Rs. 12,000 crore. In the fortnight ending on December 31, 2006, gold, silver and copper recorded the highest volumes of trade in MCX, while in NMCEX, pepper, rubber and

4.28 As pick-up in investment activity is expected to continue in 2007-08, resource mobilisation through public issues, private placements and euro issues are slated to remain encouraging in the primary market

**Fig. 4.2**

**MCX COMDEX vs Other Global Indices**  
(Base unit, days & major unit, months on X-axis)



segment. The recent policy initiatives to address the systemic issues in the primary capital market may increase the reliance on public issues as a major source of funds for Indian corporates besides helping to broaden the investor base.

4.29 With increased globalisation, behaviour of stock prices in the near-term will be largely influenced by a host of domestic as well as international factors. Global economy, after four consecutive years of strong growth, is expected to post an equally impressive growth in 2007. Favourable international economic conditions enhance the growth prospects of developing countries which in turn facilitates sustained flow of cross-border portfolio investment to emerging economies. On the domestic front, there are expectations of higher corporate investment and earnings, GDP growth of over 8 per cent for the fourth year in a row with macroeconomic stability, and Government's commitment to carry forward the economic reforms. These are expected to sustain the interest of not only the domestic investors but also scale-up FII interest in Indian equity and debt papers and to retain India as one of the preferred

destinations for portfolio investment. Improved investor awareness and expanding equity-cult among the small savers appear to augur well for buoyant stock markets. Recent trend of increased investors' preference to participate in equity markets through mutual fund conduit would enhance institutional investment in equity markets. The institutional and regulatory architecture should facilitate this further as this would counterbalance and cushion the impact of the swings in the stock prices.

4.30 While Government securities market is expected to attain further width and breadth as a result of the latest policy initiatives such as introduction of intra-day short sale and 'when issued' market, measures need to be taken to revive the corporate debt market to remove its sluggishness and encourage individual investment as well as institutional investment including those by FIIs.

4.31 The commodity exchanges, which have seen consistent increase in turnovers for the last few years, may remain vibrant in 2007-08 witnessing larger volume and value of commodities traded. Gold and crude oil account for the major part of the total

#### Box 4.5 : What commodity futures markets do?

A well-developed and effective commodity futures market, unlike physical market, facilitates offsetting the transactions without impacting on physical goods until the expiry of a contract. Futures market attracts hedgers who minimise their risks, and encourages competition from other traders who possess market information and price judgment. While hedgers have long-term perspective of the market, the traders, or arbitragers as they are often called, hold an immediate view of the market. A large number of different market players participate in buying and selling activities in the market based on diverse domestic and global information, such as price, demand and supply, climatic conditions and other market related information. All these factors put together result in efficient *price discovery* as a result of large number of buyers and sellers transacting in the futures market.

Futures market, as observed from the cross-country experience of active commodity futures markets, helps in efficient price discovery of the respective commodities and does not impair the long-run equilibrium price of commodities. At times, however, price behaviour of a commodity in the futures market might show some aberrations reacting to the element of speculation and 'bandwagon effect' inherent in any market, but it quickly reverts to long-run equilibrium price, as information flows in, reflecting fundamentals of the respective commodity. In futures market, speculators play a role in providing liquidity to the markets and may sometimes benefit from price movements, but do not have a systematic causal influence on prices.

An effective architecture for regulation of trading and for ensuring transparency as well as timely flow of information to the market participants would enhance the utility of commodity exchanges in efficient price discovery and minimise price shocks triggered by unanticipated supply demand mismatches.

#### References:

1. Ghosh, S. et al, 1987, "Stabilising Speculative Commodity Markets", New York, Oxford University Press
2. International Monetary Fund, "World Economic Outlook", September 2006

transactions in futures market at present. But, other commodities, particularly agricultural commodities, are expected to gain importance helping their price discovery process and thereby providing an opportunity for farmers, traders and consumers to obtain a reasonable

price. The proposed amendments to the Forward Contracts (Regulation Act), 1952 are expected to strengthen the regulatory aspects and ensure orderly conditions in the commodity futures market.