Secondary Market

10. Lack of sustained buoyancy in the secondary market has contributed to the poor investor interest in the primary market. Measures taken by the Government as well as SEBI in regard to buy-back of shares have therefore been designed to boost investor interest in the share market. Other measures aimed at raising the level of investor confidence in the secondary market include amendment of SEBI Takeover Regulations, extension of demat trading to more scrips, introduction of rolling settlement in the demat segment, more stringent disclosure requirements, and stipulation of additional margin requirements aimed at curbing excess volatility in share prices.

Buy-back of shares

11. The Companies (Amendment) Ordinance promulgated on October 31, 1998 has empowered companies to purchase their own shares or other specified securities (referred to as “buy-back”). As the Companies (Amendment) Bill, 1998 introduced in the House of the People has not been passed, the Ordinance was repromulgated on January 7, 1999. The permission for buy back is subject to the conditions specified by the Ordinance, including the stipulation that it should be in accordance with regulations framed by SEBI. The SEBI regulations on buy-back apply only to listed securities and as such unlisted securities issued through private placement or otherwise fall outside the purview of SEBI regulations (Box 4.2).

Sweat Equity

12. As per provisions of the Companies (Amendment) Ordinance, companies can issue sweat equity shares subject to authorisation by a resolution passed by a general meeting. The expression ‘Sweat Equity’ refers to equity shares issued by a company to directors or employees at a discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights or value additions. All limitations, restrictions and provisions relating to equity shares shall be applicable to sweat equity shares. It is worth noting here that Guidelines were issued in June 1998 to facilitate issue of GDR/ADR linked stock option to its employees by a company engaged in manufacture or production of software where not less than 80 per cent of the company's turnover is from software activities. In September 1998, this facility was extended to all companies engaged in Information Technology (IT) Software and IT Services.

Takeover Regulations

13. The reconstituted Bhagwati Committee considered the provisions of SEBI (Substantial Acquisitions of Shares and Takeovers) Regulations, 1997 relating to consolidation of holdings, threshold limit and acquisitions during the offer period. After detailed discussions, the Committee decided that (i) creeping acquisition limit be increased from the present level of 2 per cent in any period of 12 months to 5 per cent, (ii) 5 per cent creeping acquisition limit be made applicable even to persons holding above 51 per cent but below 75 per cent of a company’s shares and (iii) upon acquiring 2 per cent, disclosures be made to stock exchanges. Accordingly, SEBI decided to amend sub regulations (1) and (2) of Regulation 11 to provide for increase in the creeping acquisition from 2 per cent to 5 per cent for all persons holding between 15 per cent and 75 per cent of a company’s shares. Acquisition beyond the 5 per cent limit shall mandate an open offer in terms of the regulations. In keeping with the increase in creeping acquisition limit from 2 per cent to 5 per cent, SEBI also decided to amend Regulation 10 so as to provide for an increase in the threshold limit from 10 per cent to 15 per cent.

Margin Requirements

14. The secondary market witnessed considerable volatility in share prices. Market sentiments were affected by, inter alia, reports relating to imposition of US sanctions, and adverse developments in international financial markets arising from the spread of the East Asian financial crisis. The measures taken by SEBI to counter this included ban on short sale on June 15,1998, which remained in force for about three weeks before it was lifted on July 6, 1998. Short sale is regulated in many countries. To make recommendations regarding regulation of short sale, SEBI reconvened the B.D. Shah Committee.

15. In order to tighten the measures aimed at curbing volatility in share prices, SEBI prescribed additional volatility margins (AVM) with effect from July 6, 1998. The AVM mechanism provided for the following:—

- The daily price band was reduced from 10 per cent to 8 per cent.

BOX 4.2

Buy-back of Shares

The Companies (Amendment) Ordinance (October 31, 1998 and January 7, 1999) allows companies to buy back their own shares subject to regulations laid down by SEBI. The new Sections (77A and 77B) in the Ordinance lay down the provisions/restrictions concerning buy back of shares.

- A company can finance its buy back out of (i) its free reserves or (ii) the securities premium account or (iii) proceeds of an earlier issue other than fresh issue of shares made specifically for buy back purposes.
- A company is allowed buy back subject to the following conditions:—
  - (a) the buy back is authorised by its articles;
  - (b) a special resolution has been passed in general meeting of the company authorising buy back;
  - (c) the buy back does not exceed 25 per cent of the total paid up capital and free reserves of the company.
  - (d) debt-equity (including free reserves) ratio does not exceed to 2:1 after the proposed buy back;
  - (e) all shares or other specified securities are fully paid- up; and
  - (f) the buy back is in accordance with SEBI regulations framed for this purpose.
- The notice for the meeting convened to pass special resolution on buy back must be accompanied by an explanatory statement giving a full and complete disclosure of all material facts,the necessity for buy back, class of securities to be purchased and the amount to be invested under the buy back, and the time limit for completion of buy back. A maximum time of one year from the date of passing of resolution has been stipulated to complete the buy back.
- A company is required to destroy the shares bought back within seven days of completion of the buy back. Further, it is prohibited from issuing fresh equities within two years of buy back, except by way of bonus issue or discharge of its existing obligation of converting warrants, preference shares, debentures, stock option schemes, etc. into equity shares.
- A company which has defaulted on repayment of deposits, term loan, redemption of debenture/preference share, etc. is not allowed to buy back shares. Buy back of shares through subsidiary companies or investment companies is also prohibited.
- The Securities and Exchange Board of India (Buy Back of Securities) Regulations, 1988 provide for the following:
  - (a) Regulations cover only the listed securities of company.
  - (b) Buy back is permitted through the tender offer mode from existing share holders on proportionate basis and from odd lot holders. Buy back through the book-building mode and purchases through stock exchange are allowed for open market transactions.
  - (c) In the purchases made through the stock exchange, the details of purchases under the buy back scheme shall be made available to the stock exchange on daily basis: the details in turn shall be made available to public regularly.
  - (d) Extensive disclosures need to be made in the Explanatory Statement to be annexed for the notice for general meeting and the Letter of Offer.
  - (e) Pre and post buy back holdings of promotors need to be disclosed carefully.
  - (f) Buy back through negotiated deals, spot transactions or private arrangements is not permitted.
  - (g) To ensure strict compliance with the provisions of SEBI Regulations, merchant banker has been made to be associated in every offer for buy back, wherein he has to give a “due diligence” certificate.
  - (h) To ensure timely completion of buy back process, the Regulations provide for time-bound steps in every mode. Thus, except in cases of purchases through stock exchange, an offer for buy back shall not remain open for more than 30 days.
  - (i) To ensure security/safety, the company making the buy back offer has to open an escrow account on the same lines as provided in the Takeover Regulations.

- Existing weekly price band of 25 per cent was removed and a graded margin system as shown below was put in place in respect of volatile securities (excluding price variations due to calls, bonuses, rights, mergers, etc.)

Price variation	Margin Rates
16 % or more	5 %
24 % or more	20 %
32 % or more	30 %
40 % or more	40 %

Derivatives Trading

16. The L.C. Gupta Committee on Derivatives set up by SEBI recommended phased introduction of derivative products, with stock index futures as the starting point for derivatives trading in India. The SEBI Board considered the report of the Committee on regulatory framework for Derivatives Trading in India. Based on the examination by the Board, including the feedback from the Secondary Market Advisory Committee and responses from the Stock Exchanges, the major recommendations on Derivatives Trading were accepted. These included the following :

- Phased introduction of derivative products, with the stock index futures as starting point for equity derivative in India.

- Expanded definition of Securities under the Securities Contracts (Regulation) Act (SCRA) by declaring derivative contracts based on index of prices of securities and other derivatives contracts as securities.
- Permission to existing Stock Exchanges to trade derivatives provided they meet the eligibility conditions including adequate infrastuctural facilities, online trading and surveillance system and minimum of 50 members opting for derivative trading.
- Initial margin requirements related to the risk of loss on the position and capital adequacy norms shall be prescribed.
- Annual inspection of all the members operating in the derivative segment by the Stock Exchanges.
- Dissemination by the exchange of information about the trades, quantities and quotes in real time over atleast two information vending networks.
- The clearing corporation/house to settle derivate trades should meet certain specified eligibility conditions and the clearing corporation/house must interpose itself between both legs of every trade, becoming the legal counter party to both, or alternatively provide an unconditional guarantee for settlement of all trades.
- Two tier membership: the trading member and clearing member, and the entry norms for the clearing member would be more stringent.
- The clearing member should have a minimum networth of Rs. 3 crore and shall make a deposit of Rs. 50 lakhs with the exchange/ clearing corporation in the form of liquid assets.
- Prescription of a model Risk Disclosure Document, and monitoring broker-dealer/client relationship by the Stock Exchange and the requirement that the sales personnel working in the broker-dealer office, should pass a certification programme.
- Corporate clients/financial institutions/mutual funds should be allowed to trade derivatives only if and to the extent authorised by their Board of Directors/Trustees.
- Mutual Funds would be required to make necessary disclosures in their offer documents if they opt to trade derivatives. For the existing schemes, they would require the approval of their unit holders. The minimum contract value would be Rs. 1 lakh which would also apply in the case of individuals.

17. The Union Budget, 1998-99 proposed amendment of SCRA and the necessary Bill has been introduced in the Parliament.The National Stock Exchange (NSE) has initiated steps to introduce trading in stock index futures at short notice. The J.R.Varma Committee set up by SEBI to recommend Risk Containment Measures in the Indian Stock Index Futures Market recommended, inter alia, details of the methodology to be adopted by the derivatives exchange and clearing corporation to fix the quantum of margin for index futures, method to estimate volatility, clearing members' liquid net worth, etc.

Dematerialised Trading

18. Several initiatives have been taken by SEBI to promote dematerialised or paperless trading, which can go a long way in eliminating the risks of bad delivery and fake or forged shares. With this end in view, SEBI introduced compulsory trading of shares in dematerialised form in specified scrips by institutional investors (FIIs, Mutual Funds, Banks and Financial Institutions) with effect from January 15, 1998. SEBI also set up a Working Group comprising National Securities Depository Ltd. (NSDL), and various market participants like Custodians, Brokers, FIIs, Stock Exchanges and Mutual Funds to assess the progress in dematerialised trading and suggest further steps. Based on recommendations made by this Working Group, SEBI took the following steps/decisions:—

- Rolling settlement on T+5 basis introduced in the dematerialised segment and delivery of dematerialised shares permitted in the physical segment
- The list of shares for compulsory demat trading was expanded in phases to 103, which is scheduled to increase to 304 by February 15,1999. These scrips include the shares covered by both the Sensex and the NSE Fifty indices.
- Delivery of shares in dematerialised form has been made compulsory for all investors in 31 scrips with effect from February 15,1999.
- Delivery in dematerialised form has been made compulsory in 24 scrips with effect from January 4, 1999 for all investors whose net delivery obligation is 5000 shares or more in a settlement.
- The Central Depository Services (India) Ltd (CDL), the second Depository in the country, has been granted certificate of registration

19. Progress in demat trading in terms of companies signing agreements with depository, dematerialisation facilities available with companies etc. during 1996-98 is summarised in Table 4.2.

TABLE 4.2
Progress in Demat Trading

	As on 31st of			
	Dec. 1996	**March 1997**	**March 1998**	**Dec. 1998**
A. Number of				
(i) Companies signing agreement	12	40	191	301
(ii) Companies with demat facilities	4	23	171	291
B. Number of DPs	10	24	49	76
C. DP locations (number)	10	24	200	610
D. Demat Quantity (million shares)	8	22	1763	5057
E. Demat value (Rs. billion)	2	5	227	702

DP : Depository Participant

Source: SEBI

Secondary Market Developments

20. Analysis of important share indices in the current financial year revealed considerable volatility in trading, which was maximum in June, 1998 as per the leading indices, namely, the SENSEX (5.2%) and S&PCNX Nifty (5.1%). The movements in share prices during April-December, 1998 reflected long bear phases and short bull phases. The BSE Senex crossed 4000 in April 1998 but declined later and closed at 3686 in May, 1998. It declined steadily thereafter and closed at 2934 in August, 1998. Though it rose above the 3000 mark and closed at 3102 in September, 1998 it declined thereafter and remained below the three thousand mark for nearly three months before crossing 3400 in January 1999. Similar movements in share prices were revealed by the NSE (S&PCNX) share index during this period (Table 4.3 and Figures 4.1 and 4.2).

Turnover and Delivery Pattern

21. The turnover and delivery pattern till November, 1998 in the current financial year are given below:

Item	BSE	NSE
Turnover (Rs. crore)	182223	235993
Delivery (Rs. crore)	36222	38832
Percentage of delivery to turnover	19.88	16.45

TABLE 4.3
Stock Market Indicators

Year/month	Index[1]		Price/Earnings Ratio	Average Daily Turnover (Rs. crore)	
	Sensex	**S&P CNX Nifty**	**Sensex**	**Sensex**	**S&P CNX Nifty**
1997-98					
April	3841.11	1079.85	14.81	645	1174
May	3755.10	1050.90	14.24	572	1207
June	4256.09	1192.40	16.17	866	1858
July	4305.70	1221.50	15.84	932	1864
August	3876.08	1105.00	15.80	1019	1655
September	3902.03	1123.80	14.66	860	1512
October	3803.24	1085.25	14.89	879	2017
November	3560.29	1023.95	13.33	766	1578
December	3658.98	1079.40	13.46	822	1480
January	3224.36	930.85	NA	NA	NA
1998-99					
April	4006.81	1159.35	16.11	1404	1634
May	3686.39	1063.15	14.84	1302	1792
June	3250.69	941.65	12.94	1023	1343
July	3211.31	931.40	12.69	924	1284
August	2933.85	852.80	11.13	911	1151
September	3102.29	904.95	11.30	1257	1422
October	2812.49	824.00	9.83	1243	1435
November	2810.66	817.75	11.12	1011	1154
December	3055.41	884.25	12.08	1213	1565
January	3315.57	966.20	NA	NA	NA

1.Montly closing; Sensex (1978-79=100) and S&P CNX Nifty (1995=100). The Sensex and S&P CNX Nifty have been revamped w ith effect from November 16, 1998 and October 7, 1998 respectively after taking into account the developments in stock market.

Source : SEBI.

Fig. 4.1

BSE Sensex Movement (Monthly closing)
April-January, 1997-98 and 1998-99

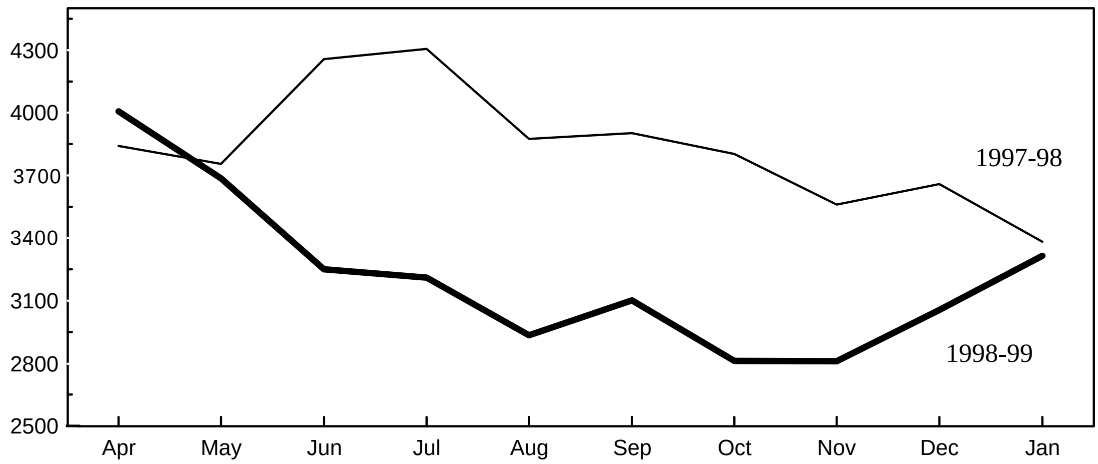
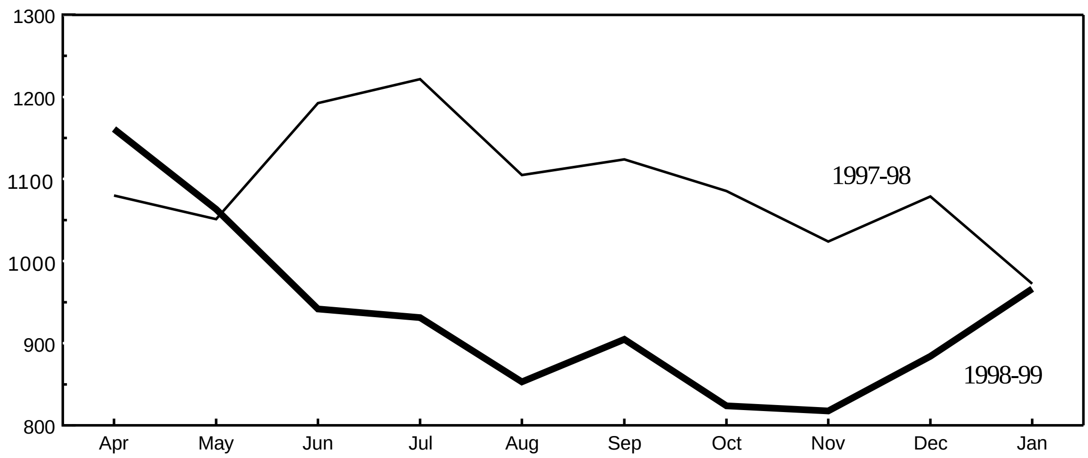


Fig. 4.2

NSE S&P CNX Nifty Movement (Monthly closing)
April-January, 1997-98 and 1998-99



Market Capitalisation

22. As per BSE estimates, the All India Market capitalisation registered a steady decline from Rs. 6,10,777 crore in April, 1998 to Rs.4,89,355 crore in August 1998. Though it rose by 3.2 per cent to reach Rs.5,04,959 crore in September, decline in share prices led to erosion in market capitalisation in both October and November, 1998 by 5.6 per cent and 1.3 per cent respectively. This meant a decline by about 23 per cent in all-India market capitalisation from Rs.6,10,777 crore in April 1998 to Rs. 4,70,240 crore in November 1998 in response to a 30 per cent decline in Sensex during the same period. The recent uptrend in share prices has improved the situation. The market capitalisation for December 1998 stood at Rs.5,02,116 crore, which exceeded that in November,1998 by 6.8 per cent.

Foreign Institutional Investors (FIIs)

23. FIIs play a significant role in share markets all over the world. The behaviour of share prices in India has also been affected by the trends in FII investment in the Indian share market. The turbulence in Asian finanancial markets affected overall FII investment in the region. In pursuance of the proposal made in the Union Budget for 1998-99, FIIs investing via 100 per cent debt route have been permitted to invest in unlisted

TABLE 4.4 Net FII Investment April-December, 1998 (US $ million)			
Month	**Equity**	**Debt**	**Total**
April	-8.4	-16.4	-24.8
May	-124.3	-94.1	-218.4
June	-190.5	-7.5	-198.0
July	22.2	-2.5	19.7
August	-90.1	-16.8	-106.9
Sept.	45.2	-12.0	33.2
Oct.	-135.4	-5.9	-141.3
Nov.	12.9	-60.0	-47.1
Dec.	78.1	-28.8	49.3
April-Dec.	-390.3	-244	-634.3

Source : SEBI

securities. The procedure for granting sub-account registration in respect of registered FIIs has also been simplified. In order to facilitiate investment by overseas investors, including NRIs, SEBI has created an overseas investment cell. While FIIs continued to repose their confidence in the Indian securities market and its regulatory framework, their response to investment in the Indian market was affected by the reduction in their exposure to Asian markets. During each of the first nine months in the current financial year except July and December net FII investment was negative. While net FII investment in equity was positive in four months during this period, that in debt was negative in all the nine months. The cumulative net FII investment (equity plus debt) declined by US $ 634 million or 6.8 per cent from US $ 9284 million in March 1997 to US $ 8650 million in December 1998.