FOREIGN INSTITUTIONAL INVESTORS AND INDIAN STOCK MARKET REFORMS

Suman*

Dr. D.P.Warne**

ABSTRACT:

Foreign institutional investors (FIIs) play an important role in Indian stock market. Securities Exchange Board of India (SEBI) gave a lot of stock market reforms after the year 2000. These reforms affected the FIIs to a large extent. I include the stock market reforms which were directly related to FIIs. These reforms were, the increased limit of investment up to 100% in tourism, highways etc. , get permission to invest in debt and government securities up to a certain limit, internet trading, get permission for short selling according to the rule of SEBI, ban on carried forward transactions etc. The author show the effect of these stock market reforms on FIIs with the help of increased trend of investment in foreign institutional investment, increased no. of SEBI registered FIIs etc. Finally these reforms have positive effect on FIIs.

Key Words: FIIs, SEBI, Short selling, carried forward transactions etc.

* Assistant Professor, G.M.N.(P.G.) College, Ambala Cantt.

** Reader, Chaudhary Devi Lal University Sirsa.

INTRODUCTION

FIIs were allowed to trade in the Indian stock market from 14th September 1992 but they made first investment in the month of January 1993. FII is defined as an institution organized outside of India for the purpose of making investments into the Indian securities market under the system prescribed by SEBI. 'FIIs' include "Overseas pension funds, mutual funds, investment trust, asset management company, nominee company, bank, institutional portfolio manager, university funds, endowments, foundations, charitable trusts, charitable societies, a trustee or power of attorney holder incorporated or established outside India proposing to make proprietary investments or investments on behalf of a broad-based fund. FIIs can invest their own funds as well as invest on behalf of their overseas clients registered as such with SEBI. These client accounts that the FII manages are known as 'sub-accounts'. Foreign institutional investor means an entity established or incorporated outside India which proposes to make investment in India. Positive word about the Indian economy combined with a fast-growing market has made India an attractive destination for foreign institutional investors. FII is defined as an institution organized outside of India for the purpose of making investments into the Indian securities market under the regulations.

OVERVIEW OF INDIAN STOCK MARKET

Stock markets refer to a market place where investors can buy and sell stocks. The price at which each buying and selling transaction takes is determined by the market forces (i.e. demand and supply for a particular stock. A stock exchange includes an association of persons or firms to regulate and supervise all transactions, rules, regulations and standard practices to govern all market dealings, authorized stock brokers and an exchange floor where stock brokers or their approved agents meet during fixed business hours to buy and sell securities. The Securities and Exchange Board of India (SEBI) is the regulatory body of the stock market. It gives rules and regulation to control the stock exchanges. These rules and regulation are called the stock market reforms. To study the stock market reforms in detail, we have to study the concepts of capital market in detail firstly.

The financial securities deal with the capital market, which include primary market and secondary market. The primary market is that part of capital market that deals with the issuance of new securities. Primary market issue can be classified in to initial public offer, right issue and preferential issue. The secondary market is the financial market for trading of securities that have already been issued in initial private or public offering. Securities initially issued in the primary market by companies are traded on the secondary market.

HISTORY OF INDIAN STOCK MARKET

The earliest records of security dealings in India are somewhat obscure. The East India Company was the dominant institution in the country's economy and it is presumed that transactions in its loan securities first began in the eighteenth century. By the 1830's, shares of banks and cotton companies were actively traded in Bombay. Though the list of tradable securities kept increasing there were only half a dozen brokers recognized by banks and merchants during the 1840s and 1850s. The number of brokers increased to about 250 shortly thereafter, when a true 'share mania' took place in India. The stock boom was the result of a disruption in the cotton supply from the United States to Britain due to the American Civil War. Later, in 1875, the Stock Exchange of Mumbai (BSE) was established as "The Native Share and Stockbrokers Association". The BSE is the oldest exchange in Asia. The BSE has evolved over the years and is currently the largest stock exchange in the country accounting for one third of trading volume and the largest share of listings and market capitalization.

In the 1980s, the number of exchanges grew dramatically and today there are 23 recognized stock exchanges in the country. In addition to the BSE, the National Stock Exchange of India Ltd. (NSE) and the Inter-connected Stock Exchange of India (ISE) are significant in terms of market capitalization and trading value. The NSE was incorporated in 1992 and in 1994 began operations in the Wholesale Debt Market (WDM) and the equities segment. Trading of derivative instruments was introduced on the exchange in 2000. ISE is a national-level exchange providing trading, clearing, settlement, risk management and surveillance support to the inter-connected market system. Fifteen regional stock exchanges are currently linked through ISE linkage and connectivity to all the participating exchanges to widen their market.

NATIONAL STOCK EXCHANGE

On the basis of the recommendations of high powered Pherwani Committee, the National Stock Exchange was incorporated in 1992 by Industrial Development Bank of India, Industrial Credit and Investment Corporation of India, Industrial Finance Corporation of India, all Insurance Corporations, selected commercial banks and others.
NSE provides exposure to investors in two types of markets, namely: Wholesale debt market and Capital market .Wholesale Debt Market is similar to money market operations, debt market operations involve institutional investors and corporate bodies entering into transactions of high value in financial instruments like treasury bills, government securities, etc. NSE has some positive points such as fully automated screen-based trading mechanism, Strictly follows the principle of an order-driven market, trading members are linked through a communication network, this network allows them to execute trade from their offices, the prices at which the buyer and seller are willing to transact will appear on the screen, when the prices match the transaction will be completed and a confirmation slip will be printed at the office.

BOMBAY STOCK EXCHANGE (BSE)

Bombay stock exchange is the oldest stock exchange in Asia with a rich heritage, new spanning three centuries in its 133 years of existence. What is now popularly known as BSE was established as "The Native share & stock Brokers' Association" in 1875. BSE is the first stock exchange in the country which obtained permanent recognition (in1956) from the Govt. of India under the Securities Contracts (Regulation) Act 1956. BSE pivotal and preeminent role in the development of the Indian Capital Markets is widely recognized. It changed from the open outcry system to an outline screen based order driven trading system in 1995. BSE is now a corporatized under the provisions of the Companies Act 1995.

REVIEW OF LITERATURE

Sivakumar S (2003) has analyzed the net flows of foreign institutional investment over the years, it also briefly analyses the nature of FII flows based on research, explore some determinants of FII flows and examined if the overall experience has been stabilizing or destabilizing for the Indian capital market. **Bose Suchismita et al (2005)** has examined the force of reforms of the foreign institutional investors' (FIIs) investment policy, on FII portfolio flows to the Indian stock markets, an aspect, studies on determinants of FIIs flows to India so far have not taken into concern. FIIs have been allowed to invest in the domestic financial market since 1992; the decision to open up the Indian financial market to FIIs portfolio flows was influenced by several factors such as the dismay in India's external finances in 1991 and disarray in the country's capital market. Aimed mainly at ensuring non-debt creating capital inflows at a time of an extreme balance of payment crisis and at developing and punish the promising capital market, foreign investment funds were welcomed to the country. Analysis also helps to assess the contact of liberalization policies as well as measures for strengthening of policy framework for FII flows, in the post-Asian crisis.

STOCK MARKET REFORMS ABOUT FOREIGN INSTITUTIONAL INVESTORS

FIIs have been allowed to invest in the Indian securities market since September 1992 when the Guidelines for Foreign Institutional Investment were issued by the Government. The SEBI (Foreign Institutional Investors) Regulations were enforced in November 1995, largely based on these Guidelines. The regulations need FIIs to register with SEBI and to obtain approval from the Reserve Bank of India (RBI) under the Foreign Exchange Regulation Act to buy and sell securities, release foreign currency and rupee bank accounts, and to forward and repatriate funds. Once SEBI registration has been obtained, an FII does not require any further consent to buy or sell securities or to move funds in and out of the country, subject to compensation of applicable tax. Foreign investors, whether registered as FIIs or not, may also invest in Indian securities outside the FIIs process.

Foreign financial service institutions have also been allowed to set up joint ventures in stock broking, asset management companies, merchant banking, and other financial services firms along with Indian partners. Foreign portfolio investments in Indian companies are limited to individual foreign ownership at 10 percent of the total issued capital of any one company and to aggregate foreign ownership at 30 percent of the total issued capital of any one company.

When India opened investment into listed equities through the FIIs framework not all foreign investors were eligible to register with the Indian securities regulator (SEBI). No FII was permitted to own more than 5% of a firm and there were restrictions on ownership by all FIIs taken together. Foreign investors faced many difficulties in accomplishing transactions in the Indian equity market. For example in 1993, the settlement system which was based on physical paper share certificates found it difficult to handle the settlement volume of foreign investors. Similarly, foreign investors who sent orders to open outcry trading floor of the Bombay stock exchange found an array of problems including high transactions costs and low probability of order execution. Thus from 1993 to 2003, the Ministry of Finance and SEBI led a strong reforms aiming at a fundamental transformation of the equity market. Presently the ceiling for overall investment for FIIs is 24% of the paid up capital of the Indian company. The limit is 20% of the paid up capital in the case of public sector banks, including the State Bank of India. The ceiling can be raised up to sectoral cap/statutory ceiling, subject to the approval of the board and the general body of the company passing a special resolution to that effect.

Also the rigid criteria of requiring FIIs and sub-account to register as a 70:30 FII/ sub-account or 100% debt FII/sub-account has recently been done away with.

There are some other reforms and their **effects on FIIs** also mentioned below:

1. Limit of investment by FIIs increased from 49% to the limit of sectoral cap for FDI with the approval of the board of directors & the shareholders. FIIs investments in sectors like hotels and tourism, petroleum, air, roads, highways, port etc. can be up to 100%. These reforms increase the profit of FIIs.
2. After the year 2007, FIIs are permitted to entering to the short selling transactions only in accordance with the specified by SEBI. This would prohibit the market manipulation.
3. Now no transaction could be carried forward and the transaction in securities would be only through stock broker is granted a certificate by SEBI.
4. After the year 2007 FIIs are permitted to invest US $ 3.2 billion in Govt. Securities.
5. Internet trading promotes competition and improves investor service.
6. Rolling settlement has a positive impact on the FIIs. This would increase the flexibility in transacting of the institutional investors. Because of it the speculative volumes reduce which was very high in India.
7. FIIs are permitted up to 23% in infrastructure companies in the security market viz. stock exchanges, deposits

8. 100% debt permitted by FIIs. It will increase the participation of FIIs. In June 2008, the limit for investment in debt by the FIIs in the govt. securities was increased from US$ 3.2 billion to US$ 5 billion and in corporate debt from US$ 3 billion. The corporate bond investment limits were further increased to US$ 6 billion in Oct. 2008 and US$15 billion in Jan. 2009.
9. The Indian financial markets are dominated by the FIIs. Although there are over 500 FIIs registered in India, only top 5 FIIs contribute over 40 % of the total portfolio investments.
10. The SEBI has also imposed volatility margins on net outstanding sale positions of FIIs.
11. The eligible categories of the FIIs applications were expanded to allow for NRI owned investment managers to register as FIIs subject to the condition that they did not invest their proprietary funds.
12. Margining of institutional trades was made mandatory with effect from April 21, 2008 and collection of margins from institutional investors on a T+1 basis.

Table 1: Trends in FIIs investment

Period	Purchase(Rs. Mn)	Sales (Rs. Mn.)	Net investment (Rs. Mn.)
2001-02	499,199	411,650	1,846
2002-03	470,601	443,710	26,889
2003-04	1,448,575	990,940	457,645
2004-05	2,169,530	1,710,730	458,800
2005-06	3,449,780	3,055,120	390,660
2006-07	5,205,090	4,896,680	308,410
2007-08	9,480,196	8,818,422	661,774
2008-09	6,145,810	6,603,920	-11,356
2009-10	8,464,400	7,037,810	30,253
2010-11	9,925,990	8,461,610	32,226

The net investment by FIIs in India has been positive every year except 2008-09(table 1). However the net investment by FIIs in 2005-06 declined by 9.6%.

Table: 2 Number of Foreign institutional investors

(At the end of March)

Year	SEBI registered FIIs in India
1992-93	0
1993-94	3

1994-95	156
1995-96	353
1996-97	439
1997-98	496
1998-99	450
1999-00	506
2000-01	527
2001-02	490
2002-03	502
2003-04	540
2004-05	685
2005-06	882
2006-07	997
2007-08	1319

Source: SEBI

Indian has emerged as an important destination for global investment. This is reflected in the no. of FIIs registered with SEBI. The number of registered FIIs rose to 1319 at the end of the year 2008 which was 0 in the year 1992-1993.

Table: 3 NET INVESTMENT BY FIIs IN EQUITY AND DEBT

(Rs. In millions)

Years	Net investment in equity	Net investment in debt
2001-02	80,670	6,850
2002-03	25,280	600
2003-04	399,590	58,050
2004-05	441,230	17,590
2005-06	488,010	(73,340)
2006-07	252,370	56,070
2007-08	534,038	127,753
2008-09	-477,070	18,950
2009-2010	1,102,200	324,380

Source: SEBI

Net investment in equity by FIIs was increased to Rs. 1,102,200 million at the end of the year 2010. It was only Rs. 80,670 million during the year 2001-02.

There are other positive effects also such as the transparency has increased due to the interne trading. It also promotes the competition and improves the services of the investors. Finally, the stock market reforms have positive effect on foreign institutional investors.

CONCLUSION

Several factors are responsible for increasing the confidence of FIIs in Indian stock market which include transparent regulatory system, abolition of long term capital gains tax etc. We discussed about the stock market reforms given by SEBI, which were directly related to the FIIs. There was a lot of such type of stock market reforms. There is a positive effect of these reforms on FIIs. As we see that the trend of investment of FIIs has increased due to these reforms. The SEBI registered FIIs were also increased. On the other side the investment in debt and equity by FIIs were increased to large extent. Transparency has increased due to the internet trading. Flexibility also increased in FIIs and the speculative transactions were reduced to the stock market reforms. Finally, it is concluded that the stock market reforms effected positively to FIIs.

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