

**Working Paper  
No: 2006/10**

**THE INDIAN STOCK MARKET IN 2005–06  
An Examination of Two Major Events**

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**October 2006**

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# THE INDIAN STOCK MARKET IN 2005–06

## An Examination of Two Major Events

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Two major events marked the Indian stock market in 2005–06. One is the galloping Sensex, the leading indicator of stock prices in India, which crossed the 10,000 mark for the first time in early February and which kept on increasing thereafter to reach 11,350 by the end of the financial year. The Sensex further crossed 12,600 on May 10, 2006, i.e. an increase of more than 25 per cent in just two months. The second is the coming into open of the IPO or the demat scam. We shall try to examine these two, one concerning the secondary market and the other relating to the primary market, in some detail, in the following.

### 1. THE SURGING SENSEX

The Sensex has risen almost continuously since May 2005 from a level of about 6,200, except for a fall during October–November 2005, to reach the 10,000 mark in early February 2006. In fact, after the mayhem of May 2004, i.e. when the new government took over at the Centre, but for some intermediate corrections, the rise in the index has been almost gradual. Many reasons have been attributed to this performance. These include: increased investments by the foreign institutional investors (FIIs); entry of new investors from countries like Japan; good performance of the economy and the corporates; a market-friendly government—not withstanding the occasional pulls and pressures applied by the Left; the efforts to improve corporate governance; low interest rates in developed countries; falling interest rates in India; and favourable fiscal measures. Fears have, however, been expressed occasionally about the nature of foreign funds especially with regard to money laundering, round tripping by resident Indians,

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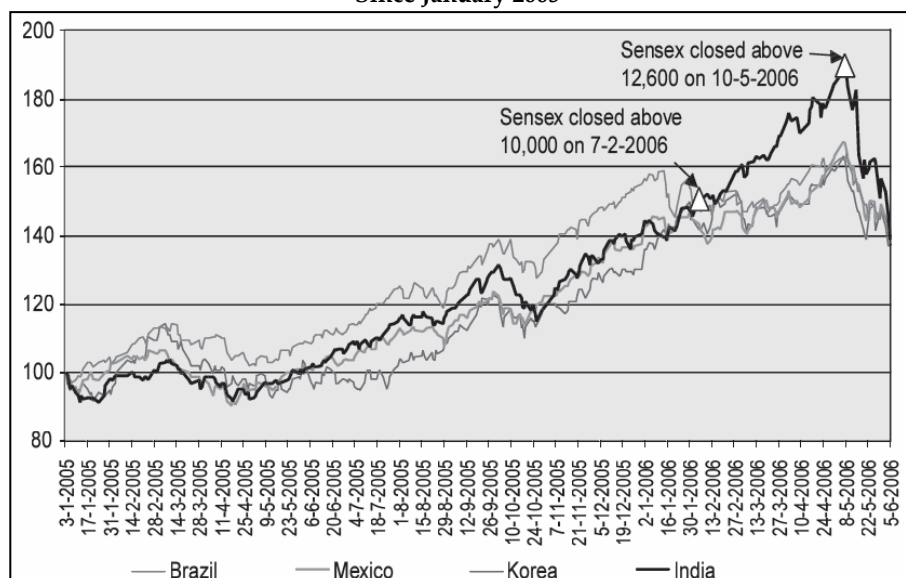
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hot money, increased volatility, etc. especially in the context of the Ketan Parekh scam and the East Asian financial crisis.

There is no doubt that since the new government was formed at the Centre there has been a surge in the registrations of foreign institutional investors (FIIs). Out of the 915 FIIs registered at the end of May 2006, as many as 416 were registered after mid-May 2004. Similarly, 1,237 of the 2,647 reported FII sub-accounts have been registered after 2003. Cumulative FII investments increased from \$ 26.43 billion at the end of May 2004 to \$ 45.26 billion by the end of March 2006.

Further, it needs to be underlined that India has not been alone in experiencing large increases in share prices since the beginning of 2005. For one thing, it can be seen from Table 1 that portfolio equity flows to developing countries increased substantially after 2002. While India's share in the total declined somewhat, it still accounted for almost one-fifth of the total flow during 2005. The other prominent recipients in 2005 were: China, Thailand, Brazil, Mexico, Turkey and South Africa. A comparison of the Sensex with some other market indices shows an amazing resemblance (See Figure-1). While the Sensex increased by 46 per cent between January 3, 2005 and early February 2006, Bovespa of Brazil and IPC of Mexico increased at an identical pace. Kospi (composite) of South Korea moved slightly ahead at 49 per cent. On the other hand, China, Taiwan, Malaysia, Indonesia, Hongkong and Thailand have been major laggards.

**Figure-1**  
**Relative Share Price Indices of Brazil, Mexico, South Korea & India**  
**Since January 2005**



Based on data available at <<http://finance.yahoo.com>>

Interestingly, early February 2006 is the point of departure for the share price movement in India. Once the Sensex crossed the 10,000 mark it started surging ahead of the other markets mentioned above. While it increased, from thereon, by more than one-fourth by 10 May, the Mexican share prices increased by 14 per cent. Korean and Brazilian markets rose even slower at nine and five per cent respectively. With the foreign funds retracting from emerging markets globally since 10 May, i.e. following the increase in US interest rates, the Sensex too fell sharply. In the Indian case, however, two additional factors are cited. The first is the large-scale selling by over-leveraged buyers. The authorities have stepped in to provide them liquidity to prevent further damage. The second is the Central Board of Direct Taxes' (CBTD) proposal to provide additional guidelines for determining whether a person is a trader or an investor in stocks. This raised fears that the FIIs might withdraw if their profits are treated as trading profits and are taxed at 40 per cent. The government subsequently clarified that the treatment of FII investments would not be changed and hence FII flows would not be affected either way.

While it does appear that for the most part India's experience is in line with the global developments, past experience and some scattered evidence do suggest that there may be more to it than meets the eye, especially with regard to the character of foreign funds. Following its investigations into the role of participatory notes (PNs) and non-resident Indians (NRIs) in the boom of 2003–04, the Securities and Exchange Board of India (SEBI) said that there were several layers (with a minimum of three) of investors in the PNs and this information was generally given by FIIs only up to the next layer and '(W)hat lies beyond this level is not known.' SEBI was supposed to investigate further into the phenomenon. We are, however, not aware of the outcome of any such follow up exercise. What one knows is that SEBI tightened the reporting system and made 'Know Your Client' (KYC) norms mandatory for the FIIs. SEBI's experience in the UBS case, however, exposed the shortcomings of India's efforts in this regard. The Securities Appellate Tribunal (SAT), in September 2005, even termed SEBI's KYC requirements as vague and that they had not been defined anywhere by the market regulator. SEBI, following its investigations into the market crash on 17 May 2004, zeroed in on UBS and asked for information on its PN operations. Not satisfied with UBS' response, SEBI prohibited UBS Securities Asia Ltd and its associates from issuing PNs against underlying Indian securities for one year. SAT, however, set aside the ban on UBS. On its part, the Expert Group on **Encouraging FII Flows and Checking the Vulnerability of Capital Markets to Speculative Flows** of the Ministry of Finance (hereinafter Expert Group), in its November 2005 report said that: 'SEBI should have full powers to obtain information regarding the final holder/beneficiaries or of any holder at any point of time in case of any investigation or surveillance action. FIIs should be obliged to provide the

information to SEBI.' Obviously, an appropriate system was not in place at least till the end of 2005.

**Table-1**  
**Net Portfolio Equity Flows to Developing Countries**

*US \$ bn.*

Year	Total	East Asia & Pacific	Europe & Central Asia	Latin America & the Caribbean	Middle East & North Africa	Sub- Saharan Africa	South Asia	
								of which, India
1998	6.9	-3.1	4.0	-2.2	0.2	8.7	-0.6	-0.6
1999	12.6	2.2	2.0	-3.6	0.7	9.0	2.4	2.3
2000	14.1	6.6	1.3	-0.6	0.2	4.2	2.4	2.3
2001	6.4	2.0	0.3	2.5	-0.1	-1.0	2.7	2.9
2002	5.8	4.0	-0.1	1.4	-0.2	-0.4	1.0	1.0
2003	25.2	12.4	0.5	3.4	0.1	0.7	8.0	8.2
2004	37.3	17.6	4.2	-0.6	0.6	6.7	8.8	8.8
2005e	61.4	26.5	2.3	12.5	0.9	7.2	12.2	12.2

*Note:* Estimate.

*Source:* World Bank, *Global Development Finance*, 2006.

The quality and quantity of information provided on FII sub-accounts raises further doubts about the monitoring mechanism. For instance, on 26 May 2006, the SEBI website listed 2,647 sub-accounts. The information provided is limited to just the name of the sub-account, registration number and name of the FII. It appears that the registration number consists of two parts: the first four digits representing the year and the last the three the serial number. It is surprising to find that in the years 2004 and 2005, the last entries were 2004999 and 2005999. It raises a doubt whether exactly 999 were registered in both the years, or the information provided is incomplete due to the faulty software used by SEBI, which does not accept any number beyond 999. Secondly, SEBI is supposed to receive information on the date and place of incorporation and constitution, if registered, name of the regulatory agency, number and types of shareholders and volume of assets. To infuse confidence in its monitoring, it is obvious that SEBI should make more information on each sub-account public.

In the context of suspicions about money laundering, round tripping and market manipulation, one needs to consider a few points. Since the new government at the Centre has taken over, non-resident Indian deposits have practically stagnated, especially in the context of their steady increase till early 2004. Is it possible that NRI (for that matter resident Indians') money is getting into the stock market, side-stepping the banking channels for better returns? It should be underlined that the term NRI has become so amorphous that many Indian businessmen, who are actively involved in

managing large Indian companies, acquired the status of NRIs. How should one interpret when some Indian promoters hold shares not only through their India-incorporated companies, but also through entities closely associated with them and which are incorporated in tax havens?<sup>1</sup> It is becoming increasingly difficult to distinguish between FDI and NRI investments, especially in the IT industry. A few erstwhile FERA companies have since come under the control of Indians, but the investments are held through foreign companies controlled by them. The government had indeed rejected in 2001 certain share transfers among some group companies, saying that such round tripping of FDI would have negative tax implications.<sup>2</sup> What is the source of such funds? Does the issue bother anyone now? Isn't there a fairly good chance of such promoters bringing in some funds through the FII route whereby they can escape the takeover code on one hand and insider-trading regulations on the other?

Another notable feature of the FII sub-accounts is that some of the investment management firms involved in India are manned and probably owned by Indians. Whose funds would they be able to manage or, put the other way round, who will entrust their moneys to 'Indian managers'—high net worth citizens of developed countries, because Indians would know about Indian companies and entrepreneurs better or, the majority of the investors would be persons of Indian origin or Indians themselves? It is relevant to look into their sources of funds but obviously difficult to unravel.

According to the Expert Group of the Ministry of Finance, the share of PNs in net FII investments increased from 27.34 per cent at the end of May 2004 to 46.73 per cent by the end of August 2005. In fact, throughout the two-year period, i.e. September 2003 to August 2005 their share was never below one-fourth (See Table-2). Interestingly, the share of PNs was the lowest in April 2005. And during the month net FII investments were also negative. Earlier in January 2004, rumours of a possible ban on PNs brought the Sensex down by 9.7 per cent in about a week's time. However, SEBI's clarification that PNs issued to unregulated entities were not required to be sold in the market immediately as they were being offered a five-year grace period and in future such notes should be issued to regulated entities only, made the Sensex jump within two days by 7.2 per cent. That is the power of PNs! And that power seems to remain in just a few hands. According to the Expert Group, out of the 733 entities registered as FIIs with the SEBI at the end of June 2005, only 17 entities were reported to have issued PNs. However, given

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<sup>1</sup> For instance, Delgrada.

<sup>2</sup> "DEA rules against round tripping of FDI—Bharti share transfer proposals rejected", *Business Line*, November 22, 2001.

the secrecy preferred by some of the investors, can one accept this information at its face value?

Why would the beneficiaries of PNs remain secretive? From whom will be they hiding? When their investment strategies can have a great influence on the market, would it be prudent to let them have a field day? In its note of dissent on the Expert Group report, the RBI indeed opposed the issuance of PNs, and stated that:

**Table-2**  
**Issuance of Participatory Notes**

<i>Month</i>	<i>Value of Underlying Debt and Equity (Rs. Cr.)</i>	<i>As a Proportion of Net FII Investment (%)</i>
Sep 2003	20,340	26.05
Oct 2003	21,140	25.13
Nov 2003	22,492	25.02
Dec 2003	25,978	27.61
Jan 2004	25,754	26.29
Feb 2004	56,377	26.21
Mar 2004	30,106	28.11
Apr 2004	31,263	27.47
May 2004	30,146	27.34
Jun 2004	28,344	25.77
Jul 2004	29,489	26.64
Aug 2004	32,562	28.76
Sep 2004	35,057	30.27
Oct 2004	38,217	32.44
Nov 2004	50,117	39.77
Dec 2004	63,791	46.85
Jan 2005	50,561	37.22
Feb 2005	50,537	34.84
Mar 2005	53,434	34.93
Apr 2005	46,386	30.62
May 2005	59,610	39.71
Jun 2005	61,016	39.27
Jul 2005	73,781	45.23
Aug 2005	78,390	46.73

*Source: INDIA, Ministry of Finance, Report of the Expert Group on Encouraging FII Flows and Checking the Vulnerability of Capital Markets to Speculative Flows, November 2005.*

“The Reserve Bank’s stance has been that the issue of Participatory Notes should not be permitted... the main concerns regarding issue of PNs are that the nature of the beneficial ownership or the identity of the investor will not be known, unlike in the case of FIIs registered with a financial regulator. Trading of these

PNs will lead to multi-layering, which will make it difficult to identify the ultimate holder of PNs. Both conceptually and in practice, restriction on suspicious flows enhances the reputation of markets and leads to healthy flows.”

Reports in the press further indicate that nearly half of FII investments are held through PNs and 60 to 80 per cent of such investments are made by hedge funds. Since India does not allow hedge funds, which are considered to be hot money, market analysts say that India is forcing hedge funds to adopt the PN route. They feel that it is unwise to prevent hedge funds, which have come to control more than a trillion of dollars. In support of some of the investors preferring the PN route, they say that the PN route helps the foreign investors avoid needless accounting and reporting expenses. This is especially because they focus on only a few stocks. This is all the more the reason one should know more about them. The tenor of the argument is that India would be a loser if it seeks to prevent such investments. The decision with regard to banning of PNs, or even putting the brakes on FII trades through additional taxation, depends upon the policy makers’ perception on the benefits flowing out of foreign portfolio investments to the Indian economy. The Expert Group listed a number of arguments like reduced cost of equity capital and balance of payments support in favour of foreign portfolio investments. The Group also underlined that ‘enlarging the demand side of Indian securities is beneficial... for Indian investors.’ It is, however, a matter of debate to what extent the ordinary Indian investor is in a position to comprehend the market developments and take advantage of them. In fact, the role of the individual investor in the Indian stock market is gradually diminishing. A stage has been reached, where the market value of the Indian individual investor’s shareholding is less than that of FIIs.

Interestingly, for sometime now, official sources have been underplaying the role of foreign institutional investors in the Indian stock market. We have referred to such attempts in the *Alternative Economic Survey: 2004–05*. In the context of the turmoil in May 2006, this is once again being reiterated. It is being claimed that mutual funds (MFs) and Indian institutions are emerging as countervailing forces. We did point out, during the late 1990s, the need to groom domestic institutions to counterbalance the actions of FIIs, which are not based on fundamentals. It should, however, be noted that though the mutual funds have come to control a sizeable amount, only a fraction of it is invested in the equity market. Even though the position changed somewhat in 2005–06, equity accounted for only about 28 per cent of net purchases of MFs during the year. The overall market capitalisation, controlled by them, is far below that owned by the FIIs. Between March 2005 and March 2006, while the share of FIIs in market capitalisation of 2,837 companies increased from 13.81 to 15.62 per cent. That of MFs increased from 2.87 to 3.69 per cent (See Table-3) and the share of banks and Indian financial institutions, however,

declined marginally from 5.86 per cent to 5.77 per cent. The share of the Indian public (excluding promoter group individuals) has come down from 11.62 to 10.85 per cent. The combined share of mutual funds, banks and financial institutions and the Indian public declined marginally from 20.35 to 20.31 per cent. The hold of FIIs in the companies forming the two major indexes, namely the Sensex and the Nifty, is quite substantial at nearly 20 per cent. Within these two index groups they account for 38 per cent of the market capitalisation of the non-promoter group. It is obvious that FIIs have a better hold on the market, both in terms of market capitalisation and in sentiment, compared to the Indian institutional investors.

**Table-3**  
**Share of Institutional Investors and Indian Public in Market Capitalisation**  
*(Percentages)*

Type of Investor	Share in Market Capitalisation of 2,837 companies		Share in the Market Capitalisation of Sensex and Nifty Companies as on 31-03-2006			
	31-Mar-05	31-Mar-06	Total		Non-Promoter Holding	
			Sensex (30)	Nifty (50)	Sensex (30)	Nifty (50)
1. FIIs	13.81	15.62	19.85	19.86	38.47	38.23
2. Mutual Funds	2.87	3.69	3.28	3.48	6.35	6.7
3. Banks & Financial Institutions	5.86	5.77	6.64	7.33	12.87	14.11
<i>Subtotal (2+3)</i>	<i>8.73</i>	<i>9.46</i>	<i>9.92</i>	<i>10.81</i>	<i>19.22</i>	<i>20.81</i>
4. Indian Public	11.62	10.85	9.15	9.14	17.73	17.6

*Source:* Based on data provided by the Prowess corporate database.

During the critical month of May 2006, MFs did play the opposite role to FIIs but the gyrations of the Sensex do suggest that without the support of FII inflows, the local institutions would not be able to sustain/help the index to recover. It is, however, a different matter that corporates have a major influence on mutual funds. As per SEBI, at the end of March 31, 2006, about 51 per cent of the net asset value of all the mutual funds belonged to corporates and institutions while only about 43 per cent belonged to individuals. The rest is owned by NRIs and FIIs. Obviously, MFs' activities do not represent Indian individual investors alone. And not all FIIs are managed by Indian entities. A good chunk is in the hands of foreign fund managers.

It would be instructive to quote the experience of South Korea in respect of foreign investors versus local individuals. The share of local individual investors in the country's market capitalisation came down drastically from 31.68 per cent in 1999 to 22.59 per cent by 2005. On the other hand, 'foreigners' increased their share from 18.47 to 37.17 per cent during the period. While local institutions increased their shares slightly, the other categories suffered.

Going by the large shares of FIIs in some companies it seems India has come back to the earlier position as it were. For instance, one of the main objectives of FERA was to contain foreign exchange outflow on account of dividends to foreign parent companies. The equity dilution strategy, though a flawed one, was supposed to serve this objective. Following the dilution, many companies became 'Indian' but the management control remained outside. Thanks to the entry of FIIs, the ownership of many Indian companies got transferred abroad (taking into account GDR issues, it would be even higher), but the control remains in India. Companies like ICICI Bank, HDFC, Satyam Computers and Infosys are more like 'foreign-owned Indian companies'. It is the foreign shareholders who receive a significant amount of the dividends—which in some cases may even exceed half (for evidence, see "Stock Market" in *Alternative Economic Survey 2004–05*).

## **2. THE DEMAT/IPO SCAM**

About a decade ago, hundreds of companies duped the investors as they virtually disappeared after collecting huge amounts of money through the primary market. Whether branded as 'vanishing companies' by the authorities or not, it is a fact that for one reason or the other, their shares are no longer traded on the stock market and the investors have ended up holding worthless share certificates. Many such companies remain listed only as a formality and practically no trading takes place in their shares and many others are no longer listed.

By contrast, this scam is characterised by a practice to unduly benefit from the primary market and was reported to be going on silently, over the past few years. This time around, it is the turn of vanishing investors who robbed genuine small investors of a chance to get a fair share of primary market offerings. According to some reports, it is not SEBI, the market regulator, which got wind of the goings on; it is a fall out of the income tax raids on a businessman in Ahmedabad, which revealed that he was controlling over 5,000 demat accounts. The 35 per cent reservation in a book-built issue for retail investors (the qualifying limit for retail investors: maximum application money Rs. 1 lakh for each applicant; earlier it was Rs. 50,000) and the proportional allotment in case of oversubscription are the attractions of this category. By placing multiple applications one improves the chances of allotment on the one hand and getting a larger number of shares on the other. The scamsters exploited this possibility.

The issue of multiple/fictitious applications is quite an old one. During the late 1950s, the Vivian Bose Commission, which looked into the allegations against the Dalmia-Jain house observed that out of the first 121 names in the register of subscribers (of D.J.

Airways) not less than 114, to whom share certificates were issued, were fictitious. The Commission indeed wondered how:

Out of the 1,60,000 shares said to have been allotted to and held by persons in such widely scattered locations no less than 1,58,850 are said to have been transferred by these 114 persons to only 4 persons and 2 concerns, and the bulk of the transfers are said to have been effected *on one day*. (emphasis added)

The provision in the Companies Act, 1956, which makes applying for shares in the names of fictitious or non-existent persons punishable with imprisonment up to five years, is fallout of the Commission's investigations. The offence has, however, gone unchecked all these years. Probably due to the magnitude and the large extent of computerisation, it has been possible to dig deep into the practice now.

According to SEBI, certain entities had cornered IPO shares reserved for retail applicants by making multiple applications in the names of fictitious/*benami* applicants. Once they got the allotments, these applicants had transferred the shares to their principals, who in turn transferred them to the financiers. The financiers sold most of these shares on the first day of listing, making windfall gains. SEBI's investigation suggests that certain depository participants masterminded the opening of thousands of demat accounts by falsifying documents to facilitate the application process. It has been estimated that through these operations the financiers gained about Rs. 72 crores. The scam brought into focus the malfunctioning of many intermediaries: banks, depositories, depository participants (DPs), brokers, sub-brokers and the internal auditors. Often, the scrutiny turned out to be perfunctory, bordering on connivance. To the extent SEBI was oblivious of these goings-on, which went on for at least three years, it could be held guilty of not properly playing its assigned role.

SEBI, for instance, now discovers that the ILFS funds public issues by accepting very little margin. In the case of IDFC's IPO, against the issue price of Rs. 36 per share, it accepted Rs. 1.50 as margin and financed Rs. 34.50. ILFS obtained a mandate from every loanee, that on allotment of shares it will transfer through off-market transfers to any other demat account of its choice and DP. SEBI's report has noted 'This sort of arrangement is not in the interests of the securities market as the same may result in creation of name lenders and not genuine investors.' A regulator with an ear to the ground would have come to know of such a practice much earlier. It is also possible that even after noticing it, SEBI failed to see the implications of it. Or worse still, it preferred to turn a blind eye until the scam broke.

## 2.1. Multiple Demat Accounts

The *Economic Survey 2004–05* attributed the fast growing number of accounts with the National Securities Depository Limited (NSDL) as a proxy for the number of participants in the market. The *Economic Survey 2005–06* also echoes this view. In the background of the multiple demat accounts scam, which showed that at NSDL there were 21 DPs wherein 500 or more account holders were sharing common addresses and that the total number of such accounts with these DPs was 44,637, the official claim could only mean ignoring of ground realities. SEBI's enquiries revealed that two of the depositories were virtually serving family interests and one of these 'has permitted opening of multiple accounts within the family in a permutation and combinations of names!' This in turn has facilitated the family to make multiple applications for shares in IPOs under the retail category by indicating separate demat accounts in the respective application forms. Indeed, according to NSDL, nine districts, or rather nine cities, each having more than one lakh demat accounts—led by Greater Mumbai, Delhi and Ahmedabad—accounted for about 50 per cent of demat accounts in the country. Is there any link between the fact that the scam is limited to the western region and that the region has the largest number of demat accounts? There is every possibility of many more multiple demat accounts existing than are revealed by the SEBI investigations.

## 2.2. Registration of Multiple Companies

SEBI's scrutiny was based on common addresses of demat accounts and the *inter se* transfer of shares between the entities located at certain addresses. Identifying relationship with common addresses could only catch some culprits. It is not also necessary that all their shares would be transferred to others before listing or sold immediately after the listing (SEBI's investigation was based on this practice of scamsters). Further, the perpetrators could use multiple addresses. For instance, a large business group, some years back, registered a number of companies at different places in Mumbai, with similar sounding names and identical authorised capital. The *sequential registration numbers* were an obvious give away. Similarly, studies at ISID find that more than 60 companies which carried names like Pagesetters, Lasersetters, Typesetters, etc. and which were registered in Kanpur, Mathura, Agra, Jalandhar and Bharatpur during 16–22 February 1988. During the 1980s, some listed companies were moved like kittens from one place to another in Delhi. Linkages through the board of directors, inter-corporate investments, auditors, stock brokers and bankers to the issue could indeed be established from Guwahati and Calcutta in the East to Ludhiana in the North and to Mumbai in the West, covering on the way places like Kanpur and Delhi (all having stock exchanges). Stock brokers seem to have played the central role in creating these

networks. The CRB group involved in yet another stock market scam was in fact a product of this era. In most stock market related scams including the one under discussion, one finds the involvement of stock brokers. Multiple company registrations probably peaked in the 1990s with Calcutta being a major hub. New companies were being registered at various places in the city, just like ants keep emerging from holes, month after month.

Thus, the past evidence shows that the extent of duplicity practiced by the Indian corporate sector is much more than that gets reflected from common registered office addresses. Such operators may have modified their modus operandi in the changed circumstances. But their objective is quite clear; take advantage of the stock market to make undue gains. Large business groups are also not far behind. Dozens of companies, at times running into hundreds, constitute their networks. Only a thorough enquiry into the nature and operations of such companies could reveal the undue benefit being derived by their promoters, of which putting up multiple applications in public issues could only be a small part.

### **2.3. Withdraw Reservation for Small Investors?**

Following the scam, there were calls for removing the special dispensation extended to the retail investors, which is the root cause of the scam. It does appear that in a boom time and as long as the issues are fully subscribed, the small investor is a disposable one. But when the going gets difficult, the very same investor is wooed to revive the market. The critics are, however, conveniently keeping silent on the practice of financing of IPOs, which is the second major contributory factor to the scam. Why should this be allowed at all? After all, the main purpose of the stock market is to directly mobilise household savings for investment purposes and avoid intermediation. Would IPO finance turn 'men of straw' (SEBI's description of the slum dwellers whose election ID cards were used by the scamsters to open demat accounts) into 'men of substance?' It is common knowledge that many small investors exit by selling the allotted shares immediately after listing. It is more likely that a larger proportion of those who avail outside finance would be exiting the market at the first available opportunity so that they can square off with the lenders and pocket whatever net capital gains they could make. Do such types of investors' involvement really help in resource mobilisation? If the financiers are bankers, there is no additional resource mobilisation. It is already there in the system!

On the other hand, one could even argue that to increase small investors' participation, IPOs/fresh issues of capital could be made a two-tier affair. At the first stage the entire issue could be reserved for them and after a pre-determined period of say 3–4 days, the

un-subscribed portion, if any, could be thrown open to everyone. Alternatively, the issue could be opened for all kinds of investors simultaneously but allotment would be first made to individual investors and the remaining portion if any, would be distributed among the institutional bidders. Why should the institutional investors be given preference at all? After all, as stated earlier, the purpose of stock markets is to promote disintermediation between savers and enterprises. One could argue that institutions are more efficient at price discovery. On the other hand, however, with the investors forced to choose within a narrow band in book-built issues, there is hardly any price-discovery. Very often the price is 'decided', so to say, even before the issue is opened. In any case, as can be seen from Table-4, out of the 20 public issues examined, in as many as 15, retail investors' subscription fully met the entire offer. And this includes Reliance Petroleum Ltd. Together with other non-institutional investors they had fully met the entire offer in 18 cases.

**Table-4**  
**Illustrative List of Public Issues Showing Substantial Contribution of Retail Investors**

S. No.	Name of the Company	Total Shares Offered to the Public (Lakh Shares)	Shares applied for by		% to Total Offer	
			Retail Investors (Lakh Shares)	Non-institutional investors (Lakh Shares)	Retail Investors (3)/(2)	Retail & Non-Institutional Investors (3)+(4)/(2)
	(1)	(2)	(3)	(4)	(5)	(6)
1	Gujarat State Petronet Ltd	1380.00	10508.59	17038.10	7.61	19.96
2	Bombay Rayon Fashions Ltd	128.63	877.91	578.12	6.83	11.32
3	Lokesh Machines Ltd	30.00	190.71	89.99	6.36	9.36
4	Plethico Pharmaceuticals Ltd	36.67	213.70	157.65	5.83	10.13
5	Piramyd Retail Ltd	50.00	283.03	150.07	5.66	8.66
6	GVK Power & Infrastructure Ltd	78.62	375.71	417.18	4.78	10.09
7	Reliance Petroleum Ltd	4500.00	20116.57	26221.32	4.47	10.30
8	Gitanjali Gems Ltd	168.50	554.06	368.05	3.29	5.47
9	Mahindra & Mahindra Financial Services Ltd	200.00	608.05	859.01	3.04	7.34
10	Kamdhenu Ispat Ltd	128.00	376.31	87.86	2.94	3.63
11	JRG Securities Ltd	36.25	103.42	43.91	2.85	4.06
12	R Systems International Ltd	39.68	67.26	5.58	1.70	1.84
13	The South Indian Bank Ltd.	181.82	243.89	159.01	1.34	2.22
14	Uttam Sugar Mills Ltd	40.00	52.32	5.87	1.31	1.45
15	Andhra Bank	765.00	813.06	632.82	1.06	1.89
16	Union Bank of India	405.00	365.36	602.06	0.90	2.39
17	Sun TV Ltd	68.89	60.55	244.47	0.88	4.43
18	Bank of Baroda	639.00	366.89	309.28	0.57	1.06
19	Opto Circuits (India) Ltd	32.00	16.03	14.24	0.50	0.95
20	JK Cement Ltd	180.00	59.24	19.70	0.33	0.44

Source: Basis of Allotment data provided by <<http://www.cmlinks.com>>

With promoters being allowed to retain/acquire majority equity, the floating stock turns out to be quite limited. If in the remaining portion institutional investors have a major say, very little room is left for individual investors. Further, assuming a conservative 2:1 debt-equity ratio, the total non-promoter shareholding would work out to a maximum of 8 per cent of the total funds deployed. Would it be that difficult to mobilise 8 per cent of the total funds required, when 92 per cent funds are already tied up? What additional benefit accrues due to the listing of such companies? Will it help faster economic growth? Will it bring larger sections of the economy under market discipline? Would it help promote professionalisation of managements beyond that forced by competition? On the other hand, it is easy to see that the promoters, intermediaries and speculators have a vested interest in such listing. Small offers at the time of the IPOs can help to command a high premium and deliver huge capital gains on their investments.

Two high profile IPOs may help to understand the make-believe nature of some of the public issues. TCS Ltd, formerly a division of Tata Sons Ltd. (TSL), made its IPO in August 2004. It was as part of TSL the Division acquired a pre-eminent position in the Indian IT industry. It had also established subsidiaries and joint ventures in different parts of the world. The declared objective of the issue was to list the company's shares thereby enhancing the visibility and use its equity shares for acquisitions and also provide liquidity to the existing shareholders. The proceeds of the issue were to be utilised to pay TSL Rs. 2,300 crores as a consideration for part divesting its equity stake in TCS and for general corporate purposes. Incidentally, the company is still owned to the extent of more than 80 per cent by TSL. Together with some Tata trusts, the promoter group owns almost 85 per cent of the equity of TCS. While the company realised Rs. 1,936 crores from the issue, it had to dip into its reserves to pay the requisite amount to TSL. Subsequently TCS paid a dividend of Rs. 626 crores (including dividend tax) for the year 2004–05. The corresponding amount disbursed during 2005–06 was Rs. 753 crores. Thus in the two years following the IPO, the promoter group has given itself more than Rs. 1,000 crores as dividend from TCS. Further, at the end of March 2005, the company's investments in mutual funds amounted Rs. 378 crores which increased to Rs. 634 crores by the end of the next year. Thus, in effect, listing helped the promoter group while the company benefited in no way, in terms of raising fresh capital. In fact, had it remained a part of Tata Sons, the substantial annual outgo of dividends would have remained with the company to be utilised in whatever manner was deemed fit, including expansion of the IT business. In fact Tata Sons should have been listed. If the group felt uncomfortable with exposing its apex company to the public, it could have hived off its non-IT/holding company activities to separate companies.

The second case one would like to analyse is that of Reliance Petroleum Ltd (RPL). The company made its IPO in April 2006. RPL was promoted by Reliance Industries Ltd (RIL) and post-issue, RIL would continue to be the parent company with at least 75 per cent shareholding. The proposed refinery and polypropylene plant of RPL was to be located adjacent to the existing refinery and petrochemicals complex of RIL. The price band offered was Rs. 57–62 for a share of Rs. 10 face value. What is, however, interesting is that RPL issued 270 crores shares at Rs. 10 each to the parent company during December 6, 2005 to February 25, 2006—269.56 crores shares on February 25, 2006. As part of the IPO, RPL issued 180 crores shares. RIL was to subscribe 90 crores shares at the issue price as part of the promoter's contribution. While according to the red herring prospectus dated March 4, 2006 the net issue to the public was 90 crores shares (excluding the shares to be subscribed by RIL), the final offer was further reduced to 45 crores shares as the remaining were subscribed by institutional investors, banks, etc. prior to the opening of the issue, at Rs. 60 per share subject to the condition that the final price would be reduced if the discovered price is lower than 60. Before the issue was opened, it was announced that RIL would sell 22.50 crores (representing 5 per cent of the company's post-issue equity) shares, out of its promoter's contribution, to the US oil major Chevron Corp (through its indirect subsidiary, Chevron India Holdings P. Ltd., Singapore) at Rs. 60 per share, which would be purchased from RIL.

The final price decided after book-building being Rs. 60 per share, one wonders what additional information was gathered through the book-building process. With equity proposed to account for 42 per cent of the project cost, it is anybody's guess how crucial the net public offer was to the project except that some would argue that the pre-issue subscription would not have been possible without the promise of liquidity offered by the listing. Secondly, in effect, RIL paid, on an average, Rs. 22.50 rupees per one share of RPL. That means a premium of Rs. 12.50 rupees on a face value of Rs. 10. If the shares to be sold to Chevron were netted, the average cost for RIL would work out to Rs. 20, or a premium of Rs. 10. On the other hand, the outside investors paid a premium of Rs. 50, which amounts to four times the premium paid by RIL. For one thing, the promoter group, which holds nearly 48 per cent of RIL, could be the single largest beneficiary of the differential pricing of the company's equity shares. Secondly, had RIL offered its own shares to Chevron and institutional investors, the promoter group's holding would have come down. To maintain their share, the promoters would have been required to bring in additional funds. It is relevant to recall that the group had floated a Reliance Petroleum Ltd. some years back and merged it subsequently with RIL. It would be interesting to see how long the second RPL would remain as a separate company.

Instead of 'encouraging' companies to come to the public with a low level of public shares, it is preferable to stipulate that non-promoter shareholding should always be in the majority. Instead of making retail investors fight for a smaller cake, let them have a bigger and fuller cake. Only then would listing be meaningful. If the promoters are not willing to accept such a proposition, the companies could make do with debt capital.

#### **2.4. Discipline the Promoters who could be Bigger Bandicoots**

The real damage to small/retail investors' interests could be done by the promoters. A SEBI spokesman used the word 'bandicoot' to describe the ultimate beneficiaries of the IPO scam. Would not unscrupulous promoters turn out to be bigger bandicoots? This is where the regulators need to be proactive. It is not enough to draw up corporate governance codes and disclosure requirements. It is the responsibility of the market regulator to see that these are observed in the letter and spirit of the law. There is a need for meticulous research in this regard. We are yet to see a beginning in this direction. It is sheer coincidence that a number of major South Korean companies are presently facing scrutiny by the country's regulators. Probably the most glaring case is that of Hyundai Automotive. The company's chairman is alleged to have benefited immensely by using a listed company Glovis, which has just 20 per cent public holding, for meeting the logistics requirements of the companies under his control. As icing on the cake, the huge profits generated by Glovis at the expense of other public companies under his control, caused massive increases in share prices and consequent capital gains to the tune of one trillion Korean Won (\$1.06 billion) for the family. With nominal public holding, the chairman's family is the real gainer in the process. Though some of these happenings are being attributed to succession related taxation issues, the fact remains that Korean big business has been able to continue with its anti-outside investor practices in spite of the attempts at improving corporate governance in the country following the Asian Financial Crisis.

Reports in the Korean press (these have been mainly obtained from the online version of *The Korea Herald*) also indicate that the prosecutors have asked for a 15-year jail term for the founder of Daewoo on charges of accounting fraud and misappropriation of company funds. In all, about 10 major business groups of Korea (Hyundai Automotive, Samsung, LG, Lotte, POSCO, etc.) are reported to be under investigation to 'eradicate the deep-rooted practice of often illegal business transactions among their affiliates' (Korean Herald). It is understood that the Hyundai group expressed 'deepest apology for the trouble we caused and our failure to act as a responsible corporate citizen,' and promised to donate one trillion Won to the society, purportedly to avoid further legal proceedings. It is also reported that the Samsung group and Lone Star also offered donations. Local

civic groups are, however, adamant to take matters to their logical conclusion. In the case of India, however, such practices generally do not come into the open; more often than not, they are revealed only when some disputing family members wash their dirty linen in public for personal gain, or when once-trusted employees start feathering their own nests. Once the dispute is settled, as if it was as an internal affair, no one seems to be interested in pursuing the cases further and bringing out the truth. Occasionally, a public personality looks like taking on the captains of industry head-on. But for some inexplicable reasons the person becomes 'silent' and peace prevails all around. With the political parties and large business interests coming closer and their relationships becoming more open, it would be difficult to expect the political system to get interested in 'destabilising large business houses'. On its part, the Indian press is keen on championing the reforms rather than reforming the business. It is not surprising that the Indian press has practically censored the corporate governance issues in Korea. But for the Internet, it would have been extremely difficult to get to know these happenings in South Korea.

In any case, what is happening in India in this regard? Are the market regulator and the Ministry of Company Affairs checking the veracity of declarations and disclosures made by the corporates? Indeed if the promoters are taking advantage of certain weak provisions, should not the loopholes be plugged? How many of the investors, who are declared as belonging to the non-promoter category, are *benamis* of the promoters? How independent are the independent directors on whom so much reliance is being placed? Who monitors the related party transactions from the point of their essentiality and arms-length pricing? Are ICAI guidelines adequate to prevent undue transfer of resources to those in control of the companies? Is the criticism about the failure of the book-building route in price discovery unfounded? How much have the promoters gained in the process? Last but not least; is there any mechanism to ascertain the antecedents of foreign portfolio investors to whose tunes the Indian stock market dances? Is a system being developed to examine the declarations of FIIs? Isn't the criterion that the sub-accounts should be regulated entities extremely vague as it even covers mere registration as a company?

The SEBI's Order in case of the demat scam and the subsequent statements to the press indicate that the concerned officials were emotionally charged. It is probably a welcome sign as it could be the indication of longstanding frustration at observing the goings on but not being able to do much for one reason or the other to bring the culprits to book. The test of the mettle and commitment of the regulator is in meeting these real challenges. One hopes that SEBI would not only start looking into these issues but also make them public, to build investor confidence.

### 3. SUMMING UP

In the last year's share price increase India may have benefited, along with some other emerging markets, from FII investment strategies. But the lingering doubts about the quality of FII funds are not entirely baseless as almost half of the funds entered through the PN route, which masks the antecedents of the investors. FII investments are being supported on two main counts. One, they reduce the cost of equity capital to enterprises. The question is to what extent the cost should be reduced. An associated question is: are there enough safeguards to ensure that the moneys thus raised are utilised to the optimum and to prevent empire building by the promoters? On the other hand, in the ensuing volatile environment, can enterprises and local investors decide about the fair value of a share? What looks like an under-priced issue in a rising market may turn out to be a vastly overvalued one in a falling one. The second is even less convincing as it seeks to provide support to balance of payments and thus have nothing to do with the financing of corporates, the main objective. Interestingly, one of the measures suggested to spread the risks is to enable domestic investors/institutions to invest in other economies. In the dependence on foreign portfolio investments, not much thought is being given to the domestic individual investor's role, position and predicament. It also needs to be given a thought whether it is better to give foreign portfolio investors all the concessions and cope with their "irrational exuberance" and suffer the volatility or to tap the huge potential of NRI professionals whose remittances have proved to be much more in terms of volume.

The steep fall in share prices after May 10, 2006 raises important questions. Against the sustained sell-off by the FIIs and the adverse international market movements, the Sensex is getting battered notwithstanding the domestic institutions' attempts to keep it afloat. It is anybody's guess as to what would have happened if the authorities had not bailed out the over-leveraged investors. Who would be responsible if the public financial institutions, which apparently have been directed by the government to shore up the market sentiment, lose heavily? The sudden departure from the global trend after the Sensex crossed the 10,000 mark also raises doubts about the quality of the money that has poured into the market. Is it that undesirable elements tried to ride the bullish market? How much bank finance has gone into the stock market both directly and indirectly? These issues need to be investigated.

India's stock market is now inextricably linked to global markets. Obviously, there will not be any going back. The country has reached a position where it cannot annoy FIIs as a class. The local institutional investors have yet to emerge as an effective countervailing force. In the desire to attract capital to the stock market, should speculative gains be taxed lower than regular incomes? It is obvious that but for the insistence of some

political parties to find out the reasons for the May 2004 crash, it is unlikely that the authorities would have enquired into the PNs. SEBI's failure to strictly impose KYC norms was indeed exposed in the UBS case. Questions also arise about the quality of information it receives/offers on the sub-accounts and PNs. If after more than a decade of dealing with FIIs, having seen the flipside of international capital flows and having experienced serious difficulties in getting behind the ownership structures, if an official expert group involving the government and the regulators could not provide details of FII investments, how can the small investors be expected to take informed decisions? The volatility not only baffles them but it also hurts their interests. When a major international investment house says that the 'fair value' of Sensex is 7,000, which ordinary investor could remain comfortable in the present situation? Asking them to remain calm and stay invested for the long term in the face of huge daily swings sounds unconvincing, to say the least. A little discussed practice of FIIs is that even in the bluest of blue chip companies (e.g. Infosys) they do not remain committed investors (See Table-5). It is inexplicable why the government feels shy to admit that FIIs lead the market and behaves as if they do not matter.

The issue of *benami*/fictitious applications is only a minor facet of the malfunctioning system. In any case, with PAN becoming mandatory to open demat accounts and the ongoing efforts to weed out duplicate PANs, the menace of multiple/bogus individual accounts could be controlled. A doubt, however, remains regarding the size of the scam. Would established intermediaries and banks risk their reputation and long term business interests just for Rs. 72 crores, which should have been shared by various layers? Has SEBI's investigation fully uncovered the scam? Only SEBI can answer these questions.

There should be clarity in the objectives. The objectives will determine whether the reservation should continue for retail investors or not. The real challenge for the regulator is to reign in unscrupulous promoters by designing more relevant disclosures, tightening the monitoring system and to minimise frivolous listing and price discovery mechanisms. The South Korean experience should provide enough indications to the extent of siphoning off of resources by the promoters for personal gain. It also provides an example of efficiency and business ethics not being synonymous.

**Table-5**  
**Changes in FII Investments in Infosys: 2001–06**

<i>Name of the FII/Sub-Account</i>	<i>Percentages</i>					
	<i>Mar '01</i>	<i>Mar '02</i>	<i>Mar '03</i>	<i>Mar '04</i>	<i>Mar '05</i>	<i>Mar '06</i>
Total Investments of FIIs	28.89	36.59	39.18	41.82	42.87	37.91
Capital International Emerging Markets Fund			1.29	1.41		
Capital International Inc.	2.33					
Capital Research & Management Company		1.47				
Copthall Mauritius Investments Ltd.				1.55	2.58	1.44
Deutsche Securities Mauritius Ltd.					1.94	
Emerging Markets Equity Trust	5.04					
Emerging Markets Growth Fund Inc		6.11	5.08	4.88	2.04	
FID Funds Mauritius Ltd.						1.01
Fidelity Management & Research Company					1.01	1.02
Goldman Sachs Investment (Mauritius) I Ltd.					2.20	1.01
Government of Singapore	5.48	3.75			1.17	1.07
HSBC Global Investment Funds				1.00		1.31
J P Morgan Fleming Asset Management						1.18
Janus Mercury Fund		1.53	1.49			
Merrill Lynch Capital Markets Espana SA SVB			4.11	3.68	3.24	2.09
Morgan Stanley & Company International Ltd.					2.29	
Morgan Stanley Dean Witter Investment		1.17				
Morgan Stanley Dean Witter Investment Management Inc.	1.39					
Morgan Stanley Dean Witter Mauritius Company Ltd.			3.93	2.01		
Oppenheimer Funds Inc.		1.20	1.21	1.14	1.12	1.00
Salomon Smith Barney Mauritius Pvt Ltd.			1.29			
UBS Securities Asia Ltd.			1.39	2.35	2.96	
UBS Warburg Asia Ltd.		1.96				

*Notes:* Only FIIs having at least 1 per cent of the shareholding are reported by the companies. Some of the FIIs may be continuing to hold shares (held shares earlier) but with less than 1 per cent of the total. No attempt has been made here to identify name changes/mergers of FIIs.

From the manner of reporting it is difficult to distinguish whether the information provided is for the ultimate beneficiary or not. Changes in individual shares could also be due to changes in the total equity

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