After reading this chapter, you will be able to:

**LO 3.1** Understand the concept of stock indices
**LO 3.2** Explain the index computation methodology
**LO 3.3** Evaluate the types of indices and the difference between these indices
**LO 3.4** Analyse about different indices of BSE and NSE
**LO 3.5** Evaluate the concept of capital market regulation and SEBI

### Introduction

We have heard people talking about how Nifty has fallen, or how the Sensex has rallied and might have wondered what are these indices, and what is their relevance in stock trading. An index is a representative number, constructed using the value of a selected number of components which can be shares, commodities, etc., based on a base year. The movement of index represents the movement of prices of the components in the index. In this chapter we will learn the construction of indices and their uses.

The history of stock indices tells us that Dow Jones Industrial Average (USA) is one of the oldest continuously quoted stock indices, which is being computed since 1896. The indices consist of 30 stocks, and they are calculated on a price weighted method of 30 stocks. The S&P index consists of 500 stocks, which also adopted the price weighted average of 500 stocks. If a country has more than one stock exchange, each one of them has a separate index, i.e., in India, we have two major stock exchanges—the Bombay Stock Exchange and the National Stock Exchange, and each has its own index. The Bombay Stock Exchange index is known as BSE SENSEX, and the NSE Index is known as S&P CNX NIFTY.

### Use of Indices

Stock market indices are used for different purposes. Some of the uses of stock indices are discussed below:

1. **Barometer of Economy**: Stock market indices act as a barometer for an economy. If an index of a country continuously performs negatively, this indicates a weak economic outlook for that country. It indirectly indicates the growth of economy. In recent years, we had seen a sharp growth in the South East Asian economies’ indices, because these
countries became the axle of the global economic growth. Contrary to this, we had seen a continuous decline in the major stock market indices in the Euro zone, because of the current economic crisis which started in early 2009.

2. **Indicator of Country’s Performance**: It also represents a country’s growth, weakness and strength. When the market index declines, it indicates a weak country, whereas a rising index is an indicator of good performance. In 2009, when the US growth declined, indices like Dow Jones, S&P 500, etc., showed a heavy fall.

3. **Benchmark for Evaluation**: Institutional investors use the index as a benchmark to evaluate their performance against the index. Stock market indices are extensively used in security analysis, and portfolio management. Investors use them for portfolio allocation.

4. **Underlying Asset for Derivative Instruments**: Stock market indices are used as underlying assets for structuring derivative instruments, like futures and option. Nifty futures, Nifty options, etc., are examples of the uses of indices for structuring derivative products.

5. **Measure of Investor Confidence**: Rising stock market indices indicate that more investors are participating in trading, and declining indices show a loss of confidence of the investors in the market, as they are keeping away from the market. For example, if Bank Nifty declines continuously, it is an indication that investors are not buying banking shares.

6. **Indicator of Industry Performance**: Indices represent prices of shares of various companies. Hence, if the companies present a good performance, the demand for their shares goes up, and consequently the indices in which these shares are included also will go up. For example, IT companies can change the trend of Nifty or SENSEX, as they have a major weight in these indices.

7. **Creation of Index Fund**: Stock market indices are used for creating index funds. An index fund is a mutual fund, or exchange traded fund, that aims to replicate the movement of an index in the financial market. IDBI Nifty Index Fund, Quantum Index Fund, etc., are examples of index funds. These funds are traded in the stock exchanges.

8. **Technical Analysis**: Technical analysts use the indices to predict the market using the historical value of indices. The relationship between individual stock and index predicts the movement of the individual share prices.

### LEARNING OUTCOME 3.2

**CONSTRUCTION PROCESS**

A stock market index can be a price index or a wealth index. The price index can be a weighted price index or an unweighted price index. In the case of a weighted price index/wealth index, weights based on market capitalisation of the shares are assigned to the prices, whereas in the unweighted price index simple arithmetical average price of the share prices is computed with a base year. This index gives an idea about how the share prices are moving. In the case of the wealth index, the base period values are adjusted for subsequent rights and bonus shares are issued. The wealth index indicates the real wealth created by the shareholders over a period of time.

Construction of an index involves selection of scrips, assigning weights for each scrip, and computing the index value. Four methods are commonly used for the computation of index. These methods are the market capitalisation method, price weighted method, equal weight index method, and free float method. These methods are discussed below in detail.

**MARKET CAPITALISATION METHOD**

Stock exchanges in India are using this method to compute various indices. Under this method, the scrips are selected for inclusion in the index, and a base period is also selected. For example, the base period can be 1990 or 2000. It can also be 1989–90 or 1999–2000. The average price of each share for the base period is computed. The number of shares outstanding is multiplied by the average price of shares to get the base market capitalisation. Similarly, current market capitalisation is computed by multiplying the current price of the scrip by the current outstanding shares. An example of computing the index value under this method is given as follows:
### Current Market Capitalisation

\[
\text{Current Market Capitalisation} = \text{Market Capitalisation} = \text{Number of shares outstanding} \times \text{Price of the security}
\]

### Base Market Capitalisation

\[
\text{Base Market Capitalisation} = \text{Base Value} = 100
\]

So the index value works out to be

\[
\frac{4180000}{3820000} \times 10 = 109.42
\]

### Price Weighted Method

Under this method, we do not consider market capitalisation. Instead, we take only the base price and the current market price. The index is constructed using these prices as the weights. An example of computation of the price weighted method is shown below:

\[
\begin{align*}
\text{Market price weighted index} &= \frac{\text{Current Price}}{\text{Base Price}} \times 100 \\
&= \frac{4197}{3838} \times 100 \\
&= 109.35
\end{align*}
\]

### Equal Weight Method

In this case also, market capitalisation is not considered. Instead, equal weights are assigned to the scrips in the index. For example, if there are four scrips, the weight for each scrip will be ¼ or 0.25. Instead, taking the absolute value of the prices, the price change between the current market price and base price is computed, which is multiplied by the assigned weights to get the weighted average value of each scrip. The sum total of these weighted averages is added to the base index value, which is normally 100. An example of the construction of this index is given below.
Equal Weighted index = 100 + Weighted Average
= 100 + 10.45
= 110.45

Free Float Method Index Calculation
Under the free float method of index calculation, the shares which are available for trading are considered than the total shares which are outstanding. Most of the time, promoters who hold majority of shares, strategic investors, governments holding, etc., will not be available for trading. Under the free float method, these shares, which are not made available in the market, would not be considered for calculating market capitalisation. Exchanges usually collect quarterly statements to find out the exact number of shares available for trading in the market. The method of computation of an index, which is based on free float, is explained under the BSE Indices.

**DIFFERENCE BETWEEN INDICES**

Though indices are constructed using the same methodology, often, they do not move in consonance. Many times, we have seen that when the SENSEX is moving up, Nifty may be going down. Similarly, the points of change also differ between the two indices. The main reasons for this variation are:

1. **Number of components in the index**
2. **Composition of stocks**
3. **Weights assigned to components**
4. **Base year**

1. **Number of Components**: The numbers of stocks included in each index make it different from the other. The more number of shares are included, the more the index would be representative of the sector. For example, SENSEX has 30 stocks and Nifty comprises 50 stocks. The well-known international index is constructed based on 30 stocks, whereas FTSE 100 has 100 stocks included in it. STOXX comprises 50 stocks. NSE’s S&P Nifty 500 is structured, based on 500 stocks. Nifty Midcap has 200 stocks in it. BSE-100, which was formerly known as BSE National Index, has 100 stocks. Previously, out of 100 stocks 22 were quoted in BSE, and the rest were quoted in BSE and other exchanges. In 1989, this index was reconstituted with the base year as 1983–84, based on 100 stocks traded in BSE.

2. **Composition of Stock**: The exchanges change the composition of the indices by dropping or adding fresh companies. When a company is de-listed, or the trading volume comes below the eligibility criteria for that index, that scrip is dropped and a fresh scrip is added. For example, in 1996, BSE replaced 15 stocks in SENSEX. The latest change took place in December 2010. Nifty changed its composition in 1996 and 1998. NSE had changed the composition of its Nifty Junior also in 1998 October. Considering the growth of the IT industry, now IT stocks have been given a major weight in the indices. The composition, and the frequency of changing the composition, differs from index to index.

3. **Weights Assigned to Scrips**: The weights allotted to each company’s scrip also influences the movement of the index. These weights may represent price or value. While the popular US stock index Dow Jones, and Asian popular index Nikkei 225 of Tokyo Stock Exchange, are weighted with the price, BSE’ SENSEX, Nifty, etc., are weighted with value. The price weights are arrived at by adding together the current prices of the stocks traded in the stock exchange, and dividing them by the total number of outstanding stocks. An example of price weighting is worked out in the previous paragraphs. In this method, the index is influenced more by the stocks with higher price than the stocks with lower price. The number of stocks is periodically adjusted to cover stock splits, rights shares, and bonus shares.

The market value weighted index represents the current market capitalisation. The current market capitalisation is computed by multiplying the current market price of each stock with the total number of outstanding shares in respect of that stock. Computation of
the market capitalisation weighted method is shown in a previous example. Most of the
indices all over the world, and those in India, except Economic Times’ Ordinary Share
Index, are weighted with value. Each scrip influences the index proportionate to the
importance of that scrip in the market. Hence, price changes that take place in scrips, with
high market capitalisation, often have a great impact on the index. The price changes on
account of rights issue; or bonus issue of shares also create changes in the index, because
these corporate actions increase the number of outstanding shares, and at the same time
bring down the prices of those shares.

In an unweighted index, all stocks carry equal weights. An example of computation
of equal weight index is worked out in a previous paragraph. Since all the stocks carry
equal weight price; or volume of the scrips do not create much impact on the index. The
movement of price is computed, based on the percentage change in the average price of
the stocks in the particular index. Under this method, it is assumed that the investors are
deploying equal amount of money in each stock included in the index. The Value Line
Index of the New York Stock Exchange does not use weights; rather a geometric mean is
used instead of an arithmetic mean.

4. **Base Year:** The base year of various indices differ. If the base year is close to the current
year, the prices will be more representative of the current trend. If the base period is too
close, the investor will lose chances to get historical information. The base year is usually
revised after passing a certain period, to make it more current (Table 3.1).

### Table 3.1 No. of Constituents and Base Year of Major Indices

<table>
<thead>
<tr>
<th>Index Name</th>
<th>No. of Scrips</th>
<th>Base Year</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Major International Indices</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dow Jones (Price Weighted)</td>
<td>30</td>
<td>1928</td>
</tr>
<tr>
<td>NASDAQ 100 Stock Index</td>
<td>100</td>
<td>1985</td>
</tr>
<tr>
<td>DAX</td>
<td>30</td>
<td>1987</td>
</tr>
<tr>
<td>Hang Seng</td>
<td>45</td>
<td>1964</td>
</tr>
<tr>
<td>Singapore (FTSE Strait)</td>
<td>30</td>
<td>2008</td>
</tr>
<tr>
<td>Shanghai Composite</td>
<td>All Listed Shares A &amp; B in Shangai</td>
<td>1990</td>
</tr>
<tr>
<td>CAC 40</td>
<td>40</td>
<td>1987</td>
</tr>
<tr>
<td>KRX 100 Index (Korea)</td>
<td>100</td>
<td>2001</td>
</tr>
<tr>
<td><strong>Major Indian Indices</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BSE 30</td>
<td>30</td>
<td>1978</td>
</tr>
<tr>
<td>CNX NIFTY</td>
<td>50</td>
<td>1995</td>
</tr>
<tr>
<td>CNX BANKEX</td>
<td>12</td>
<td>2000</td>
</tr>
<tr>
<td>CNX IT Index</td>
<td>20</td>
<td>1995</td>
</tr>
<tr>
<td>BSE Auto Index</td>
<td>11</td>
<td>1999</td>
</tr>
<tr>
<td>BSE BANKEX</td>
<td>14</td>
<td>1999</td>
</tr>
<tr>
<td>BSE Capital Goods</td>
<td>19</td>
<td>1999</td>
</tr>
<tr>
<td>BSE FMCG</td>
<td>10</td>
<td>1999</td>
</tr>
<tr>
<td>BSE Reality</td>
<td>15</td>
<td>2005</td>
</tr>
<tr>
<td>BSE Health Care</td>
<td>18</td>
<td>1999</td>
</tr>
<tr>
<td>BSE CD</td>
<td>8</td>
<td>1999</td>
</tr>
<tr>
<td>BSE Power</td>
<td>19</td>
<td>2005</td>
</tr>
<tr>
<td>BSE Teck</td>
<td>30</td>
<td>2001</td>
</tr>
<tr>
<td>BSE Metal</td>
<td>13</td>
<td>1999</td>
</tr>
<tr>
<td>BSE IT</td>
<td>10</td>
<td>1999</td>
</tr>
<tr>
<td>BSE PSU</td>
<td>61</td>
<td>1999</td>
</tr>
</tbody>
</table>

*Source: www.bseindia.com; www.nseindia.com (accessed on 01/03/2011)*
BSE INDICES

BSE’s flagship index is SENSEX, which is structured, based on 30 stocks. BSE has also structured various sectoral indices, mid cap stocks, banking stocks, IT stocks, realty stocks, automobile sector, health care, FMCG, power, consumer goods, capital goods, and so on. These indices and their composition are discussed below in detail.

BSE SENSEX

BSE’s Index, better known as SENSEX, was first compiled in 1986, and was calculated on a ‘Market Capitalisation-Weighted’ methodology of 30 component stocks, representing large, well-established, and financially sound companies across key sectors. The movement of the SENSEX from 1990 to 2010 is shown in Fig. 3.1, which demonstrates the performance of the Indian capital market during the last 10 years. The base year of the SENSEX was taken as 1978–79. The SENSEX is a worldwide accepted stock market index representing performance of the Indian capital market.

Fig. 3.1 Movement of the SENSEX: 1990–2010

The index is constructed, based on a globally accepted construction, and review methodology. From September 1, 2003, the methodology used for construction of the SENSEX was changed to globally accepted, and followed ‘free float market capitalisation-weighted’ methodology. All major index providers like MSCI, FTSE, STOXX, S&P, and Dow Jones use the free-float methodology. SENSEX provides the time series data over a fairly long period of time (from 1979 onwards). Though the index is structured, based on 30 stocks, the selection of scrip is done giving wide representation for new industrial sectors like IT, services, telecom, consumer goods, two and three wheeler auto sector, and so on. BSE ensures that the continuity and integrity of the index is not in any way affected, so that anyone can compare the current market conditions with those prevailing a decade ago, easily without distortion of any facts in the market analysis. The selection of scrips for inclusion in the index is done based on certain qualitative and quantitative criteria. These criteria are discussed next.

SENSEX and Composition

The base period of SENSEX is 1978–79, and the base value is 100 index points. The calculation of SENSEX involves dividing the free-float market capitalisation of 30 companies in the index by a number called the Index Divisor. The Index Divisor is the only link to the original base period value of the SENSEX. For instance, if ABC has an equity capital of 1.72 billion, with each share having a face value of ₹10, and its closing price in BSE on January 2011 was ₹175, then ABC company has a market capitalisation on that date which is 175 × 1.72/10 = ₹30.1 billion. One can calculate BSE 30 stocks market capital on a particular day in the same method. The selection of scrips is done by giving wide representation to the industries. BSE follows qualitative and quantitative criteria in selection of stocks for inclusion in the index.
Qualitative Criteria

The qualitative criteria consist of industry representation and track record.

*Industry Representation:* Scrips are selected from major industries in India, so as to give a true representation of each sector. This process makes the index a true representative of the economic growth in the country. The selection of scrips is done carefully so as to ensure that the selected scrip reflects the present state of the industry as well as future prospects. For example, Infosys stock is having a major weightage in SENSEX, because that share represents the whole IT industry, as the progress of IT industry is reflected in this stock. The changes in the price of Infosys can make changes in the trend of the index.

*Track Record:* Only shares of companies having an acceptable track record are considered for inclusion in the index. Companies included in the Z group, listed mutual funds, scrips suspended on the last day of the month prior to review date, scrips objected to by the Surveillance department of the Exchange, and those that are traded under permitted category are excluded.

*Listing History:* The scrip should have a listing history of at least three months at BSE. However, scrips with a listing history of one month are accepted, if the average free-float market capitalisation of a newly listed company ranks in the top 10 of all companies listed at BSE. Companies listed on account of a merger/demerger/amalgamation, have been exempted from minimum listing history.

Quantitative Criteria

BSE considers quantitative criteria such as trading history, revenue.

*Trading History:* The scrip should have been traded on each and every trading day in the last three months at BSE. Exceptions are considered in extreme reasons like scrip suspension, and so on. Higher frequency in trading increases liquidity of the scrips.

*Revenue:* The selected companies should have reported revenue in the latest four quarters from its core activity.

*Market Capitalisation:* Companies satisfying the eligibility criteria such as track record, listing history, trading history, reporting of revenue, etc., are shortlisted, and from this list of the top 75 companies based on free-float market capitalisation (avg. 3 months), companies are selected. Any additional companies that are in the top 75, based on full market capitalisation (avg. 3 months), are also included.

*Ranking of Scrips:* The filtered list of constituents selected, based on market capitalisation (which can be greater than 75 companies), is then ranked on absolute turnover (avg. 3 months). In this process, the scrips that have a cumulative turnover of more than 98 per cent are excluded, so long as the remaining list has more than 30 scrips.

*Assigning Weights:* Weights are assigned, based on free-float market capitalisation. The filtered list, as mentioned in the previous paragraph, is then sorted by free float market capitalisation and any company having a weight within this filtered constituent list of more than 0.50 per cent is excluded. All remaining companies will be sorted on sector, and sub-sorted in the descending order of rank on free-float market capitalisation.

Method of Construction of SENSEX

As discussed in the introductory part of SENSEX, globally accepted and widely used free-float method is used for construction of this index. We have explained the free-float in an earlier paragraph. Free-float can be defined as the shareholding of investors that would not come, in the normal course, into the open market for trading, as these shares are treated as ‘Controlling/Strategic Holdings’. Specifically, the following categories of holding are generally excluded from the definition of free-float:

- Shares held by founders/directors/acquirers, which has control element.
- Shares held by persons/bodies with “Controlling Interest”.
- Shares held by the government as promoter/acquirer.
- Holdings through the FDI Route.
- Strategic stakes by private corporate bodies/individuals.
- Equity held by associate/group companies (cross-holdings).
- Equity held by Employee Welfare Trusts.
- Locked-in shares, and shares which would not be sold in the open market in the normal course.

The free-float factor for each company is determined, based on the detailed information submitted by the companies in the prescribed format on a quarterly basis. BSE has placed the format on its website. Free-float market capitalisation is computed by multiplying the total market capitalisation with the free-float factor. Once the free-float of a company is determined, it is rounded-off to the higher multiple of 5, and each company is categorised into one of the 20 bands given in Table 3.2. A free-float factor, of say 0.55, means that only 55% of the market capitalisation of the company will be considered for index calculation.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Reliance</td>
<td>0.55</td>
<td>Bharti ARTL</td>
<td>0.35</td>
<td>Sterlite In</td>
<td>0.45</td>
</tr>
<tr>
<td>Infosys Tech</td>
<td>0.85</td>
<td>Tata Motors</td>
<td>0.7</td>
<td>Tata Power</td>
<td>0.7</td>
</tr>
<tr>
<td>ICICI Bank</td>
<td>1</td>
<td>Tata Steel</td>
<td>0.7</td>
<td>Bajaj Auto</td>
<td>0.5</td>
</tr>
<tr>
<td>ITC Ltd</td>
<td>0.7</td>
<td>BH EL</td>
<td>0.35</td>
<td>Maruti Suzuki</td>
<td>0.5</td>
</tr>
<tr>
<td>L&amp;T</td>
<td>0.9</td>
<td>Hind Unilever</td>
<td>0.5</td>
<td>Cipla Ltd</td>
<td>0.65</td>
</tr>
<tr>
<td>HDFC</td>
<td>0.9</td>
<td>Mahindra &amp; M</td>
<td>0.8</td>
<td>Hero Honda M</td>
<td>0.5</td>
</tr>
<tr>
<td>HDFC Bank Lt</td>
<td>0.8</td>
<td>NTPC Ltd</td>
<td>0.2</td>
<td>REL Infra</td>
<td>0.55</td>
</tr>
<tr>
<td>SBI</td>
<td>0.45</td>
<td>Jindal Steel</td>
<td>0.45</td>
<td>JP Associates</td>
<td>0.55</td>
</tr>
<tr>
<td>TCS Ltd</td>
<td>0.3</td>
<td>Hindalco</td>
<td>0.7</td>
<td>DLF Limited</td>
<td>0.25</td>
</tr>
<tr>
<td>ONG Corp Ltd</td>
<td>0.2</td>
<td>WIPRO Ltd</td>
<td>0.25</td>
<td>REL Com Ltd</td>
<td>0.35</td>
</tr>
</tbody>
</table>

Source: www.bseindia.com (accessed on 01/03/2011)

Online Computation: The value of SENSEX is computed online on real-time basis, and then disseminated. The changes in the prices of the constituents are collected during the trading time and incorporated into the index, thereby making the index updated, so that the index also moves along with the real time price movements.

Index Closure Algorithm: The closing SENSEX on any trading day is computed, taking the weighted average of all the trades on SENSEX constituents in the last 30 minutes of trading session. If a SENSEX constituent has not traded in the last 30 minutes, the last traded price is taken for computation of the Index closure. If a SENSEX constituent has not traded at all in a day, then its last day’s closing price is taken for computation of Index closure. The use of Index Closure Algorithm prevents any intentional manipulation of the closing index value.

Index Maintenance: One of the major tasks in maintaining the index is to update the base year average. The base year average updating includes replacement of stocks, adjustments for additional capital issue, rights issue, bonus issue, dividend, etc., and similar corporate announcements. However, the adjustments for corporate actions do not per se affect the index values. The maintenance is done on a day-to-day basis. BSE Index Committee has set a broad index policy, and the Index Cell of BSE does the maintenance in tune with this policy. The Index Committee is constituted by drawing experts from the area of capital market, fund managers, market participants and members of the BSE Governing Board. Index Cell ensures that SENSEX and all the other BSE indices maintain their benchmark properties by striking a delicate balance between frequent replacements in index, and maintaining its historical continuity. Table 3.3 shows the year-wise break up of replacement of scrips since 1992.

The issuing of additional shares in the form of right issue, bonus issue, stock splits, etc., increases the number of outstanding shares, and therefore periodical adjustments are necessary in the market capitalisation. Adjustment is required, also, when new shares are issued by way of conversion of debentures, mergers, spin-offs, etc., or when equity is reduced by way of buy-back
BSE uses the following formula for adjustment of the additional shares issued by constituent companies.

The formula for adjusting the Base Market Capitalisation is as follows:

$$\text{New Base Market Capitalisation (NBMC)} = \text{OBMC} \times \left( \frac{\text{NMC}}{\text{OMC}} \right)$$

Where:

- OBMC = Old Base Market Capitalisation
- NMC = New Market Capitalisation
- OMC = Old Market Capitalisation.

Example: A company issues right shares, which increases the market capitalisation of the shares of that company, by say, ₹200 crore. The existing Base Market Capitalisation (Old Base Market Capitalisation), say, is ₹2000 crore, and the aggregate market capitalisation of all the shares, included in the index before the right issue is made, is, say ₹4500 crore. The “New Base Market Capitalisation” will then be

$$\text{New Base Market Capitalisation} = 2000 \times \left( \frac{4500 + 200}{4500} \right) = 2088.89$$

This figure of ₹2088.89 crore will be used as the Base Market Capitalisation for calculating the index number from then onwards, till the next base change becomes necessary.

### SUB-INDICES AND COMPOSITION

BSE sub-indices and their composition is dealt with below.

### BSE Sub-Indices

Sectorial performance information is important, which may help analysts, fund managers, and investors to identify outstanding sectors which usually gave high returns, while investing in. BSE has 14 sectorial indices that measure the performance of different segments of the economy through movement of the stock prices of the leading companies.

### Auto Index

BSE Auto Index tracks the performance of the Automobile and Automobile ancillary industry stocks. It is calculated on the free-float market capitalisation method. As India is the fastest growing country, the Auto Index has a vital role to play. It shows the liquidity on the banking sector, economic growth, and consumer spending behaviours. In an underperforming economy, Auto Index performs very poorly.

### BANKEX

In an emerging economy like India, banks play a vital role in lending in various sectors. If the performance of the BANKEX is poor, it is a clear indication of stagnation of economy. In the case of India, most of the banks belong to the government, so it may not be possible for FII to invest beyond a certain extent. In this perspective, they usually buy BANKEX, which would not have any cap. Free-float market capitalisation is used to calculate the index. This sector is also known

### Table 3.3 Year-Wise Break up of Stock Replacement in BSE SENSEX

<table>
<thead>
<tr>
<th>Year</th>
<th>No. of Replacements</th>
<th>Year</th>
<th>No. of Replacements</th>
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</thead>
<tbody>
<tr>
<td>1992</td>
<td>1</td>
<td>2004</td>
<td>2</td>
</tr>
<tr>
<td>1996</td>
<td>16</td>
<td>2005</td>
<td>2</td>
</tr>
<tr>
<td>1998</td>
<td>4</td>
<td>2006</td>
<td>1</td>
</tr>
<tr>
<td>2000</td>
<td>4</td>
<td>2007</td>
<td>2</td>
</tr>
<tr>
<td>2001</td>
<td>1</td>
<td>2008</td>
<td>3</td>
</tr>
<tr>
<td>2002</td>
<td>4</td>
<td>2009</td>
<td>2</td>
</tr>
<tr>
<td>2003</td>
<td>5</td>
<td>2010</td>
<td>3</td>
</tr>
</tbody>
</table>

Source: www.bseindia.com (accessed on 27/02/2011)
as interest rate sensitive sector, which always track, CRR, REPO, Reverse Repo, and the interest rate of the country. It also factors inflation. Inflation and Banking Index are inversely correlated.

**BSE–Capital Goods**

Like banks and the automobile sector, capital goods sector growth is also vital for an emerging economy like India. Its performance indicates the growth of infrastructure. This Index is also calculated on a free-float method.

**BSE–Consumer Durables**

The Sectorial Index shows the consumer durable stocks’ movements. Titan is the heavyweight stock having 44 per cent weightage on the Index. It is also constructed on the basis of a free-float method.

**BSE–FMCG**

ITC and HUL are the heavyweight stocks, holding more than 70 per cent of the weight in this index. Rural income growth can be measured through FMCG index. A free-float method is adopted to calculate the index. The FMCG sector is also known as defensive sector stock; because these stocks usually have low beta, thereby, no major movements can be expected on a regular basis.

**BSE–Healthcare**

The three frontline stocks, Dr Reddy, Sun Pharma, and Cipla constitute major weightage to this index. It is said to be a defensive sector, and these sectorial stocks have lower beta as compared to Auto and IT indices.

**BSE–INFOTECH**

This index consists of frontline IT stocks such as Infosys, Wipro, TCS, and other major companies in the IT sector. IT stocks are considered to be a high beta stock. The prices of IT stocks clash with ADR, as the changes in ADR price movement can have an impact on the prices of these stocks. The movement of the rupee against major foreign currencies, especially the dollar, can affect this indeed, positively or negatively.

**BSE–Metal Index**

BSE Metal Index is constructed with 15 stocks, which includes Steel, Aluminium, Copper, Zinc, etc., stocks. The Index is calculated on a free-float method. Metal Index performs according to the metal’s movements on LME (London Metal Exchange) and Shanghai Market. Its performance also depends on dollar/euro and the Dollar Index. If the Dollar Index is firm, then the Metal Index is likely to fall and vice versa. If euro gains over dollar, then the Metal Index is likely to out-perform the market. Metal Index out performance is likely to have negative impact on Auto Mobile index.

**BSE–Oil and Gas Index**

BSE Oil and Gas index is not directly correlated with crude gas prices, because they are given to the general public at a discounted price by the government of India. Oil and natural gas producers and oil marketing companies comprise this sector. Reliance owns nearly 60 per cent weightage in this sector. ONGC takes the second position by owning nearly 16 weightage on this Index. A free-float method is used to calculate Index. If international crude oil prices are down, usually OMC sector stocks outperform.

**BSE–Power Index**

BSE power Index is an emerging sector. This sector is expected to progress tremendously in the coming decades, because India is going to send billion of US dollars for its energy savings economy. The index is also calculated on a free-float method. BHEL, NTPC, and Tata Power
contribute the major weightage to this sector. It is interesting to note that Dow Jones Industrial Average does not contain any stock from this sector.

**BASE–Reality Index**

DLF, Unitech, HDIL, and India Bull Real Estate are contributing nearly 75 per cent weightage to this sector, of which DLF holds the major weightage. It is also calculated on a free-float method. The sector is known as interest rate sensitive sector. If the interest rate goes high, this sector performs negatively. This sector is high, having positive correlation with the banking sector. Like the banking sector, it is inversely correlated with interest rates.

The sub indices composition is the same as we had seen in the case of BSE SENSEX. It is calculated on the free-float market capitalisation method.

**NIFTY AND COMPOSITION**

In NSE, indices are owned and managed by India Index Services and Products Ltd. (IISL). It is a joint venture between NSE and CRISIL. In NSE, nine indices are maintained, computed and traded. The S&P CNX NIFTY is the headline index on the National Stock Exchange of India. Fig. 3.2 shows the movement of Nifty from 1995 to 2011. It includes 50 stocks from various sectors of the economy, and they are highly liquid in nature. S&P CNX Nifty constitutes nearly 60 per cent of the total market capitalisation of the equity market. The 50 stocks are from 22 sectors, and it offers investment managers to create an efficient portfolio. Table 3.4 shows the constituents of Nifty.

**Fig. 3.2 Movement of Nifty: 1995–2011**

The index has started from 1996 with base period, and it is well suited for benchmarking, index funds, and index derivatives. The National Stock Exchange adopted the Market Capitalisation Weighted index based on the free float method.

Index Level = Sum of (Price of stock * Number of shares) * Free float adjustment factor/index divisor.

To find out the free float capitalisation of a company, calculate the market capitalisation of a company, and then multiply it by its free-float factor.

**Sub-indices and Composition**

The major sub-indices of Nifty are discussed below.

**S&P CNX DEFTY**

A US dollar denominated index, based on the S&P CNX Nifty, offers opportunity for benchmarking the foreign institutional investors. It offers an instrument to measure the returns of Nifty in dollar terms. This ensures that the risk arising out of currency fluctuation is covered through the S&P CNX Defty.
<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Company</th>
<th>Industry</th>
<th>NSE Symbol</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>ACC Ltd.</td>
<td>CEMENT AND CEMENT PRODUCTS</td>
<td>ACC</td>
</tr>
<tr>
<td>2.</td>
<td>Ambuja Cements Ltd.</td>
<td>CEMENT AND CEMENT PRODUCTS</td>
<td>AMBUJACEM</td>
</tr>
<tr>
<td>3.</td>
<td>Axis Bank Ltd.</td>
<td>BANKS</td>
<td>AXISBANK</td>
</tr>
<tr>
<td>4.</td>
<td>Bajaj Auto Ltd.</td>
<td>AUTOMOBILES – 2 AND 3 WHEELERS</td>
<td>BAJAJ-AUTO</td>
</tr>
<tr>
<td>5.</td>
<td>Bharat Heavy Electricals Ltd.</td>
<td>ELECTRICAL EQUIPMENT</td>
<td>BHEL</td>
</tr>
<tr>
<td>6.</td>
<td>Bharat Petroleum Corporation Ltd.</td>
<td></td>
<td>BPCL</td>
</tr>
<tr>
<td>7.</td>
<td>Bharti Airtel Ltd.</td>
<td>TELECOMMUNICATION – SERVICES</td>
<td>BHARTIARTL</td>
</tr>
<tr>
<td>8.</td>
<td>Cairn India Ltd.</td>
<td>OIL EXPLORATION/PRODUCTION</td>
<td>CAIRN</td>
</tr>
<tr>
<td>9.</td>
<td>Cipla Ltd.</td>
<td>PHARMACEUTICALS</td>
<td>CIPLA</td>
</tr>
<tr>
<td>10.</td>
<td>DLF Ltd.</td>
<td>CONSTRUCTION</td>
<td>DLF</td>
</tr>
<tr>
<td>11.</td>
<td>Dr. Reddy's Laboratories Ltd.</td>
<td>PHARMACEUTICALS</td>
<td>DRREDGY</td>
</tr>
<tr>
<td>12.</td>
<td>GAIL (India) Ltd.</td>
<td>GAS</td>
<td>GAIL</td>
</tr>
<tr>
<td>13.</td>
<td>HCL Technologies Ltd.</td>
<td>COMPUTERS – SOFTWARE</td>
<td>HCLTECH</td>
</tr>
<tr>
<td>14.</td>
<td>HDFC Bank Ltd.</td>
<td>BANKS</td>
<td>HDFC'BANK</td>
</tr>
<tr>
<td>15.</td>
<td>Hero Honda Motors Ltd.</td>
<td>AUTOMOBILES – 2 AND 3 WHEELERS</td>
<td>HEROHONDA</td>
</tr>
<tr>
<td>16.</td>
<td>Hindalco Industries Ltd.</td>
<td>ALUMINIUM</td>
<td>HINDALCO</td>
</tr>
<tr>
<td>17.</td>
<td>Hindustan Unilever Ltd.</td>
<td>DIVERSIFIED</td>
<td>HINDUNILVR</td>
</tr>
<tr>
<td>18.</td>
<td>Housing Development Finance Corporation Ltd.</td>
<td>FINANCE – HOUSING</td>
<td>HDFC</td>
</tr>
<tr>
<td>19.</td>
<td>ITC Ltd.</td>
<td>CIGARETTES</td>
<td>ITC</td>
</tr>
<tr>
<td>20.</td>
<td>ICICI Bank Ltd.</td>
<td>BANKS</td>
<td>ICICIBANK</td>
</tr>
<tr>
<td>21.</td>
<td>Infosys Technologies Ltd.</td>
<td>COMPUTERS – SOFTWARE</td>
<td>INFOSYSTCH</td>
</tr>
<tr>
<td>22.</td>
<td>Infrastructure Development Finance Co. Ltd.</td>
<td>FINANCIAL INSTITUTION</td>
<td>IDFC</td>
</tr>
<tr>
<td>23.</td>
<td>Jaiprakash Associates Ltd.</td>
<td>DIVERSIFIED</td>
<td>JPAASSOCIAT</td>
</tr>
<tr>
<td>24.</td>
<td>Jindal Steel &amp; Power Ltd.</td>
<td>STEEL AND STEEL PRODUCTS</td>
<td>JINDALSTEL</td>
</tr>
<tr>
<td>25.</td>
<td>Kotak Mahindra Bank Ltd.</td>
<td>BANKS</td>
<td>KOTAKBANK</td>
</tr>
<tr>
<td>26.</td>
<td>Larsen &amp; Toubro Ltd.</td>
<td>ENGINEERING</td>
<td>LT</td>
</tr>
<tr>
<td>27.</td>
<td>Mahindra &amp; Mahindra Ltd.</td>
<td>AUTOMOBILES – 4 WHEELERS</td>
<td>M&amp;M</td>
</tr>
<tr>
<td>28.</td>
<td>Maruti Suzuki India Ltd.</td>
<td>AUTOMOBILES – 4 WHEELERS</td>
<td>MARUTI</td>
</tr>
<tr>
<td>29.</td>
<td>NTPC Ltd.</td>
<td>POWER</td>
<td>NTPC</td>
</tr>
<tr>
<td>30.</td>
<td>Oil &amp; Natural Gas Corporation Ltd.</td>
<td>OIL EXPLORATION/PRODUCTION</td>
<td>ONGC</td>
</tr>
<tr>
<td>31.</td>
<td>Power Grid Corporation of India Ltd.</td>
<td>POWER</td>
<td>POWERGRID</td>
</tr>
<tr>
<td>32.</td>
<td>Punjab National Bank</td>
<td>BANKS</td>
<td>PNB</td>
</tr>
<tr>
<td>33.</td>
<td>Ranbaxy Laboratories Ltd.</td>
<td>PHARMACEUTICALS</td>
<td>RANBAXY</td>
</tr>
<tr>
<td>34.</td>
<td>Reliance Capital Ltd.</td>
<td>FINANCE</td>
<td>RELCAPITAL</td>
</tr>
<tr>
<td>35.</td>
<td>Reliance Communications Ltd.</td>
<td>TELECOMMUNICATION – SERVICES</td>
<td>RCOM</td>
</tr>
<tr>
<td>36.</td>
<td>Reliance Industries Ltd.</td>
<td>REFINERIES</td>
<td>RELIANCE</td>
</tr>
<tr>
<td>37.</td>
<td>Reliance Infrastructure Ltd.</td>
<td>POWER</td>
<td>RELINFRA</td>
</tr>
<tr>
<td>38.</td>
<td>Reliance Power Ltd.</td>
<td>POWER</td>
<td>RPOWER</td>
</tr>
<tr>
<td>39.</td>
<td>Sesa Goa Ltd.</td>
<td>MINING</td>
<td>SESAGOA</td>
</tr>
</tbody>
</table>

(Contd.)
40. Siemens Ltd. ELECTRICAL EQUIPMENT SIEMENS
41. State Bank of India BANKS SBIN
42. Steel Authority of India Ltd. STEEL AND STEEL PRODUCTS SAIL
43. Sterlite Industries (India) Ltd. METALS STER
44. Sun Pharmaceutical Industries Ltd. PHARMACEUTICALS SUNPHARMA
45. Suzlon Energy Ltd. ELECTRICAL EQUIPMENT SUZLON
46. Tata Consultancy Services Ltd. COMPUTERS – SOFTWARE TCS
47. Tata Motors Ltd. AUTOMOBILES – 4 WHEELERS TATAMOTORS
48. Tata Power Co. Ltd. POWER TATAPOWER
49. Tata Steel Ltd. STEEL AND STEEL PRODUCTS TATASTEEL
50. Wipro Ltd. COMPUTERS – SOFTWARE WIPRO

Source: www.nseindia.com (accessed on 28/02/2011)

**CNX NIFTY Junior**

CNX Nifty Junior is the next rung of highly liquid stocks after S&P CNX Nifty. They are the most liquid stocks excluded from S&P Nifty Junior. It constitutes 11% of the free-float market capitalisation, as on 30 September, 2010.

**S&P CNX 500**

It disaggregated into 72 industry indices. It represents about 90% of the free float market capitalisation, and 87% of the total turnover recorded on NSE as on September 30, 2010.

**CNX MIDCAP 200**

The medium capitalised segment attracts a lot of investors, because of the high growth potential of this sector. It represents about 72% of the total market capitalisation of the Mid-Cap Universe. The Mid-Cap Universe is defined as stocks having average six months market capitalisation between ₹75 crore and ₹750 crore.

**CNX BANK NIFTY**

The banking industry is one of the fastest growing areas in a developing country like India. CNX BANK Index is an index constituted with most liquid and large capitalised Indian banking stocks. CNX BANK Nifty represents about 85% of the free-float market capitalisation of the banking sector, as on September 30, 2010.

**CNX IT**

(This index is the one that has more than 50% of its turnover in IT related activities.) CNX IT Index represents 90% of the free float market capitalisation of the IT sector, as on September 30, 2010.

Other indices are CNX FMCG, CNX PSE, CNX MNC, CNX Service Sector, S&P CNX Industry Indices (separate indices are carved out of S&P CNX 500 for 72 industries, representing each industry), Customised Indices to suit clients requirements, CNX Energy, CNX Pharma, CNX Infrastructure, CNX PSU Bank, CNX Realty, S&P CNX NIFTY Shariah/SNP CNX500 Shariah, and S&P ESG India.

**Volatility Index:** India VIX is a volatility index, based on the NIFTY Index Option prices. From the best bid-ask prices of NIFTY Options, a volatility figure (%) is calculated, which indicates the expected market volatility over the next 30 calendar days. It is usually known as fear index, as it indicates the fear of the investors. Usually, aggressive traders extensively use historical volatility for the creation of directional trading strategies. Whenever historical volatility reaches the previous historical levels, one should buy the asset, and when it reaches the lower boundaries, one has to sell the underlying asset’s price.

**Scrip Selection Criteria at NSE**

The indices of NSE are constructed by India Index Services & Products Ltd. (IISL), a joint venture established by NSE and CRISIL in 1998, for providing a variety of indices and index related
services to the Indian capital market. IISL uses the free-float market capitalisation method for computation of indices. Some of the important criteria for selection of a stock into indices are: liquidity and minimum floating stock.

(a) *Liquidity*: The stock should have enough liquidity. Liquidity, in this context, means a market where large orders can be executed without incurring a high transaction cost. The transaction cost referred here is not the fixed costs, typically incurred like brokerage, transaction charges, depository charges, etc., but is the cost attributable to lack of market liquidity. Liquidity in the market is created by buyers and sellers who look out for buying and selling opportunities. Lower liquidity results into higher transaction costs for the buyers and sellers. The stock should have an average impact cost of 0.50% or less during the last six months, and for 90% of the observations, a basket size of ₹2 crore.

The market liquidity is computed from the Electronic Order Book available with NSE. This style of market dispenses with market makers, and allows anyone in the market to execute orders against the best available counter orders. The market may thus be thought of as possessing liquidity in terms of outstanding orders, lying on the buy and sell side of the order book, which represent the intention to buy or sell. The advantage of this system is that, when a buyer or seller approaches the market with an intention to buy a particular stock, he can execute his buy order in the stock against such sell orders, which are already lying in the order book, and vice versa. An example of the Electronic Order Book maintained by NSE is shown in Table 3.5.

### Table 3.5  Example of Electronic Order Book at NSE

<table>
<thead>
<tr>
<th>Sr.No.</th>
<th>Quantity</th>
<th>Price</th>
<th>Quantity</th>
<th>Price</th>
<th>Sr. No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>1000</td>
<td>3.50</td>
<td>2000</td>
<td>4.00</td>
<td>5</td>
</tr>
<tr>
<td>2.</td>
<td>1000</td>
<td>3.40</td>
<td>1000</td>
<td>4.05</td>
<td>6</td>
</tr>
<tr>
<td>3.</td>
<td>2000</td>
<td>3.40</td>
<td>500</td>
<td>4.20</td>
<td>7</td>
</tr>
<tr>
<td>4.</td>
<td>1000</td>
<td>3.30</td>
<td>100</td>
<td>4.25</td>
<td>8</td>
</tr>
</tbody>
</table>

*Source: www.nseindia.com (accessed on 01/03/2011)*

*Computation of Impact Cost:* The impact cost can be computed from the following example:

### Order Book Details

<table>
<thead>
<tr>
<th>Buy Quantity</th>
<th>Buy Price</th>
<th>Sell Quantity</th>
<th>Sell Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>1000</td>
<td>100</td>
<td>1000</td>
<td>101</td>
</tr>
<tr>
<td>2000</td>
<td>99</td>
<td>1500</td>
<td>105</td>
</tr>
<tr>
<td>1000</td>
<td>98</td>
<td>1000</td>
<td>106</td>
</tr>
</tbody>
</table>

From the above information, the impact cost for buying 2000 shares can be computed as follows:

- **Order Quantity** = 2000
- Hence, the order will be executed as 1000 @ 101 and 1000 @ 105
- The ideal price = \((100 + 101)/2 = 100.50\)
- Actual buy price = \((1000 \times 101) + (1000 \times 105)/2000\)
  = \((101000 + 105000)/2000 = 206000/2000\)
  = 103
- Impact Cost for 2000 shares = \((103 - 100.50)/100.50 \times 100 = 2.49\%\)

(b) Companies eligible for inclusion in Nifty should have at least a 10% floating stock.

(c) Others: A company which comes out with initial public issue will be eligible for inclusion in the Nifty, if it fulfills the normal eligible criteria.
REMOVAL OF A STOCK FROM INDICES

India Index Services Ltd. (IISL) has constituted an Index Policy Committee for managing all the indices at NSE. The Index Management Sub-committee, under the Index Policy Committee, takes decisions with regard to additions/deletions of any company in the indices. Sometimes, stocks can be replaced with new stocks if the previous index constituent delists from the exchange, if there are compulsory changes like corporate actions, etc., and when a better candidate is available in the replacement pool. The index is reviewed every six months, and a six weeks notice is given to the market before making any changes in the index.

LEARNING OUTCOME 3.5

Financial market regulation is assuming greater importance across the world, especially after the recent global financial crisis. The G20 summit held in Seoul in Korea in November 11–12, 2010 also had decided to tighten the financial regulation and supervision to save economies from the vagaries of financial crisis. Capital market, being the barometer of economic progress, requires closer supervision and regulations in order to protect the interest of investors and retain their confidence in the system.

GENESIS OF CAPITAL MARKET REGULATION

Capital market is the system from which the investor can acquire financial assets for investment purposes. Capital market securities are bought and sold through stock exchanges. Traditionally, the buying and selling transactions took place at the trading floor of stock exchanges following the open outcry system. Under this system, the buyers and sellers assembled on the trading floor, and the prices were loudly announced. Once the prices were matched, the buyer and seller approached the stock exchange office and settled the transactions. The system was a crude method and had several defects.

- The buyer and seller did not know each other, and hence there was no guarantee that each party would meet their obligations, leading to potential default risk.
- The stock exchange did not buy or sell. They acted as only a meeting place, and hence did not have much control over the buyers and sellers.
- The prices could be manipulated to either side leading to heavy losses.
- The traders could enter into speculative practices for short-term profits.
- There was no risk management system; as such there were many instances of failures by the counterparty resulting into heavy losses to the other party; sometimes leading to a closure of business.
- Companies could easily manipulate the prices of their scrips through surrogate trades.
- Managerial personnel in the company, who had access to critical information, used this for making profit by trading in the company shares.
- The management control of a company could easily be captured through large-scale acquisitions using market mechanism.
- Companies could easily fleece investors by floating paper companies and vanishing after collecting money from people.

The most affected people were small investors who were afraid of entering into capital market transactions. As a first attempt to bring in some control over the capital market operations, and also regulate mobilisation of resources through public issue of shares, the Securities (Contract) Regulation (SCR) Act was passed in 1956. While the Companies Act 1956 contained provisions relating to issue of shares, debentures, etc., by corporate entities, the SCR Act addressed the issue of regulation of securities. As per the provisions of SCRA, the public issue of shares required permission from the Controller of Capital Issues. However, there was no proper machinery to control trading malpractices. In the Budget Speech 1987–88, the then Finance Minister had stressed the need for a machinery to regulate and supervise the capital market operations in the country.
He had promised the House that a Board with adequate statutory powers would be constituted to undertake this task. Consequently, the Securities and Exchange Board of India was constituted to regulate and supervise the capital market in the country. But, it took another 4 years to empower the Board with statutory powers. It was in 1992 that the Securities and Exchange Board of India (SEBI) Act was passed in the parliament. The Act transferred all the powers of the Controller of Capital Issues to SEBI, and made it a statutorily empowered regulator and supervisor of capital market.

Capital market is a part of financial market and has connections with other institutions delivering financial services. Banking is one of the major sectors which is closely connected with the capital market. The control and supervision of banks is exercised by the Reserve Bank of India. Another financial service connected with the capital market is the insurance service. Insurance companies are launching policies under unit-linked schemes where the policies are attached to a fund. The premium collected is pooled in a fund which is invested in capital market instruments or debt instruments, and the return is shared with the policy holder. For example, LICs Market Plus, Money plus, etc., come under this category. Hence, regulation of insurance services is also essential, which is now performed by the Insurance Regulatory and Development Authority of India. Other regulators which are connected with the capital market are Pension Fund Regulatory and Development Authority, Forward Market Commission, Financial Intelligence Unit of India, and Ministry of Corporate Affairs and Ministry of Finance.

**SEcurities AND EXChANGe BOARd OF India**

The Securities and Exchange Board of India (SEBI) was established in 1988 to undertake the regulation and supervision of capital market. But, the statutory powers were conferred on SEBI only in 1992, after passing the Securities and Exchange Board of India Act.

**Objectives**

The objectives of constituting SEBI are:

- Regulate the business in stock exchanges and any other securities market.
- Register and regulate the work of brokers, sub-brokers, transfer agents, bankers to issue, underwriters, portfolio managers, investment managers, or any other bodies associated with the securities market in any manner.
- Register and regulate Mutual Funds.
- Prohibit fraudulent trade practices relating to securities market.
- Promote investor education.
- Prohibit insider trade.
- Regulate substantial acquisition of shares and takeover of companies, and perform any other function as called upon by the Central Government.

**Functions**

Section 11 (1) of the Securities Exchange Board of India Act broadly requires SEBI to protect the interests of investors in securities, and to promote the development of, and to regulate the securities market, by such measures as it thinks fit. More specifically, the Act requires SEBI to:

1. Regulate the business in stock exchanges and any other securities markets
2. Register and regulate the working of stock brokers, sub-brokers, transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers, and such other intermediaries who may be associated with securities markets in any manner
3. Register and regulate the working of venture capital funds and collective investment schemes, including mutual funds
4. Promote and regulate self-regulatory organisations
5. Prohibit fraudulent and unfair trade practices relating to securities markets
6. Promote investors’ education and training of intermediaries of securities markets
7. Prohibit insider trading in securities
8. Regulate substantial acquisition of shares and take-over of companies
9. Call for information from, undertake inspection, conduct inquiries and audits of the stock exchanges, mutual funds, other persons associated with the securities market intermediaries and self-regulatory organisations in the securities market
10. Perform such functions and exercise such powers under the provisions of the Securities Contracts (Regulation) Act, 1956 (42 of 1956), as may be delegated to it by the Central Government
11. Levy fees or other charges for carrying out the purposes of the functions of SEBI
12. Conduct research necessary for carrying out the above functions

Organisation

SEBI is governed by a Board consisting of the following members:
(a) a Chairman;
(b) two members from amongst the officials of the Central Government dealing with Finance;
(c) one member from amongst the officials of the Reserve Bank, and four other members of whom at least three shall be the whole-time members,
(d) Five other members of whom at least three shall be the whole-time members.

The general superintendence, direction, and the management of the affairs of SEBI are vested in the Board of members, which may exercise all powers, and do all acts and things which may be exercised or done by the Board.

The Headquarters of SEBI is in Mumbai, and it has regional offices at Delhi, Kolkata, Chennai, and Ahmedabad.

Market Regulation Process

The Act confers on SEBI the same powers vested in a Civil Court under the Code of Civil Procedures, 1908 (5 of 1908), while trying a suit in respect of the discovery and production of books of account and other documents, summoning and enforcing the attendance of persons and examining them on oath; inspection of any books, registers and other documents of any person operating in securities markets, inspection of any book, or register, or other document or record of the companies issuing securities, or the securities which are traded in securities markets, and issuing commissions for the examination of witnesses or documents.

The Act empowers SEBI to impose the following penalties on those violating the provisions of the Act or the Code of Conduct issued by SEBI under the provisions of the Act:
(a) Suspend the trading of any security in a recognised stock exchange;
(b) Restrain persons from accessing the securities market, and prohibit any person associated with securities market to buy, sell or deal in securities;
(c) Suspend any office-bearer of any stock exchange or self-regulatory organisation from holding such a position;
(d) Impound and retain the proceeds or securities in respect of any transaction which is under investigation;
(e) Attach, one or more bank account or accounts (in which transactions relating to the proceeds actually involved in violation are entered) of any intermediary or any person associated with the securities market in any manner involved in violation of any of the provisions of this Act, or the rules or the regulations made there, subject to prior approval by the Judicial Magistrate of the first class having jurisdiction;
(f) Direct any intermediary or any person associated with the securities market in any manner not to dispose of, or alienate, an asset forming part of any transaction which is under investigation;
(g) Regulate or prohibit issue of prospectus, offer document, or advertisement soliciting money for issue of securities;
(h) Issue directions to the intermediaries or participants in the security markets in the interest of the investors, and to ensure orderly development of securities market;
(i) Prevent the affairs of any intermediary or other persons conducting business in a manner detrimental to the interest of investors;

(j) Secure the proper management of any such intermediary, or person associated with securities market;

(k) Issue directions to any company in the interest of investors in securities and security markets.

**SEBI’s Role in IPO**

A company coming out with an IPO has to submit its draft prospectus to SEBI before it is submitted to the Registrar of Companies. SEBI is empowered to make necessary corrections/modifications in the draft prospectus. It has issued guidelines with regard to the procedure to be followed in IPO. They have also issued guidelines for merchant bankers, Registrars and Transfer Agents, underwriters, advertisers, printers, and other participants in the primary market. Besides, they have also issued guidelines on depository participants, IPO grading, and so on. The issuing company is required to comply with the requirements as per these guidelines. SEBI also monitors the IPO by calling for periodical reports. After closing the issue, the issuing company also has to submit the prescribed reports to SEBI. SEBI’s intervention in the IPO market has brought better control over IPO issues in India. Some of the initiatives in regulating the primary market are discussed below.

**Entry Norms**

SEBI Disclosure and Investor Protection Guidelines issued in 2000, and updated up to July 2009, prescribes the following entry norms for an unlisted company entering the capital market with a public issue of shares. The norms are listed below.

1. The company should have net tangible assets of at least ₹3 crore in each of the preceding 3 full years (of 12 months each), of which not more than 50% are held in monetary assets.
2. The company should have a track record of distributable profits in terms of Section 205 of the Companies Act, 1956, for at least three (3) out of immediately preceding five (5) years.
3. The company should have a net worth of at least ₹1 crore in each of the preceding 3 full years (of 12 months each).
4. In case the company had changed its name within the last one year, at least 50% of the revenue for the preceding 1 full year should have been earned by the company from the activity suggested by the new name.
5. The aggregate of the proposed issue, and all previous issues made in the same financial year in terms of size (i.e., offer through offer document + firm allotment + promoters’ contribution through the offer document), should not exceed five (5) times its pre-issue net worth as per the audited balance sheet of the last financial year.
6. The number of prospective allottees should not be less than one thousand (1000).

SEBI permits an unlisted company which does not comply with the above requirements, to issue shares to the public if it meets the following requirements.

(a) The issue is made through the book-building process, with at least (50% of net offer to public) being allotted to the Qualified Institutional Buyers (QIBs), failing which the full subscription monies shall be refunded; or

   The “project” has at least 15% participation by Financial Institutions/Scheduled Commercial Banks, of which at least 10% come from the appraiser(s). In addition to this, at least 10% of the issue size shall be allotted to QIBs, failing which the full subscription monies shall be refunded.

(b) The minimum post issue face value capital of the company should be ₹10 crore; or there should be a compulsory market making for at least 2 years from the date of listing of the shares subject to compliance with the following conditions:

   (i) Market makers undertake to offer buy and sell quotes for a minimum depth of 300 shares;

   (ii) Market makers undertake to ensure that the bid-ask spread (difference between quotations for sale and purchase) for their quotes shall not at any time exceed 10%;

   (iii) Market makers on each of such stock exchanges, as on the date of allotment of securities, should maintain inventories of at least 5% of the proposed issue of the company.
IPO Grading

SEBI guidelines make it mandatory on the part of an unlisted company, coming out with public issue of shares, to obtain grading from at least one credit rating agency. Rating agencies like CRISIL, CARE, etc., will assess the company’s fundamentals which are provided by the issuer or from the source it considers reliable, and will rate the IPO on a five-point scale. Companies which come under the rating of 1/5 indicate poor fundamentals, and the companies rated with 5/5 indicate strong fundamentals and vice versa. IPO Grading is calculated by the companies using different parameters, and they are usually applicable for long-term investments. The IPO grading companies will analyse the: (a) business prospects of the industry and Company prospects, (b) financial prospects, and (c) management quality and their corporate governance. The grading so obtained, along with the rationale/description furnished by the credit rating agency (ies) for each of the grades obtained, should be disclosed on the Prospectus (in case of fixed price issue) or Red Herring Prospectus (in case of book built issue). The expenses incurred for grading IPO have to be borne by the unlisted company obtaining grading for IPO.

Pricing of IPO

SEBI allows free pricing of securities issued by an unlisted company. Listed and unlisted companies while issuing equity shares, or securities convertible on a future date into equity shares, may issue such securities to applicants in the firm allotment category at a price different from the price at which the net offer to the public is made, provided that the price at which the security is being offered to the applicants in firm allotment category is higher than the price at which securities are offered to the public. SEBI has also permitted issuer companies to mention a price band of 20% (cap in the price band should not be more than 20% of the floor price) in the offer document filed with the Board, and the actual price can be determined at a later date before filing of the offer document with ROCs.

In case of initial public offer by an unlisted company, if the issue price is ₹500 or more, the issuer company enjoys a discretion to fix the face value below ₹10 per share, subject to the condition that the face value shall in no case be less than Re.1 per share, and if issue price is less than ₹500 per share, the face value shall be ₹10 per share. SEBI has required the existing companies, having a face value of shares of ₹100 or ₹10, to comply with the above guidelines, either by splitting or consolidating the shares. The guidelines also require the companies to comply with the following norms:

1. The shares shall not be issued in the denomination of decimal of a rupee;
2. The denomination of the existing shares shall not be altered to a denomination of decimal of a rupee;
3. At any given time, there shall be only one denomination for the shares of the company;
4. The companies seeking to change the standard denomination may do so after amending the Memorandum and Articles of Association, if required;
5. The company shall adhere to the disclosure and accounting norms specified by SEBI from time to time.

Promoters’ Contribution

The promoters’ contribution in an unlisted company going for public issue of shares should be not less than 20 per cent of the post issue capital. In case of listed companies also, the minimum promoters’ contribution is 20 per cent of the post issue capital. Promoters are required to bring in the full amount of the promoters’ contribution, including a premium, at least one day prior to the issue opening date. However, if the promoters’ contribution is more than ₹100 crore, promoters are permitted to bring in ₹100 crore prior to the opening date of the issue, and they can bring in the balance amount on pro-rata basis, before the calls are made to the public. The requirement of promoters’ contribution is not applicable in the following cases:

(a) Companies which have been listed on a stock exchange for at least 3 years, and have a track record of dividend payment for at least 3 immediately preceding years;
(b) Companies where no identifiable promoter or promoter group exists;
(c) In case of rights issue.

The promoters’ contribution is subject to a lock in a period of 3 years from the date of allotment in the public issue of shares, and the last date would be 3 years from the date of the commencement
of commercial production or date of allotment in the public issue, whichever is later. During the
lock in period, the shares cannot be sold. But, such shares can be pledged with a bank or financial
institution as collateral security for procuring a loan. These shares are not transferable during the
lock in period, and the share certificates should carry the inscription ‘non-transferable’ along with
the duration of lock in period. However, the shares can be transferred among the promoter group,
or to a new promoter, or persons in control of the company, subject to continuance of the lock in
period for the remaining period in the hands of the transferee.

Disclosure
An unlisted company, making public issue of shares, is now required to place the draft prospectus
as a public document. SEBI has prescribed a format for drafting prospectus. The draft prospectus
should contain certain essential disclosures such as details of promoters and the project, names of
merchant bankers and underwriters, risk factors, financial projections, IPO grading together with
the rationale behind the grading as given by the rating agencies, and so on. The draft prospectus
has now become more transparent and accountable. As per the recommendations of CB Bhave
Committee, SEBI has required the listed companies to file quarterly unaudited financial results
with the stock exchanges where the shares have been listed.

Book Building
SEBI has allowed issuing companies to opt for 75 per cent of the issue through book building, and
gives 25 per cent to the public. This minimum 25 per cent of the issue size has to be separately
identified as ‘net offer to public’. Underwriting is mandatory for the ‘net offer to public’ portion.
An issuing company opting for book building should appoint one of the lead managers as Book
Runner. The company has to file the draft prospectus with SEBI showing the price band and a copy
of the draft prospectus among the book runner and institutional buyers. A company can also issue
shares through 100 per cent book building process, in which case the condition with regard to the
25 per cent ‘net offer to the public’ stipulation should be complied with. These shares should be
made available to the public at the price fixed through the book building process. The introduction
of book building process in Indian capital market enabled the issuing companies to obtain the best
price for their shares.

Allocation of Shares
In order to ensure that small investors also get an opportunity to buy a stake in a company, SEBI
has a stipulated minimum allotment to the general public. Where the issuing company has routed
the issue through 100 per cent book building, the allocation has to be made in the following
manner:
(a) Not less than 35% of the net offer to retail individual investors;
(b) Not less than 15% of the net offer to the public to non-institutional investors, i.e., investors
other than retail individual investors and Qualified Institutional Buyers;
(c) Not more than 50% of the net offer to the public shall be available for allocation to Qualified
Institutional Buyers.

If the company has issued the shares through 75 per cent book building, and 25 per cent at the
price determined by book building, the allocation should be as follows:
(a) In the book built portion, not less than 25% of the net offer to the public should be allotted
to non-Qualified Institutional Buyers, and not more than 50% of the net offer to the public
should be allotted to Qualified Institutional Buyers.
(b) The balance 25% of the net offer to the public, offered at a price determined through
book building, should be allotted only to retail individual investors who have either not
participated or have not received any allocation, in the book built portion.

The minimum number of allottees is prescribed as 1000. The allotment process has to be
completed within 15 days from the date of closure, failing which, interest at the rate of 15 per
cent has to be paid for the delayed period. In case of over oversubscription, the allotment has
to be decided on pro-rata basis by a panel consisting of the lead merchant banker, the executive
director/managing director of the designated stock exchange, a public representative (wherever
applicable), and the Registrar to the issue. Where the issue is underwritten, 60 days are allowed to
complete the devolvement portion and allot the shares. The supervision of allotment by SEBI has made the process more transparent and free from malpractices and manipulations.

**Online IPO through Stock Exchanges (e-IPO)**

SEBI has now introduced a system by which companies can issue IPOs through stock exchanges for online subscription. For this purpose, the issuing company has to enter into a necessary agreement with the stock exchanges having the requisite system for online offer of shares. The process and procedures, prescribed for the offline offer, are applicable for online IPOs also. In the case of online IPOs, the brokers are required to collect the client registration duly filled up and signed by the applicant before placing order in the system, in order to comply with the KYC norms. The broker is also required to collect 100 per cent value of the order placed as margin money, which has to be credited to an escrow account opened for this purpose with the clearing house bank. The subscriber has the option of either receiving the shares in the demat account, or in the form of a physical certificate.

**Application Supported by Blocked Accounts (ASBA)**

SEBI had introduced the ASBA process for IPOs in 2008. Under this method, subscribers can request their banks to block the required amount in their bank account, and forward the application to the company. For this purpose, the application for shares has to be submitted in ASBA format which can be downloaded from the websites of NSE, BSE, or SEBI. The list of banks and their branches, where the ASBA facility is available, is published on the website of SEBI.

**SEBI’s Role in Secondary Market Operations**

Secondary market operations take place through market intermediaries such as stock exchanges, brokers, sub-brokers, and so on. Only stock exchanges recognised by SEBI can participate in the secondary market operations. In order to streamline the secondary market operations and to protect the interest of investors, SEBI has introduced various measures.

**Governance of Stock Exchanges**

The governance of stock exchanges has now been streamlined by SEBI by issuing guidelines on stock exchanges and their administration through their Master Circular dated December 31, 2010. All recognised stock exchanges have now been allotted with a code number by SEBI. Small stock exchanges are now permitted to float a subsidiary company to acquire trading membership in other stock exchanges, subject to compliance of the guidelines issued by SEBI in this respect. The governing board of stock exchanges is now reconstituted with one-fourth of directors from trading members, one-fourth of the strength representing public interest directors, and the balance directors elected from the shareholders. The directors, other than the public interest directors, are to be elected from the shareholders. Shareholder members should be elected from members other than trading members or associate of trading members. No director shall continue in the position for more than two terms. SEBI has also a prescribed code of conduct for the directors of the governing board.

**Trading Infrastructure Facilities**

In 2008, SEBI had laid down the groundwork to allow small and medium enterprises to list on SME Exchange. Under this scheme, Small and Medium Enterprises (SME) are permitted to set up stock exchanges subject to compliance with the following guidelines:

(i) Corporate and demutualised entities should be compliant with the requirements of maintaining public shareholding, and the shareholding restrictions prescribed by the Securities Contract Regulations, 2006.

(ii) The entity’s balance sheet net worth should be at least ₹100 crore:

(iii) They should have nation wide trading terminals and an online screen-based trading system, a suitable Business Continuity Plan, including a disaster recovery site.

(iv) These entities have an online surveillance capability which monitors positions, prices, and volumes in real time so as to check market manipulation.

(v) They should have adequate arbitration and investor grievances redressal mechanism operative from all the four regions of the country.
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(vi) They should have adequate inspection capability.
(vii) Also, they should have the same risk management system and surveillance system, as are
required for cash market segment of a recognised stock exchange.
(viii) Information about trades, quantities, and quotes should be disseminated by the recognised
stock exchange in real time to at least two information vending networks, which are
accessible to investors in the country.
(ix) The trading system of the stock exchange may be quote driven, or a hybrid of quote driven,
and order driven. The settlement system in the stock exchange should be the same as that
of the cash market of a recognised stock exchange.
(x) The clearing function of the stock exchange should be performed by a clearing corporation/
clearing house.
(xi) The minimum lot size for trading on the stock exchange should be one lakh rupees.
SEBI has made market making compulsory for the scrips traded in these stock exchanges. Besides,
the stock exchanges are required to provide online trading facilities to the investors. According
to the latest estimates, exchanges can roll out the SME exchange in the second-half of year 2011.

Trading Hours
With a view to align Indian markets with the international markets, to facilitate assimilation of any
economic information that may flow in from other global markets, SEBI permitted the stock
exchanges to set their trading hours (in the cash and derivatives segments), subject to the condition
that the trading hours are between 9 am and 5 pm. Accordingly, BSE and NSE changed their
trading time from 9.55 am – 3.30 pm to 9.00 am – 3.30 pm.

Margin Trading
Brokers extend financial support by way of margin for trading in stocks. According to SEBI
guidelines, margin trading financing restricts broking firms to lend more than 50 per cent of the
value of securities purchased by their customers. Besides, margin financing can be extended to
only a maximum of 500 stocks identified by SEBI.

Clearing and Settlement System
In April, 2002, SEBI introduced T+3 rolling settlement in the Indian capital market. The rolling
settlement was shortened to T+2 with effect from April 1, 2003. All trading transactions should be
cleared and settled only through the centralised clearing mechanism. National Securities Clearance
Corporation Ltd. and Clearing Corporation of India Ltd. are providing clearing and settlement of
trading transactions, which took place at the stock exchanges. The stock exchanges are now
required to provide the following facilities desirable for further smoothing clearing and settlement
process.

(a) Facility of online confirmation of trades by custodians.
(b) System to capture the details of the client’s depository account and bank account.
(c) System for online transmission of the client-wise pay-in obligation to the depository, so
that the depository in turn could download the security pay-in instructions to depository
participants, in respect to the investor maintaining an account with them.
(d) System wherein the pay-out files could be sent to the clearing banks with a request for
online credit to the bank accounts of the clients.
(e) The stock exchanges would support development of front end software for brokers to map
the Client ID through abbreviated keys to facilitate faster order entry for inserting the
unique client code speedily.

However, these are not preconditions for the introduction of T + 2 rolling settlement. As regards
auction settlement, SEBI has prescribed that the auction for the first settlement shall be conducted
on the same day, and that the second settlement shall be conducted on the next day, along with the
shortages/auction of that day. The settlement of that transaction shall take place on the next day.
SEBI has also stipulated norms for determining close out prices.

Wholesale and Debt Market
In order to facilitate trading in debt instrument on the floors of stock exchanges, SEBI issued
instructions to the depositories, viz. CDSL and NSDL to admit debt instruments for
dematerialisation. Accordingly, the debt instruments like corporate bonds, government securities, etc., are traded on the floors of NSE and BSE. In order to facilitate the trading in debt instruments, both the exchanges have carved out separate Wholesale Debt Market (WDM) segment, and are allowing screen-based trading in the debt instruments. SEBI has made the rating of debt instruments by a recognised credit rating agency mandatory for admitting them in stock exchanges for trading. FIIs are also permitted to invest in debt instruments.

**Price Stabilisation**

With a view to check undesirable price movements and speculative activities, SEBI has initiated various measures. SEBI has required stock exchanges to monitor the price movements and apply circuit breakers wherever the prices cross the prescribed upper/lower bands. In order to facilitate stock exchanges to take effective steps, SEBI has prescribed price bands. In order to enable better price discovery and to maximise the amount which could be raised by an issuer, SEBI introduced the pure auction method in further public offerings by listed entities. In this method, the QIB bidders are free to bid at any price above the floor price. The bidder who bids at the highest price is allotted the number of securities that he has bid for, and then the bidder who has bid at the second highest price, and so on, until all the specified securities on offer are exhausted. Allotment is made on price priority basis and at differential prices. Allotment to retail individual investors, non-institutional investors, and employees of the issuer is made proportionately at the floor price. The measures initiated by SEBI to bring price stabilisation are discussed in detail below under the heading – Surveillance.

**Delisting**

In order to protect the interest of investors, SEBI has prescribed strict norms for delisting of securities. Accordingly, securities listed in a stock exchange can be delisted either voluntarily by the company or compulsorily by the stock exchange.

**Brokers and Sub-brokers**

Registration of stock brokers and sub-brokers with SEBI is now mandatory. The brokers and sub-brokers are required to comply with the guidelines issued by SEBI, failing which SEBI is empowered to impose a penalty. In order to enable the investors to access the stock markets, SEBI introduced the concept of Authorised Persons (AP). AP appointed by a stock broker can access the trading platform of a stock exchange as an agent of a stock broker. A stock broker may appoint one or more APs after obtaining prior approval of the stock exchange concerned for each such person. The approval, as well as the appointment, shall be for specific segments of the exchange.

**Opening of Trading Account**

SEBI has issued detailed guidelines with regard to the opening of a trading account with brokers and sub-brokers. These guidelines are issued as a part of its drive against money laundering. Accordingly, it is now mandatory that opening of accounts with brokers and sub-brokers requires compliance with KYC norms.

**KYC Norms**

Brokers in securities market are obliged to collect detailed data of their clients. SEBI made it mandatory to brokers to know their client norms. The regulation has been put in place to ensure that there is no dummy client. With the introduction of the anti-money laundering law in the financial service sector in the country, the KYC norms have been made more stringent, which necessitate the broking firms to obtain solid identity and address proof from the clients, verify and confirm correctness before trading and demat accounts are opened.

**PAN for Trading in Securities**

It is mandatory that doing business of shares must have PAN (Permanent Account Number). The market regulator also made furnishing of PAN details mandatory in case of deletion of name of the deceased shareholder, where the shares are held by two or more shareholders. In April, 2007, SEBI had made PAN mandatory for all securities market transactions.
In order to ensure that the brokers, sub-brokers and trading members comply with the rules, regulations and guidelines issued by SEBI, they conduct periodical inspections of the books of accounts and records of these intermediaries. According to the Annual Report for 2009–10 of SEBI, 34 inspections were conducted on the stock exchanges and 2 inspections on sub-brokers. These inspections revealed some serious irregularities in the operations of these intermediaries. These irregularities are classified under the following heads:

(i) Failure in complying with certain KYC norms
(ii) Failure in complying with the guidelines on contract notes
(iii) Deficiency in services to investors, and absence of an effective grievance redressal mechanism
(iv) Objectionable practices in funding and securities activities
(v) Deficiency in management of trading terminals
(vi) Failure in maintaining proper books of accounts and records
(vii) Non-compliance with provisions relating to spot/negotiated deals
(viii) Manipulative practices like circular trading, creating false markets, securing financing transactions, misusing exchange facilities
(ix) Non-submission/delayed submission of audit reports
(x) Dealing with unregistered sub-brokers
(xi) Undertaking business other than trading in securities
(xii) Default in making payment of fees to SEBI and stock exchanges
(xiii) Changing status or constitution without the prior approval from SEBI
(xiv) Violations of provisions relating to advertisements/internet based trading
(xv) Non-appointment of compliance officer
(xvi) Non-compliance with trading restrictions imposed by stock exchanges
(xvii) Trading in unlisted shares
(xviii) Failure in reporting off-the-floor trading transactions
(xix) Failure to inform the cancelation of sub-brokeship to clients
(xx) Absence of policy on internal controls, employees’ insider trading, prevention of money laundering, and so on
(xxii) Violation of norms with regard to delivery vs payment.

In view of these irregularities, SEBI has now advised the stock exchanges and clearing corporations to carry out annual inspection of all active members in various segments and confirm the following:

(a) Compliance with provisions of all relevant Acts, Rules and Regulations.
(b) Efficiency of the grievance redressal mechanism.

SEBI has required the stock exchanges/clearing corporations to initiate follow-up, remedial, penal actions on the findings in the report within 6 months from the conclusion of audit.

**Insider Trading**

SEBI has taken various measures to prevent insider trading, price rigging, and market manipulations. SEBI conducts periodical investigations to prevent market manipulations and insider trading. SEBI has taken initiatives against insider trading as well. The Finance Minister informed the Parliament that SEBI had initiated action in 39 cases of insider trading within a period of two years as per a report published in *The Indian Express*. According to the Annual Report of SEBI for the period 2009–10, 46 cases of market manipulations and price rigging have been detected through investigations, as against 62 in 2008–09. The number of insider trading detected comes to 10 in 2009–10, as against 12 in 2008–09. The Prohibition of Insider Trading Regulations issued by SEBI in 1992, and amended in 1992, and 2008, has prohibited any activity including communicating, counseling, or dealing in securities of a listed company by an insider in the company. The Regulations defines an insider as follows:

(i) Any person who is, or was, connected with the company or is deemed to have been connected with the company, and who is reasonably expected to have access to unpublished price sensitive information in respect to securities of a company, or
(ii) Who has received, or has had access, to such unpublished price sensitive information.
Accordingly, it has now become mandatory on the part of every listed company to formulate policies on disclosures and internal procedures for prevention of insider trading. The regulations have also made it mandatory on the part of directors, officers, and substantial shareholders in a listed company to disclose their interest or holding in the company to SEBI, and all the stock exchanges where the shares have been listed within two working days, from the date of joining the company. SEBI has circulated a model code of conduct for compliance by the listed companies. Section 15 G of Securities and Exchange Board of India Act empowers SEBI to impose a penalty on the insider who violates the provision of the Act, as also the Rules and Regulations on Prohibition of Insider Trading in Listed Companies, with a fine of ₹25 crore or three times of the profit made out of insider trading, whichever is higher.

**Key Terms**

**Index:** An index is a representative number, constructed using the value of selected number of components which can be shares, commodities, and so on.

**Market capitalisation:** It is the product of number of outstanding shares of the company and current share price.

**Free float shares:** Such shares of the company which can easily come in the market for trading i.e., shares held by the investors other than directors, promoters and their relatives.

**BSE SENSEX:** It is flagship index of BSE comprising 30 shares listed on BSE.

**NIFTY:** It is flagship index of NSE comprising 50 shares listed on NSE.

**Sectorial indices:** Indices calculated using shares of a specific industrial sector like Auto Index, IT Index, and so on.

**Liquidity:** It means large orders can be executed in the share without incurring a high transaction cost or paying high price than competitive price.

**SCRA Act:** This act addresses the issues relating to the regulation of new issue market and secondary market.

**IPO Grading:** Grading of the IPO by rating agencies from the viewpoint of its sustainability and solvency.

**Online IPO:** SEBI has now introduced a system by which companies can issue IPOs through stock exchange online subscription.

**In Review**

Dow Jones Industrial Average (DJIA) is one of the oldest continuously quoted stock indices, which is being computed since 1896. This is based on 30 stocks, and it is calculated on a price weighted method. In India, there are two prominent stock indices i.e., BSE SENSEX and S&P CNX NIFTY. Apart from these two, there are several other indices calculated and used for different purpose. BSE SENSEX comprises 30 shares, whereas S&P CNX NIFTY comprises 50 shares; and both are calculated using market capitalisation weights.

In the capital market, activities that affect investors the most are the ones involving small investors, therefore, there should be an effective mechanism to safeguard the interest of small investors. Safeguarding small investors is one of the objectives of SEBI (Securities and Exchange Rate of India). SEBI was established in the year 1992 to regulate new issue market and secondary market—stock exchanges including different intermediaries of these markets. It regulates stock exchanges, stock brokers, sub-brokers, aims to prohibit insider trading, regulates substantial acquisition by means of code of conduct for takeover and merger.
Multiple-Choice Questions

1. BSE Sensex consists of ________ shares.
   (a) 50  (b) 500  (c) 30  (d) 300

2. S&P CNX Nifty consists of ________ shares.
   (a) 50  (b) 500  (c) 30  (d) 300

3. Which of the following is an India stock index?
   (a) S&P CNX NIFTY  (b) NASDAQ  (c) S&P 500  (d) None of these

4. Which of the following is the basic criterion for including a share in index by NSE?
   (a) Liquidity  (b) Minimum floating stock  (c) Both of these  (d) None of these

5. Which of the following is the qualitative criteria adopted by BSE for selecting shares as
   index constituent?
   (a) Track record  (b) Trading history  (c) Revenue  (d) None of these

6. Which of the following not the quantitative criteria adopted by BSE for selecting shares as
   index constituent?
   (a) Industry representation  (b) Trading history  (c) Revenue  (d) None of these

7. India VIX is:
   (a) Value index  (b) Vision index  (c) Volatility index  (d) None of these

8. Entry norm for a company for public issue of shares is:
   (a) Minimum net tangible assets of ₹3 crore
   (b) Minimum net worth of ₹1 crore
   (c) Number of prospective allottees should not be less than 1000.
   (d) All of these

9. Which of the following criterion is used for IPO grading?
   (a) Business prospects  (b) Financial prospects  (c) Management quality  (d) All of these

10. SEBI allows ________ pricing of IPOs.
    (a) Regulated  (b) Controlled  (c) Free  (d) None of these

Key to MCQs

1. (c)  2. (a)  3. (a)  4. (c)  5. (a)  6. (a)  7. (c)  8. (a)  9. (p)  10. (a)

Concept Questions

1. Explain the concept of stock market index. How it acts as a barometer of the economy?
2. What purpose is served by the index of stock market?
3. Write short note on ‘free float market capitalisation’.
4. Discuss different methodologies for calculating stock indices.
5. Write a note on BSE SENSEX and S&P CNX NIFTY.
6. What is ‘price weighted index’?
7. Briefly explain the functions of SEBI. Are these functions sufficient to regulate new issue market and secondary market?
8. Discuss how SEBI regulates IPOs.