MARKET MADNESS

Breaking the Brokers

Pressure is on India's securities watchdog to modernize the country's exchanges and toughen up regulations.

By Jon Thorn

February 28 should have been the start of the best post-budget stock market rally in Indian history, but it turned out to be the worst rout. Over the past two months, India has seen collapsing share prices, a liquidity meltdown, insolvent banks and brokers, arrests and firings, at least three suicides, and hundreds of millions of dollars of bank deposits and broker assets wiped out. Market liquidity has plunged 80%; some stocks have fallen by 40%, some of which were already down by 80% from the previous year.

What exactly went so wrong, and where do we go from here? The answer to the first question lies in the "business as usual" practices on Indian stock markets. The answer to the second should become clear within the next two or three months.

The Union Budget marked the first clear and sustainable evidence that the Indian government had finally become serious about the economy and the market. The budget included a 5% cut in personal income tax rates, a 3.5% reduction in corporate rates, a lower fiscal deficit target, power charges enforcement and privatization. The dividend tax was reduced to 10% from 20%. The Reserve Bank of India had cut interest rates twice by 50 basis points. In response to all this the market rose 4.4%.

But the optimism turned to fear and panic, and despair for some, when on March 2 a group of broker-directors of the Bombay Stock Exchange joined forces to attack the investment positions of Ketan Parekh. Mr. Parekh was the market's biggest bull. His investing in India media, software and telecoms firms during the global rise in technology stocks earned him a fortune and the nickname "Bombay Bull". Indeed, Mr. Parekh became so influential that many analysts enthusiastically tracked what became known as the "K-10 Index" – his top 10 investments at any given time. The "KP effect" was when the price of such stocks moved up.

The broker-owned BSE has a tradition of bull and bear speculators who attempt to manipulate stock prices by making hundreds of trades at successively higher or lower prices, then exiting with a profit. But much of this is done on borrowed money, a practice that inflates trading volumes and leaves the markets open to large and unexpected shifts. Under the nations *badla* system, speculators pay interest, or badla, rates of 20% or more to intermediaries to finance their trades.

But only 10% a trades are settled within the one-week settlement period. In practice, therefore, many speculators postpone settling their trades for as long as the badla intermediary permits. Brokers can make money financing their clients' badla debt by borrowing from an intermediary and keeping the spread between the two rates, plus a sakes commission. This helped to fuel the stellar rise of Mr. Parekh during the technology boom.

Mr. Parekh's problems began with the decline in technology shares and worsened after he and his clients faced huge margin calls on stocks that in some cases were down 90% from their previous highs. Every week demanded another check to cover the interest on those positions. By allegedly accessing privileged information through the BSE's surveillance department, a coalition of bears moved to squeeze Mr. Parekh in a bid to stem losses from what they believed would be a negative market reaction to the budget.

Shockingly, one of the first of the bears to be implicated in the conspiracy was BSE President Anand Rathi, who resigned March 8. Shortly afterwards, four finance companies associated with him were ordered by the Securities and Exchange Board of India to suspend their operations. In the meantime, hot money fleeing the market pummeled Mr. Parekh's K-10 Index, and any stock suspected of an association. Market players who had ridden on Mr. Parekh's coattails were forced to sell almost anything to meet their ever-increasing interest payments to maintain their long positions.

For his part, Mr. Parekh finally stopped paying on his widening margin calls and was arrested March 29 on charges of conspiracy, breach of trust and fraud. The Bank of India claimed it had lost about $30 million after checks issued on behalf of Mr. Parekh by a co-operative bank bounced. The co-operative bank, whose president is now under investigation, was expressly forbidden by law to lend cash to brokers or against securities trading.

Mr. Parekh has so far revealed that he was involved in massive schemes in which capital was invested through his companies to buy stock in a creditor firm to support share prices. In another case, he purchased shares in two small media companies on behalf of a larger one, without revealing that the larger company was the beneficial owner. The total bill for his misdeeds will be around $150 million.

Interestingly, while all this domestic pain was occurring in March, foreign investors were net buyers of $450.5 million worth of Indian stocks. The total net 2001 purchase by foreigners is now close to the total for the whole year of 2000. Domestic investors were net sellers of shares worth $62.8 million.

There is likely to be other high-profile casualties in the BSE scandal, perhaps at the Unit Trust of India, the Indian equivalent of CalPERS and Fidelity combined, and even at SEBI. On April 3, Finance Minister Yashwant Sinha said he would pursue all wrongdoers, wherever they may be. As in the bribery debacle that engulfed the Ministry of Defense and ruling party, the political noise continues.

And yet there are encouraging signs SEBI is finally acting like a regulator. On March 13, it suspended the board of BSE. The following day, it announced that beginning July 1 it would implement a rolling settlement system for 200 stocks, a number it has recently raised to 250, and it declared that the BSE would be wrested from the hands of the brokers and corporatized.

These actions actually cap SEBI's running albeit unacknowledged dispute with many brokers over the badla system, which the brokers have fought one rearguard action after another to retain. In 1996, with the support of foreign and large domestic brokerages, SEBI targeted badla by moving from floor-based to screen-based trading. Next was the dematerialization of share certificates; almost all trades are now settled through electronic book entry.

The most recent battle was over a rolling settlement period, by which share markets would follow a five-day trading cycle, with all trades during a cycle settled five days after at ends. SEBI officials rightly saw that a rolling settlement would make the badla system harder to operate, less profitable and, ultimately, unworkable, thus lowering the revenues of the brokers who rely on it.

In October, SEBI introduced a trial rolling settlement for 15 stocks. But daily trading volumes dried up, in some cases from 200,000 to 2,000 shares a day. But it was the same brokers who depressed the trading volumes and then complained the new system wouldn't work. SEBI didn't listen, but neither did it take action to expand rolling settlement.

As the criminal investigation into the scandal continues, SEBI is likely to take control of the market. Perhaps 25% of brokers will not be in business this time next year. As a result, it will be almost impossible to manipulate the market as in the past. That will be good for capital markets and investors. But the litmus test will be SEBI's ability to deliver on implementing a rolling settlement system in July.

Mr. Thorn is the managing director of The India Capital Fund PCC, formerly The Indian Smaller Companies Fund Ltd.