Quality practices are welcome

MARKET TALK

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The Securities and Exchange Board of India (Sebi) has been introducing a lot of progressive measures to protect the interests of investors. The time frame for initial public offerings and rights issue has been compressed, the power of attorney given to brokers by clients modified to protect investors and entry loads on mutual funds have been abolished. Sebi is now looking at the selling practices of distributors and is in the process of coming out with regulations to prevent mis-selling.

Sebi has also appointed a group of market participants to recommend the eligibility criteria for various intermediaries and suggest improvements in their functioning. It is surprising that this group, called Committee on Review of Eligibility Norms (CORE), has converted this opportunity to try and create closed clubs and eliminate competition in the market place.

Having more intermediaries has always been in the consumer's interest. Whether one looks at the financial sector, telecoms, airlines, automobiles or stock brokers, the conclusion is the same. The number of investors and trading volumes increased dramatically after the National Stock Exchange broke the monopoly of the Bombay Stock Exchange (BSE).

The recommendations of CORE are an attempt to go back to the closed club culture. In the garb of improving the functioning of the market, an attempt has been made to eliminate smaller operators and to prevent the entry of new operators in various intermediary segments.

To give an example, one just needs $100,000 to start a mutual fund in the US. The existing regulations in India require a minimum networth of Rs10 crore to set up a mutual fund whereas CORE has recommended increasing this requirement to Rs50 crore. To put things in perspective, this would be more than 100 times the requirement in the US. Today, with a total networth of just Rs2 crore, one can be a global asset management company managing mutual funds in the US, the UK, Europe, Singapore and Japan.

Similarly, networth increases have been recommended for portfolio managers, stock brokers, debenture trustees, merchant bankers, registrars and transfer agents, custodians and so on.

It is ironical that the best capitalized mutual funds are incurring the maximum losses on account of the steep distribution commissions that are paid and on account of the heavy advertising expenses. Smaller asset management companies such as Benchmark Asset Management Co. Ltd have managed to run a profitable operation despite a small capital base.

Similarly, the stock brokerage ventures of some large institutions have not been very successful despite the strong financial muscle of the promoters while many of the smaller brokers run a profitable business.

To my mind, these recommendations could have come only on account of either of the following two reasons:

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The first reason could be the inability to distinguish an agency activity from that of a principal activity. An agency activity is one where the intermediary is only acting on behalf of the principal. Hence a broker intermediates a trade for the client and an asset management company only takes investment decisions for the fund. This kind of an activity requires intellectual capital, integrity and adherence to best practices.

It does not require a high financial networth. This is unlike principal activities such as banking or insurance where the company is primarily responsible to repay the deposits or to pay the policy holders' liabilities.

The second and the less charitable reason for recommending such a high networth could be to reduce competition and to create entry barriers. An interesting point to note is that none of the operators on the panel would have any difficulty in meeting the proposed networth requirements.

In any case, events in 2008 have shown us the risks of creating a concentration of resources in a few big financial institutions. Such concentration only creates "too big to fail" institutions and volatility in the market. If we were to have just four or five big mutual fund houses in India, the markets would move only based on the views of a handful of fund managers.

India has the oldest stock exchange of Asia in the BSE, which was established in 1875. UTI, India's first mutual fund, was started in 1963. Despite this, we have about 17 million demat account holders in the country and about 48 million folios for mutual funds. These numbers are inflated considering the fact that many people would invest in more than one mutual fund scheme or have demat accounts with multiple depository participants. Let us compare these numbers with the number of mobile phone subscribers. Even though mobile phones were introduced as late as 1994, we have today more than 600 million mobile phone connections.

The challenge today for the market participants as well as the regulator is to increase financial inclusion and investor penetration. All talk of consolidation and of higher capital requirements indicating an intermediary's seriousness about the business is driven by the larger operators. They are not able to figure out how to increase their customer base and run a profitable business in the stricter regulatory framework of no entry loads, no mis-selling and so on. They would love to see fewer competitors in the market place.

These larger operators would do well to use their financial muscle towards investor education and better service levels instead of lobbying for a return to the Licence Raj.

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