Address by Shri Ananth Narayan G, WTM SEBI
Mint BFSI Summit 2025, Mumbai
Capital Formation: Opportunities, challenges and way forward
January 17, 2025

Introduction

Good evening. I thank Mint for giving me the opportunity to address this august gathering. I thought I would use this opportunity to reflect on the current trends, some of the opportunities and challenges, and the way forward around capital formation in the economy.

First, I will look back at the very positive story of rising all-round flows, both from investors and now issuers – trends that the ecosystem should recognize and celebrate.

Second, I will argue that there is no room for complacency; that opportunities for sustained capital formation still abound, as do challenges. The whole ecosystem has much to do to maintain and grow the trust and faith of the ecosystem.

Finally, I will present our approach to fostering trust while growing the ecosystem – as exemplified in recent examples around FPIs, AIFs, and Equity Derivatives. I will then suggest some takeaways for the future.

Rising quantum of investments and issuances

A key positive feature of the last few years, particularly after Covid-19, has been the rise of the domestic investor – across MFs, AIFs, and PMS.

Mutual Funds & IPOs

Let us start with investments into domestic Mutual Funds. During the six years between FY15 and FY20, net risk-oriented investor inflows into MF Schemes – which I define here as flows into equity-oriented schemes, into hybrid schemes (excluding arbitrage funds), and into equity index funds and ETFs – averaged around INR 1.4 lakh crores per year.

After Covid-19, during the three years between FY22 and FY24, this number rose sharply to INR 3.2 lakh crore on average per year.

In the current FY25, for 9 months until December 2024, this number has hit a record of INR 4.8 lakh crores. Note that this number is over 30% of the incremental time deposits booked by banks during the same period.

On the supply side of the equation, between FY22 and FY24, the supply of fresh paper by listed companies (that is, issuances excluding OFS) averaged around INR 1.5 lakh crores per year. I have in the past expressed apprehensions that supply of paper may not be keeping pace with the rise in demand, suggesting the risk of asset inflation and sub-optimal capital formation.

However, during the current FY25, supply of fresh paper by companies (excluding OFS) has already risen to an all-time high of over INR 2.9 lakh crores. Across all sources, the gap between demand and supply has narrowed this year, even as both sets of numbers have individually risen quite a bit.

For capital markets seeking capital formation, this is indeed the best possible outcome – rising demand for and rising fresh supply of securities.

AIFs

Alongside MFs, there has been a significant rise in flows into Alternate Investment Funds over the years – something that is perhaps less appreciated.

As of September 2024, the net funds raised by AIFs from investors crossed INR 5 lakh crores, with a creditable increase of INR 1.1 lakh crore (or 29%) on a year-on-year basis – the YoY change crossing the INR 1 lakh crore mark for the first time. Around 65% of net funds raised by AIFs are from domestic investors.

Similarly, the total commitments made by investors to AIFs have risen to INR 12.4 crores, with a rise of INR 2.9 lakh crores (or 30%) on a year-on-year basis – somewhat comparable with the flows into MFs during that period. Commitments have increased by 31% on a Compounded Annual Growth Rate (CAGR) basis over the past 5 years.

Opportunities and Challenges

The trends in demand and supply of securities is remarkable – and deserves celebration.

However, there is simply no room for complacency.

First, opportunities to grow the pot still abound. While we have over 13 crore unique investors in the SEBI ecosystem now, a number that has tripled from just 4.4 crores 5 years ago, CBDT data suggests that over 60 crore Indians that have linked their PAN number with AADHAR.

On the flip side, there are challenges as well. We have a fundamental responsibility to preserve and grow the trust of the rising number of investors in the capital markets ecosystem. Any egregious Type I errors, such as governance failures, technology failures, market manipulation, or fraud can endanger trust and kill the goose that is laying golden eggs.

At the same time, we are also conscious that even as we take steps collectively to prevent or rapidly address Type I errors, we must ensure that regulations do not come in the way of capital formation – which would constitute a Type II error.

In statistics, it is not possible to minimize Type I and Type II errors simultaneously. I suggest however that in our regulatory approach, if we apply our minds collectively and constructively, we can find win-win solutions where we minimize both Type I and Type II errors. I will give some practical examples of this from our recent experiences in FPIs, AIFs, and Derivatives.

1) FPI

Since the time that we opened our country to foreign portfolio flows three decades ago, we have had periodic instances of concerns being raised around the identity of investors behind some FIIs/ FPIs/ P-Notes/ ODIs.

If in fact there was circumvention of SEBI's stipulations round Minimum Public Shareholding (MPS) or Substantial Acquisition of Shares and takeovers (SAST), that would constitute a Type I error.

One way to detect this would have been to stipulate that every foreign investor must disclose all details of their ownership, control, and economic interest to the last cent, on a look through basis. However, instituting such a requirement across all FPIs would have led to large Type II errors; giving full details of all investors can be extremely onerous for legitimate Investment Managers and Funds of international jurisdictions, where structures such as omnibus accounts exist.

In August 2023, with the approval of the SEBI Board, we instead introduced a focused and clinical risk-based approach to mandating extensive disclosures. In respect of possible MPS and SAST circumvention, first, only FPIs that met a concentration criterion of more than 50% of their AUM invested in a single corporate group were considered for additional disclosures. Even here, no additional data was sought from funds such as Sovereign Wealth Funds, Public Retail funds, and ETFs, where there was regulatory comfort around their identity on a trust-but-verify basis. Others, however, were required to provide granular disclosures on a look-through basis.

Similarly, there was a 'size' criteria for granular disclosures by FPIs with AUM over INR 25,000 crores. This was to guard against the potential circumvention of Press Note 3 stipulations by FPIs with large Indian equity portfolios, with the potential to disrupt orderly functioning of Indian securities markets by their actions. Once again, some funds (such as Sovereign Wealth Funds) were exempted from additional disclosures based on objective and transparent trust-but-verify considerations.

Beyond FPIs, these requirements have now been extended to ODI (erstwhile P-Notes) as well.

How has this approach performed on Type I and Type II errors?

First, the specific and targeted FPIs that were required to provide additional disclosures but were unable to do so, had to exit the country by September 9, 2024, to avoid stringent penalties. Note that FPI flows were a significant net positive during January 20204 to September 2024. We can also confirm that notwithstanding baseless speculation from some quarters, any FPI outflows after September 2024 cannot be attributed to this circular. Finally, we can also confirm that to date, no FPIs have been required to cut positions or exit under the INR 25,000 criteria (to prevent circumvention of PN3 stipulations).

I have to compliment the ecosystem of custodians, DDPs, FPIs, depositories and other stakeholders, who worked closely with SEBI to ensure that we minimized Type I and Type II errors through this implementation. I think this has gone a long way in strengthening the trust in the ecosystem, without coming in the way of legitimate investments.

Separately, through 2024, alongside this implementation, SEBI has also worked closely with all stakeholders to bring about Ease of Doing Business for FPIs. Thanks to our collective efforts, processes have been improved so that like domestic investors, FPIs can now access their funds on the day of settlement itself; a significant improvement over the past. A common and transparent SOP for FPI registration has been put in place, and the registration process has been and will continue to be simplified. Depositories have built trackers allowing us to have an overview of pending registrations. SEBI now has an FPI outreach cell that has interacted with over 1,000 FPIs this financial year, including to address their specific issues. Am happy to report that we are seeing around on average 130 new FPI registrations per month in FY25 so far – nearly twice the number in FY24.

2) AIFs

Let me turn to the area of AIFs now. We have already noted that this industry is now growing significantly, and the annual rise in AIF investment commitments is now of a similar order of magnitude as the growth in the MF ecosystem.

You may recall that around two years ago, SEBI first highlighted a significant Type I error surrounding AIFs. We had found that a significant chunk of AIFs appeared to be structured to circumvent existing financial sector regulations; including RBI regulations, FEM-NDI regulations, and IBC stipulations.

Through 2024, our approach alongside industry was to address this concern, while ensuring that we minimized any collateral damage of Type II errors. A framework is now in place, which effectively translates into a clear and specific set of do's and don'ts that AIF Investment Managers must follow, to guard against any such circumvention. These do's and don'ts have been put together by the industry itself via the Standards Forum for AIFs, in consultation with SEBI. They have been designed to be focused and targeted; as an example, AIFs with significantly large (or even single) investors are required to adhere to the simple principle of ensuring that the investor is not prohibited from making the ultimate investment directly. In addition, both the assets of AIFs and the units of investors are now largely in dematerialized form – a significant benefit to investors, while improving regulatory visibility all around.

With the contours of this solution in place to address the Type I error alluded to above, the resulting increase in all-round trust has allowed all of us to pivot towards taking steps to improve ease of doing business. Tranching – a route that was in the past misused by some to circumvent RBI regulations – has now been allowed for certain sets of investors. AIFs have been allowed to pledge their equity investments in the infrastructure sector, so that their investee companies can raise debt. AIFs have also been given significant flexibility to deal with unliquidated investments beyond the expiry of the fund. In addition, there is now a framework for erstwhile VCFs with unliquidated investments to migrate to the AIF regime seamlessly. The process for accreditation of investors has also been considerably simplified. I believe that popularizing the concept of Accredited Investors can further contribute to the growth of the AIF and Angel Fund ecosystem.

3) F&O and MIIs

I have recently spoken of SEBI's approach towards equity derivatives, so I will not elaborate on this subject today.

Suffice to say that I believe SEBI's approach towards Equity F&O exemplifies our approach to try and minimize both Type I and Type II errors.

There was a potential Type I error here, in the form of consistent small investor losses, and the potential for structural risk vulnerabilities.

Our extensive and detailed consultations helped identify the main issue – clinically and specifically – as specifically egregious overtrading in index options on expiry day. In October 2024, we took a series of 6 steps that were largely designed to address this specific issue surgically, without painting all of F&O with one broad brush.

Even as we judge the impact of these steps over the next few months, we are now looking at ways to grow the F&O ecosystem so that it contributes to price discovery, market depth, risk management, and ultimately, to capital formation. We will look to improve the risk metrics in F&O and consider both tactical and structural steps to reduce the risk and fear of any manipulation across cash and derivative markets.

In this connection, as our recent orders have demonstrated, between exchanges and SEBI, we have strong surveillance mechanisms. While we can never say that we are perfect, we are watching and learning all the time. We will continue to invest in surveillance to safeguard trust in the ecosystem.

It is worth noting here that our MIIs (exchanges, clearing corporations, depositories) are the first line regulators charged with ensuring investor protection and market integrity. Amongst other things, they are required to ensure adequate disclosures by issuers, conduct appropriate surveillance to deliver a free and fair market bereft of unfair trading practices, manage risks and operations to deliver smooth clearing and settlements, monitor the conduct of brokers and other intermediaries, and ensure that market technology platforms and ledgers are fair, secure, reliable, and resilient.

Indian MIIs have a unique operating model in that they are empowered by law to regulate their own paying clients such as listed corporates, Trading Members, Clearing Members, and Depository Participants. They are required to primarily focus on the investing public as a public utility, while ensuring the integrity of capital markets. At the same time, they are also commercial entities, in competition with each other, and the larger MIIs in equity markets now enjoy high operating margins with Profit Before Tax/ Income margins well in excess of 50%.

To preserve and grow the trust in the ecosystem, it is crucial that MIIs – as is required by law today – continue to give primacy to ensure technology and operational resilience, risk management, and ensuring compliance in investor interest, over business considerations.

In essence, when questions around areas such as F&O and SME IPOs come up, MIIs should be the ones taking the lead in finding appropriate solutions that are in the interest of the investing ecosystem, over their own commercial considerations.

We have collectively taken some steps to ensure this – including working closely with the Public Interest Directors (PIDs) on the Boards of MIIs, and ensuring that crucial KMPs of the

MII have a dual reporting to both the MD as well as the relevant Board Committees. Further steps may be needed to strengthen the framework of governance in MIIs, and ensuring that they are seen to be first-line regulators first. We have also proposed some possible ways to strengthen the independence of Clearing Corporations and ensure their continued focus on risk management.

Conclusion

Our funds ecosystem has grown significantly in recent times, with substantial growth in both issuances and investments. While we may have specific issues and concerns, at the overall level, we must acknowledge that something good is underway.

There are opportunities and challenges ahead. One key imperative is to preserve and strengthen the trust in the ecosystem. Type I errors – such as governance failures, technology failures, market manipulation, or fraud can endanger trust and kill the goose that is laying golden eggs. We must collectively continue to guard against these. This is too big a risk to be left to regulators alone.

We are also conscious of Type II errors, where in our zeal to minimize Type I errors, we could create a framework that comes in the way of legitimate and desirable capital formation.

For our part, I can promise you all that we look at both risks very closely and leverage extensive consultation to try and minimize both together. The topical examples that I have tried to provide today – around recent events in FPI, AIF, and F&O – hopefully stand testimony to this approach.

In turn, I ask that all stakeholders must strive to be trusted advisors who focus on both potential errors equally. On Type I errors, when you see something, please say something. On removing Type II errors, when you make your suggestions, please think about how the risks of any resultant Type I errors can be mitigated.

Here’s to us working collectively to ensure sustained capital formation in our country.

Thank you for this opportunity, and your patience.