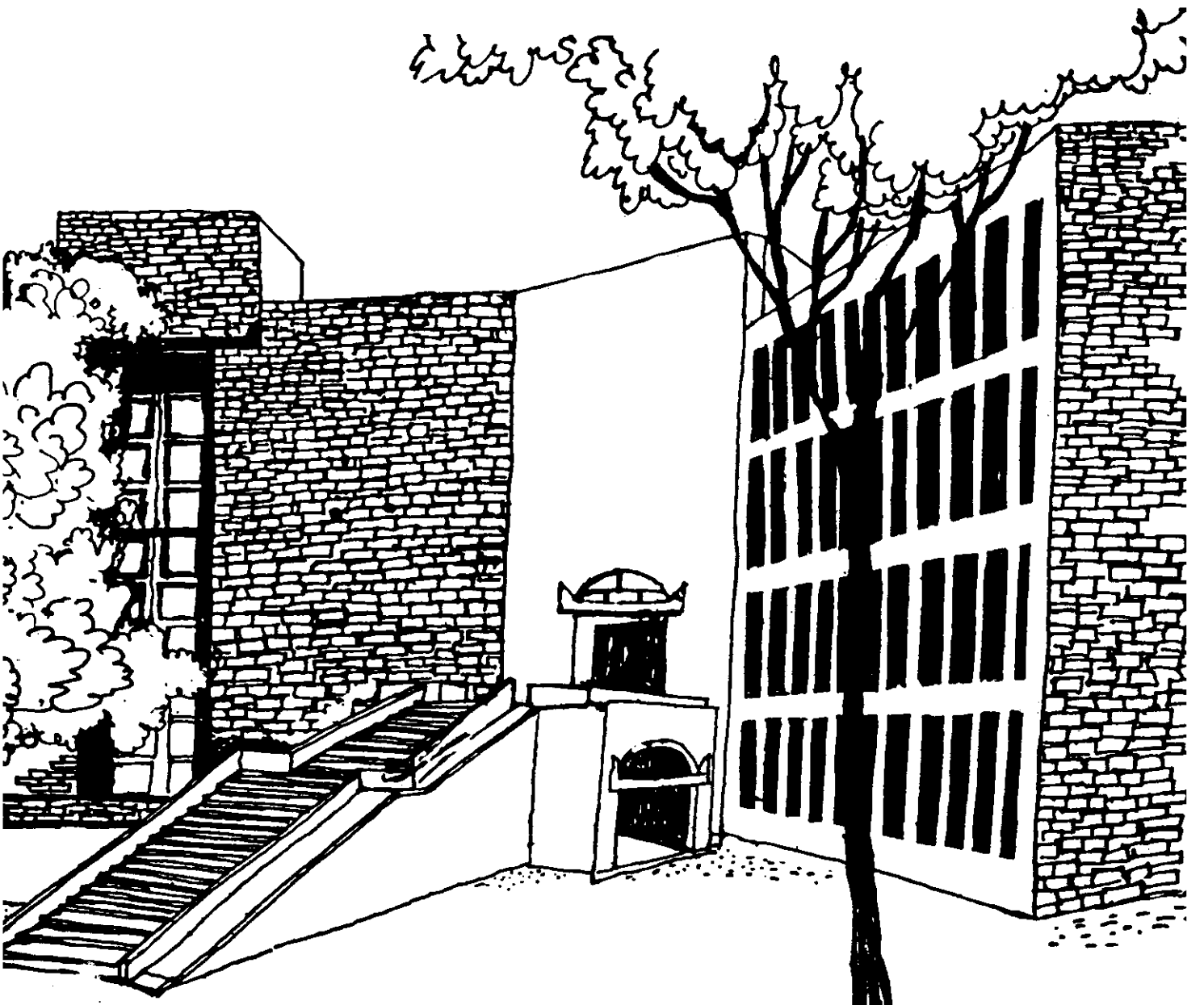




Working Paper



**REVAMPING STOCK EXCHANGE
OPERATIONS - SOME SUGGESTIONS**

By

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REVAMPING STOCK EXCHANGE OPERATIONS - SOME SUGGESTIONS

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ABSTRACT

Stock Exchanges have been playing a major role in mobilizing private savings for industrial growth. With increasing participation of general public in securities markets, the system set up by the brokers by forming an association of themselves to regulate trading and to protect the interests of member brokers, is proving to be inadequate and detrimental to the interests of general investing public. With frequent market closures and payment crisis, the need has arisen to reexamine the system and suggest suitable regulatory policy measures which would focus on invisible but effective maintenance of market discipline and depend on strengthening of professional and financial support services which will make market work as they should. This paper examines some of these issues and suggests the following policy measures :

- 1) Collect margins on gross business and not on net business of a broker*
 - 2) Insulate investment business from speculative trading*
 - 3) Complete automation of stock exchange operations*
 - 4) Provide explicitly for investor protection in bye-laws of the stock exchanges*
 - 5) Strict enforcement of rules and regulations*
 - 6) Nominate active and knowledgeable public representatives on governing boards of exchanges*
 - 7) Establishment of unified regulatory body*
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REVAMPING STOCK EXCHANGE OPERATIONS - SOME SUGGESTIONS

(Dr. Ramesh Gupta)

To encourage private savings and investment in corporate sector, it is necessary that suitable regulatory and administrative mechanism be evolved for investors' protection which would result in building confidence among investor class for broader public participation in stock markets. Although many of the brokers and government officials claim that our stock exchanges, (particularly Bombay Stock Exchange), are highly sophisticated and well regulated, yet the happenings of last few months on Bombay and Ahmedabad Stock Exchanges, raise many doubts about their fairness to the genuine investors. To retain the investors' confidence in our stock exchanges, we would need to relook at its trading and settlement practices and some of the regulatory provisions which govern our stock exchanges.

Stock Exchanges as Self-Regulating Organisations

In India, the stock exchanges function as self-regulatory organizations (SRO's) having their own rules, regulations and bye-laws. An exchange generally has a *governing board* in which majority of brokers are elected by broker members, and others are government nominees and public representatives nominated by the government. The governing board has a President and a Vice-President who are appointed by the Central Government on the recommendation of the elected members of the governing board.

Each exchange has an *Executive Director* (ED) who supervises operational matters and has powers, subject to control and supervision of the governing board, to (a) enforce rules, regulations and bye-laws, and (b) to impose penalties and/or suspend a member from trading for violation of bye-laws and/or non-compliance with the directions of the Exchange authorities. The ED is a key functionary of a stock exchange. He monitors the activities of the SE, such as trading, margin requirements, kerb dealing, matching of transactions, settlement, etc. He also supervises the staff of the exchange with the help of an official called Secretary who looks after administrative matters.

At present, the Executive Director is appointed by the governing board with the approval of the Central Government. He is under obligation to implement the rules and regulations fairly and equitably; however, sometimes a ruling by ED gets him into a conflicting position with the members of the governing board, particularly if the ruling hurts the interests of powerful members of the governing board. Since ED's appointment is at the will of the governing board, he comes under great pressure to compromise in implementing the rules and/or in disciplining brokers.

In most of the exchanges, governing board is dominated by a few brokers who do substantial speculative business. Speculative trading among brokers is very heavy and kerb trading is very common.* Some brokers are very busy in trading and do not care much about the paper work. Often transactions are not reported to the stock exchange authorities and at times reported transac-

tions do not match in reported price and quantity . As a result, settlements do not get completed in time. And if settlements are delayed, regular functioning of market gets affected and ED is forced to close the market for trading. Delayed settlements and frequent market closures adversely affect the investors.

Once the trading activities are suspended, kerb deals become common. The small share brokers and investors are denied the opportunities of fair and legal trade. In kerb deals, spreads between ask and bid prices are very high and market tends to become highly speculative. Speculators and big operators manipulate the market prices extensively using available information. Rumours are spread rampantly and unhesitatingly, and investor is denied an opportunity to get-in or get-out of a scrip at a fair price and time as well.

What Ails Stock Exchange Functioning ?

PAYMENT CRISIS

Frequently, there are problems of payment arising out of settlement at the pay-in period. These problems arise because of many reasons. Some of them are as follows :

Frequent Delays in Settlements

Settlements are delayed due to incomplete paper work. During this period prices of volatile stocks fluctuate a great deal, the operators become reluctant to pay the difference between their transaction price and the *havala* rates (i.e., make-up prices at which transactions are carried forward) fixed by the

stock exchange authorities. For example, in the past few months when market was declining, due to delay in earlier settlement, make-up prices announced by the stock exchange authorities were much higher than the ruling current prices (e.g., for settlement no. 12 in Ahmedabad Reliance *havala* rate was Rs. 170 while the then market price was Rs. 130, and for settlement no. 13 Reliance *havala* rate was Rs. 150, while the then ruling price was Rs. 100-110). Authorities could not keep up with the fall in the stock prices. The operators knew their real losses are much larger than the payments currently demanded by the exchange. The operators knew that pretty soon authorities would ask for more money in the next settlement as new *havala* rates would be much lower than the earlier rates. Operators get concerned about the total losses for which they have to pay in coming settlements, and therefore, opt not to honour even present payments. In Ahmedabad, this had been the precise case because of which many innocent brokers and investors had to bear the brunt of losses. Delayed settlements were the major contributor to the present state of affairs. If settlements were done in time, the computed losses would have been smaller and operators would have continuously adjusted their outstanding position as prices were changing. However, market remain closed and settlements were delayed for weeks, with every decline in prices cumulative losses of the bull operators and therefore the payments to be made became larger and larger amounts. As there was no settlement for a considerable length of period, honest brokers could not collect the price differences from their clients, as payments did not become due

until pay-out of previous settlement was completed. Losses kept on accumulating, liabilities kept on increasing and operators (including big clients) started refusing payments.

Inadequate Margins

Stock exchange authorities are hesitant to take action against brokers, because if a broker declares himself a defaulter, exchange authorities cannot do much as they have very low deposits from the brokers. First, margin requirements are very low, and second, most influential brokers avoid margin requirements by not reporting all the business.

Due to low margin requirements and facility of carrying forward the transactions, trading on small equity is common. Brokers over trade on their own account and/or on their speculative clients' account. Existing margin requirements on stock trading are abysmally low and defy all norms of debt:equity ratios. While for most productive activities (like for manufacturing etc.) the debt equity norm is 2:1, for speculative trading in the stock market norm is an unconscionable high. Most of the time, margins are 5 to 10 % of the value of net outstanding business, which provides a debt equity ratio of 10 to 1 on net outstanding business and not on the total business. While the risk of price fluctuation is on the total business. Such low margins on buying and selling encourage unsustainable speculation. ➤

Further, most of the brokers do not comply with margin requirements. Despite margin requirements being abysmally low,

brokers indulge in unfair and even unethical practices to avoid these margins. Some of the common practices to avoid margins are:

i) Chalu-upla in which modus operandi is that the deals on which margins are payable are reversed in the books of the transacting parties just before the settlement period comes to a close, and thus taken off the books. Since in the books there is no outstanding business, no margins are deposited with the stock exchange authorities. However, the deals remain very much alive and are reentered in the books at the beginning of the next settlement period and the earlier position is restored. Thus, transactions are carried forward to the next settlement period without depositing the required margins.

ii) Another tactic used by the brokers is vandhas (objection memos) to evade margins. With tacit approval of counter-part broker, parties report the transaction to the exchange authorities which do not match in quantity or price and an objection memo is filed. Once an objection memo is filed, pending reconciliation, the deal is off the purview of particular settlement. Parties do not have to pay margins on these transactions. Later, by exchanging debit and/or credit notes (known as *kapalis*), the parties legitimize the deal.

iii) At present, stock exchange authorities require margins on net position. The net position often disguises the real extent of speculative involvement of the brokers. Let me give an example to understand the menace which this practice causes. In a

given settlement period, broker A buys 100 Tisco shares on behalf of client X from broker B and then does a second transaction in which he sells 100 Tisco to broker C on behalf of client Y. As per current rules of the exchange, net position of broker A in Tisco is zero, and he is not required to deposit any margin. However, he collects margins from his customers X and Y. This collected margin remains with the broker. If broker A is a prudent broker, he would be content to earn interest on this money. However, in reality, the brokers are not content with their commission and interest income. They also indulge heavily in transacting on their own account. Without putting a single rupee of their own, they can easily speculate and pay margin from the funds collected from clients for any net outstanding position. This practice of collecting margins on net position has a tremendous multiplier effect on speculative activity on a stock exchange and seems to be the root cause of the payment problems which Bombay and Ahmedabad Stock Exchange are currently facing.

Inadequate Investors' Protection

When there is a payment crisis, the exchange governing board functions as a closed club for the benefit of member brokers only and very often to the disadvantage of the investing public, completely ignoring their interests. This is done in the following way:

i) When there is a payment crisis, the governing board does not disclose the true position of a broker to the public. Investor community does not really come to know of troubled brokers for a

long time. Stock exchange authorities and brokers are concerned about settling the accounts among member brokers and the exchange completely ignores the interests of investing public. Most often, brokers form their own groups and transfer assets and liabilities among themselves through *kapali* and many other devices which result in a changed risk profile of a given broker. The investors who do business with such brokers are kept completely in dark and thus, the risk level which investor had planned vis-a-vis his broker changes drastically.

ii) The exchange authorities take very long time to declare broker as a defaulter. Until such period, such brokers can continue to fleece the innocent public till the governing board decides to declare publicly a particular broker defaulter.

iii) Further, when a broker is declared defaulter, the provisions of the Securities Contracts (Regulation) Act 1956 and the rules, bye-laws and regulations framed thereunder by the stock exchanges recognize the claims of member brokers only, and do not consider defaulted broker's liability to the general investing public. Assets seized from a defaulted broker are used to settle accounts among the brokers themselves, leaving defaulting broker's clients high and dry. All assets (including non-business related) are seized by the arbitration committee of the stock exchange and are distributed among member brokers. If there is any excess left, it is deposited in brokers' protection fund. This fund is generally used for the welfare of brokers and to compensate losses incurred by the brokers for any default which may take place in future. There have been several cases of this kind. Recently, a case of

this malpractice was filed in Gujrat High Court and the Court has issued a stay order dated 14.1.91 to the Ahmedabad Stock Exchange not to dispose off a defaulting broker's assets without considering the dues of the petitioning investor.

The authorities must realize that :

- a) *The present system of trading on Dalal Street favours speculation. Eighty to ninety per cent of the trading is in speculative securities (Specified group). Even there, four to five securities account for 40 to 50 per cent of all transactions.*
- b) *Although forward trading is banned, buying and selling short on margins are being permitted through a dubious mechanism of carrying forward transactions.*
- c) *Margins required are low. They defy all norms of prudent trading. Such low margins, and that is also on net position encourage, unsustainable speculation.*
- d) *The stock exchanges, as they are structured now, are unable to regulate speculative activities. The market often faces payment crisis, delays in settlement, and frequent closures.*
- e) *At present, stock exchanges are functioning in such a way that they are controlled by the brokers, for the brokers ignoring investors' interests altogether.*

WHAT CAN BE DONE :

To develop a healthy investor-oriented secondary markets, following suggestions are made :

1. Collect Margins on Gross Business of the Brokers

Better administration of purchase and sale on margins is needed. Margins must be collected on the gross position of a broker rather than the net position in a given scrip. Margins should be high enough to ensure completion of transactions on settlement dates. The principle of leverage must come into play.

In other countries, trading in securities on margin is allowed but it is highly regulated and monitored regularly. What the margin requirement should be is not a matter of negotiation or whims and fancies of the stock exchange authorities. For example, in United States, the initial margin requirements are determined by the Federal Reserve System, in order to control and regulate the volume of credit. In addition, the New York Stock Exchange (NYSE) has its own margin requirements for smooth functioning of the market.

NYSE insists on a maintenance margin that is required of each account at the end of each transaction day. The maintenance margin requirement is 5 per cent of the current market value of securities. Whenever the deposits brokers and their clients maintain as collateral fall below 25 per cent of the current value, the account holders are called upon to increase their collateral. They have to increase it to a higher level of 35 per cent of the

current market value so as to allow some leeway for further price fluctuations. If the account holder fails to deposit the extra amount demanded, a part of his existing holding is auctioned to bring his collateral to the desired level. Thus, a strict follow-up of margin requirements ensures smooth functioning of the market.

Even in a highly capitalistic economy like the United States with millions of widely spread shareholders and high volume of trading, excess speculation is being curbed on regular exchanges through a requirement that trader put in a high equity margin. In socialistic India, with a lower spread of equity holding and in spite of banning credit for speculative trading, we have permitted, through devious methods, both credit as well as low equity for traders. Speculative trading is excessive in relation to the investors' transactions; it can be curbed through higher margin requirements and continuous monitoring.

2. Insulate Investment Business from Speculative Trading

A new framework for trading and settlement procedures which would segregate speculative trade from investment trade has to be evolved. At present, the trading of a speculator in shares like Reliance, Tisco etc. is mixed with the business deal of a genuine investor. As a result, a genuine investor is subject to the same risk of price volatility, settlement delays, payment problems which a speculator is willing to take. Trading for these two kinds of investors must be so segregated, that a genuine investor

may still participate in the secondary markets without taking undue risk.

Following are the alternatives available to the regulatory authorities :

(a) Allow only Cash Trading :

At present, only on four stock exchanges, i.e., Bombay, Ahmedabad, Delhi and Calcutta, distinction is made between specified and non-specified group of securities at the time of settlement. Other 15 stock exchanges (including Madras) allow trading only on cash basis. First suggestion is to abolish distinction between specified and non-specified groups of securities. Let all securities be traded on cash basis and let there be weekly settlements, as being currently done with out any problems in Madras and other exchanges.

(b) Allow Dual Trading in a Scrip:

If speculative trading (i.e., trading which generally involves taking substantial investment risk with very low capital base) must be retained to provide liquidity and continuity in the secondary markets, then markets for two types of traders must be segregated. One way is to allow specified group scrips also to be included for trading in non-specified group. Under this system, in a given scrip in which such dual trading is allowed, a genuine investor can do business in cash group while the speculator who do not intend to take or give delivery can operate in the forward group (specified group). At a given point of time,

there may be some price difference for the same scrip due to differences in risks involved in this two types of trading, but arbitrageurs would ensure that the price differential is kept to the minimum commensurate with the differences in the risk perceptions.

(c) Introduce Forward Trading :

The other alternative is to allow forward trading. In India, forward trading was banned in 1969. But in a disguise form we have been allowing forward trading with all the nuisance of spoiling genuine investment market. In forward trading, the forward price, which generally is different from spot price, is known in advance when deal is put through and delivery cannot be enforced before the agreed date. Our system of carrying forward of transactions facilitates speculation about future prices without specifying the forward price and delivery date. In this system prices become highly volatile and traders do not look beyond next settlement. No long term trends about prices emerges, and such a system of trading and settlement does not serve any purpose. All over the world, trading and settlement for forward and cash transactions in a given scrip are done separately. Speculative trading must be separated from investment business.

3. Complete Automation of Stock Exchange Operations:

Automation on stock exchanges is a must as it would make the brokers' transactions transparent and would reduce the chances of misreporting as it provides an 'audit trail' for each

transaction. It would also smoothen the settlement procedure. If automation is there, it would be much easier for exchange authorities to keep a surveillance on a broker's activities, not only in relation to other brokers, but with his clients also. At present, stock exchange does not take into account the business liability of a broker to his clients. This must be done despite brokers resistance to computerization by the brokers.

4. Provide Explicitly for Investors Protection in Bye-laws of the Stock Exchanges

The Exchange authorities must take a total view of investment business of a broker and monitor it to ensure smooth settlements not only among brokers through exchanges, but between brokers and clients also. The exchanges are public institutions and can not be run as private club of broker members without recognizing any obligation to the investing public at large. On the pattern of the U.K.'s Financial Services Act of 1986, brokers must be held responsible for all their investment business including business with clients. To protect investors, the U.K. Act provides for a Compensation Fund to cover those cases where firms carrying on investment business are unable, or likely to be unable, to meet their civil liabilities to investors. Similarly, in U.S.A. a separate Act 'The Securities Protection Act of 1970' provides for a Securities Investors Protection Corporation - a nonprofit organization whose membership comprises the brokers and members of security exchanges. The corporation collects fees from the members and the funds collected are used for the protec-

tion of investors.

At present, there is hardly any regulation which adequately protects the investors. With increasing participation of general public in securities markets, there is a compelling need for immediate legislation protecting investors' interest.

5. Strict Enforcement of Rules and Regulations

At present stock exchanges are functioning as closed clubs for the benefit of brokers, ignoring investors' interests. Dominance of the stock exchange by a few brokers does create problems. There are plenty of rules and regulations on the books but enforcement is lacking. Complicated enforcement procedures most often result in condoning the offense or in accepting a compromise. Most often, unscrupulous brokers are accommodated at the cost of investors.

6. Nominate Active and Knowledgeable Public Representatives on Governing Boards of Exchanges:

At present, the government has its own nominees on the exchange's board of governors and also nominate the public representatives. Most often, it is found that the elected brokers on the governing board dominate the proceedings, because of their majority in number. Public nominees do not take their job seriously and many times it is alleged by member brokers that these nominees do not quite understand the intricacies of the market. To protect the interests of investors, the government must ensure

that these public representatives not only truly represent the interests of the investing public but also understand the market mechanisms and intricacies.

7. Establishment of Unified Regulatory Body :

To streamline the functioning of the stock exchanges in India, a unified body with necessary statutory powers to regulate and oversee is a must. However, question often asked is whether proposed Security Exchange Board of India (Sebi) be able to handle all the responsibilities ? Or Sebi would need to encourage investor-oriented organizations independent of broker community to monitor the activities of the stock exchanges and help Sebi in its task of reforming and regulating the activities of Indian stock exchanges ?

It would not be possible for Sebi to have administrative machinery to monitor the wide-ranging activities of stock exchanges, brokers, merchant bankers, mutual funds, financial institutions etc., Probably, it would end up being a mere licensing authority unless it seeks help of truly independent local investors' organizations.

Frequent public intervention cannot cure the ills of a system which is badly structured and infested with vested interests. And therefore, regulatory policy must focus on invisible but effective maintenance of market discipline and depend on strengthening all the professional and financial support services which will make market work as they should.