CHAPTER 4
STOCK MARKET PRACTICES, INSTRUMENTS
AND DEVICES

Over the last ten years the stock market in India has been experiencing quick and remarkable changes in all its sphere of activities. It has witnessed a dynamic growth keeping pace with the ever-increasing need for fool-proof trading practices. The Securities and Exchange Board of India (SEBI) has been precisely performing this task at the same time seeking various ways and means to improve upon services for the benefit of investors. For successful operation in the stock market, the brokers shall be familiar with various trading practices and stock market instruments.

4.1 Stock Market Practices

The stock exchange infrastructure has improved considerably in the recent period, thanks to the measures taken by the Securities and Exchange Board of India. The trading mechanism as well as the operations of the exchanges have been computerised. A number of measures have been taken to ensure that the stock market operate in an orderly, safe and fair manner.
4.1.1. Pattern of Trading

Trading in the stock market takes place under three sections as practiced in Bombay Stock Exchange, the pioneer Stock Exchange in India.

i) Group (A) - Specified shares

ii) Group (B) - Non-specified shares (now split into B1 and B2)

iii) Group (C) - Odd lots and permitted securities.¹

4.1.1.1. Group (A) Shares

Under Group (A), only those shares that are actively traded numbering 140 shares are included.

The criteria for listing in this specified group are as follows:

i. The shares should be fully paid up equity shares, which have already been listed on the stock exchange for at least five years on the cash list.

ii. The company's paid-up equity capital should be at least rupees five crores.

iii. The shares should have been actively traded while on the cash list.

iv. The shares should be widely dispersed and a large volume of shares is available with the public for trading.

v. The company should have a record of good earnings and dividends over the past few years before inclusion in the specified list.²

4.1.1.2 Group (B) Shares

The listed securities other than Group (A) shares are placed in Group (B). They are split into B1 and B2 group of which those well traded are put in group B1. Shares in B2 Group are not actively traded.

4.1.1.3 Group (C) Shares

Odd lots and permitted securities are included in Group (C). Blocks of Shares other than market lots (market lots being 5,50 or 100, depending upon the face value) are known as odd lots. Permitted securities are securities, which are not listed on a particular stock exchange, but are permitted to be traded on any exchange in the country.

4.1.2 Trading Procedure

Transactions in shares are done on the floor of a stock exchange or through on-line trading system in the official trading hours. Official trading hours may vary from exchange to exchange. The members or their authorised assistants have to wear a badge or carry with them identity cards given by the exchange to enter the trading

They also carry a sauda or block book. Sauda or block book is a book of transactions executed on the floor. A slip containing brief details of the bargain is put in a box for confirmation by the exchange.

4.1.2.1. Contract Note

The details of all the contracts executed are noted in a 'Pucca Sauda Book'. On the basis of this, contract notes are prepared in prescribed forms, containing the name and address of the client, the number of shares of a particular company, rate, date of delivery, etc. A contract note is an agreement for the transaction executed on behalf of a client by the broker. The copy of the contract note is sent on the same day or following day to the client. As per SEBI guidelines, the broker has to supply the contract note to the client within 24 hours of the execution of the order.

4.1.2.2. Delivery of Share Certificate

A contract which has been executed on behalf of a client or on the member's own account culminates in the delivery of share certificate and receipt of payment of shares. There are the following four ways in which deliveries of securities can be effected.

---

3 Ibid 2, p.209
4.1.2.2.1 Hand Delivery

In this method, delivery and payment should be completed on the day fixed at the time of entering into the bargain. But the period should not exceed 14 days following the date of the contract.\(^6\)

4.1.2.2.2. Spot Delivery

These transactions are to be settled by delivery and payment on the date of the contract or on the next day.

4.1.2.2.3. Special Delivery

Under this method, delivery and payment are made at any time after 14 days, but not exceeding two months, following the date of the contract as may be stipulated when entering into the bargain and permitted by the Governing Board or the President of the exchange.

The three types of transactions, described above, are called spot or ready transactions. They must be settled by delivery and payment and cannot be carried forward.

4.1.2.2.4 Delivery for clearing

All transactions in the specified list or Group (A) are effected only through the clearing house.\(^7\) The securities for delivery will be

---


\(^7\) Ibid 6, p.23.
delivered to the buyer within a week after settlement and seller receives cash within the same time from the clearing house. The specified group shares have the facility of carry forward of deals to the next settlement without taking or giving delivery.

4.1.3 Settlement of Transactions

When one buys or sells shares in the stock exchange, two types of trading is possible i.e., forward account and cash account. In the forward account, one deals in specified or ‘A’ list shares. In the cash account, non-specified or ‘B’ list securities are traded.

The settlement procedure for specified and non-specified shares is different.

4.1.3.1 Settlement Procedure for Specified Shares

The specified list of securities is settled through the clearing house. A settlement period is the time given to settle the trades and it differs with the exchange. The Bombay Stock Exchange follows the weekly settlement system. It means that a transaction entered into any time between Monday and Friday is settled on the following Monday. In the past, before the Securities and Exchange Board of India made weekly settlements mandatory, exchanges even had fortnightly settlements.

---

8 Ibid 4, p.385.
The old badla system (carry forward) was banned on December 1993. The new carry forward system was introduced in January 1996. Under the new carry forward system, purchase or sale transactions during one settlement period can be carried forward for a period of 75 days from the date of transaction. All transactions entered into by a broker either on behalf of his client, or on own account or for jobbing, have to be tracked by him on the basis of the date of the transaction. The stock exchange will not keep track on these transactions individually. A broker is required to furnish a certificate every month stating that he has not violated the carry forward norm of 75 days. If stock exchange authorities feel otherwise then they can inspect the broker’s book at any time. Every broker who opted for carry forward transactions will have a uniform format to maintain the data.

The badla session conducted by the exchange facilitates the carrying forward of transactions. Badla charges are the interest payable for carrying over of transactions from one settlement to the other on the value of shares. When the badla charges are paid by buyers to the sellers, it is called contango or seeda badla and when it is payable by sellers to buyers, it is called backwardation or undha badla.

---

When settlement day and badla sessions are over, then the computer centre of the exchange verifies all the details provided by the members and prepares the following statements for each member:

i. Money settlement depicting the difference between the payable/receivable slips.

ii. Statement of share certificates to be delivered or received.

iii. Statement of carry over transactions.

On the basis of the above statements from the computer centre, members provide the pay/receive slips to the clearing house of the exchange. Along with this, members provide cheques/drafts for the purchase order and hand over the share certificates along with transfer deeds for their sale orders. This complete process is done on the pay-in day.

The clearing house authorities process the cheques/drafts for the purchase order and checks the delivery of securities as per sale order. On pay-out day, the clearing house makes the payments and delivers the securities to the concerned members.

The clearing house plays a very important role in the settlement of transactions, in the specified list. In most of the stock
exchanges, the clearing house has been set up to settle the sale and purchase contracts of securities.\textsuperscript{10}

4.1.3.2 Settlement Procedure for Non-specified Securities

Theoretically, while dealing in securities in the non-specified list one is supposed to pay the price immediately and take delivery of the share certificate. This creates problems in stock exchanges where large number of transactions take place every day. Hence stock exchanges have formulated a procedure by which settlement of transactions amongst brokers is easily facilitated. On settlement day itself payment and delivery take place. The weekly settlement system is followed for the 'B' list in all the stock exchanges.

4.1.3.3. Settlement in Odd Lots

Some stock exchanges hold special trading sessions for odd lots on specific days. There are a few members who specialise in odd lots. The Bombay Stock Exchange holds an odd lot session on every alternate Saturdays. Certain Institutions like the UTI, GIC and Canara Bank provide over-the-counter facility on a limited scale for odd lots to investors.

4.1.4 Auction

If any member fails to deliver the scrips on the final day, auctions are arranged by the stock exchanges in order to facilitate deliveries. Auction in ‘A’ list securities is automatic whereas in ‘B’ list securities, it is arranged on request by the member. The stock exchange authorities invite quotations from the members in desired scrips for auction purpose.

4.1.5 Badla Procedure

The Budliwala or financier lends cash to the market by taking up delivery on the due date for those who wish to carry over their purchases or he lends securities to the market when it is short, by giving delivery on the due date for those who wish to carry over their sales. In this way ‘Badla’ is simply an interest paid to the lender or financier in the stock market, who engages in money lending or loaning of securities.

The rate of interest or badla charges depends upon the demand and supply of funds in the market. The rate of interest is fluctuating in nature and consequently it would be different for every settlement period.

11 Ibid. 10, p.382.
Badla rates are also linked with floating stock and volume of trading activity.\textsuperscript{12} When floating stock is very high and badla financiers have to lift all of them, the badla rates go up and vice versa. If the floating stock completely vanishes, undha badla occurs. Thus there is a direct relationship between badla rate and floating stock. Whenever overtrading takes place, operators tend to operate recklessly and they borrow money at higher rates. It is called over-bought position. The reverse happens when there is a heavy bear hammering and market goes into oversold position. The rate of badla helps in judging the speculative activity and market trends.\textsuperscript{13}

Recently the SEBI has refixed the badla limit to rupees forty crores. Earlier the badla limit was fixed at rupees twenty crores. SEBI has also decided to do away with the carry-over period of 75 days.\textsuperscript{14}

The Bombay Stock Exchange has introduced a new-look Badla called BLESS (Borrowing and Lending Securities Scheme) with effect from January 22, 2001. The new scheme enables borrowers to withdraw shares subject to the payment of appropriate margins and risk management measures, in addition to the existing facilities available under the BSE's carry-forward system.\textsuperscript{15}

\textsuperscript{12} Ibid. 4, p.397.
\textsuperscript{13} "Theory of Badla", Capital Market, February 6-19, 1987 p.52-54.
\textsuperscript{14} "Badla limit has been doubled" Mathrubhumi, Kochi, June 15, 2000, p.9.
\textsuperscript{15} "BSE Scraps badla" Economic Times, Mumbai, Vol. 40, No.305, January 5, 2001, p.3.
The new-look badla system does away with the Modified Carry-Forward System. The BLESS system would provide the facilities of lending and borrowing of securities to BSE members as well as their constituents, and will also serve the purpose of deferral of settlement obligations. The scheme enables investors to carry forward their positions of normal settlement by paying or receiving securities' lending and borrowing charges.

Explaining the reasons for introducing the new scheme, Mr. Anand Rathi, President of Bombay Stock Exchange said that BLESS would promote securities' lending and borrowing activities in the capital markets and provide a commercially competitive product. All the other features of the existing carry forward system, like margins etc. continue to be the same.

4.1.6 Automatic Lending and Borrowing Mechanism (ALBM)

ALBM is a badla product introduced recently by the National Stock Exchange. Its basic purpose is to facilitate lending and borrowing of securities/funds to meet their pay-in obligations. It results in carrying forward of the positions in the normal settlement as in the case of Modified Carry Forward System.

---

Under this system if a member meets a shortfall on account of his pay-in, he can borrow the same under the ALBM for a certain rate of interest. In the ALBM session, all the lending and borrowing transactions are executed with reference to a price called Securities Lending Price. Securities Lending Price is the closing price of the security on the date prior to the ALBM session. The difference between the Securities Lending Price and the rate at which transactions are executed in the ALBM session is the returns from borrowing/lending.

An exchange would be eligible to introduce the ALBM if it satisfies the following conditions:

1. The exchange must demonstrate that it has a well designed software for margin computation and well established governance structures and administrative infrastructure for monitoring and enforcing the margining system.

2. The exchange or its clearing corporation must be an approved intermediary under the stock-lending scheme.

4.1.6.1 Eligibility of Scrips for ALBM

Exchanges desirous of implementing ALBM will obtain SEBI approval for:

1. The eligibility criteria for scrips to be included in the ALBM list.
2. The process of choosing the scrips in the ALBM list.

3. Disclosure and transparency provisions relating to the above.

4.1.6.2 Position Limits

There is a position limit per broker of Rs.40 crores in the aggregate and Rs.5 crores per scrip. These limits are determined on the basis of gross position for the broker.

The National Stock Exchange has at present 226 scrips in ALBM where carry forward facility is available. The inclusion of scrips in the ALBM segment is significant as it imparts a good amount of liquidity in the stocks, which have speculative interest.17

In fact, the impact of inclusion of a scrip in the ALBM is far higher than the inclusion in Group A of BSE because of NSE’s wider reach, more trading members and relative convenience in the NSE’s ALBM.

The SEBI in its Board meeting on May 14, 2001 has decided to ban all deferral products, namely, ALBM, BLESS, Modified Carry Forward System (MCFS) and Continuous Net Settlement (CNS) from July 2, 2001 as proposed by the J.R. Varma Committee Report. It has

---

also decided to introduce options on individual scrips from July 2, 2001 onwards.

4.2 Stock Market Instruments And Devices

The stock market in India is undergoing sweeping reforms. A significant feature of this reform is that modern instruments and devices are introduced and put into practice. These instruments and devices are examined along with the prevailing system.

4.2.1 Margin Trading

The stock exchanges impose three types of margins in specified shares, namely, daily margin, adhoc margin and carry over margin. Through these margins, the stock exchanges can check and control the speculative activities and help to ensure that the volume of trading by a member is within his risk-bearing capacity and according to his financial resources.

\[\text{Ibid. 4, p.376.}\]
4.2.1.1 Daily Margins

Daily margins are imposed on speculative or volatile securities in order to have a check and control on the rise or fall in prices. The rate of daily margins depends upon the extent of rise or fall in prices and on the technical position of the market. Normally, the rate of such daily margins does not generally exceed 10 percent of the contract price.

4.2.1.2. Ad-hoc Margins

When some of the members do more volume of trading which is beyond their financial resources and risk bearing capacity, the stock exchanges impose ad-hoc margin on such members. There is no standard rate of such margin like the daily margin. The imposition of such margins depends on the subjective assessment of the market trends by the stock exchange authorities.

4.2.1.3. Carry Over Margins

When a transaction is carried over from one settlement to another settlement, the stock exchange fixes the 'making up price' (Hawala rate) taking into consideration the closing price on the last business day of the current settlement. The 'making up prices' are
marked up and marked down by a uniform margin of three percent collected both from purchaser and seller respectively. The overall impact of three per cent margin from buyer and seller comes to six percent of the value of shares being carried over. The carry over margin of minimum three per cent is compulsory and is uniform in all exchanges. Previously these margins were collected in cash or deposit in the form of approved securities by the stock exchange. Now all the margins are collected only in cash.

4.2.2 Circuit Breakers

It is a mechanism by which exchanges temporarily suspend the trading in a security when its prices are volatile and tend to breach the price band.¹⁹ Price band is the daily/weekly price limits within which price of a security is allowed to rise or fall. Earlier, the price band fixed by the Securities and Exchange Board of India was eight per cent upward or downward from the previous day’s closing price. Later on, to protect the interest of investors, it was relaxed by SEBI with effect from May 2, 2000. Once a scrip touched eight per cent upward or downward from the previous day’s closing price, then after half an hour cooling, the price band would be relaxed by four per cent more, thus the total daily limit was allowed to twelve per cent.

The SEBI Chairman, Mr. D.R. Mehta commented that the measure was intended to provide an ‘exit route’ to small investors, particularly when a scrip hit the lower end of the filter and that the relaxation of controls was also considered in line with the growing maturity levels of the capital market.\textsuperscript{20}

With effect from July 3, 2000, the price band was again relaxed by eight per cent more from the original level thus making the total daily limit to sixteen per cent.\textsuperscript{21}

However, the SEBI has decided to lift the circuit breakers on individual stocks from July 2, 2001, when the trading starts in the rolling settlement mode.

\textbf{4.2.3 Depositories}

The capital market transactions in India were characterised by mounting paper work. The rapid increase in the volume of transactions brought into sharp focus the inadequacies of the settlement mechanism which called for physical movement of share certificates in recording ownership changes in the company’s books.\textsuperscript{22} The serious risks attendant on paper-based settlement such as bad deliveries, delays in

\textsuperscript{20} "SEBI relaxes price bands", \emph{The Hindu}, Kochi, Vol/123, No. 101, April 27, 2000, p.19.
\textsuperscript{21} "New Circuit Filters with effect from July 2000", \emph{Economic Times}, Mumbai, June 22, 2000, p.7.
\textsuperscript{22} Krishnamurty, R "Depositories: responsibilities of auditing profession", \emph{The Hindu}, Coimbatore, November 3, 1996, p.25.
transfer, mutilation, loss, forgery and theft of certificates had been repeatedly highlighted in several investor forums.

The Depositories Act which came into force during 1995-96 is a milestone in the development of the Indian Capital Market. This was followed by issue of the SEBI (Depositories and Participants) Regulations, which was promulgated by the Government in May 1996.

A brief review of the features contained in the Depositories Act and the Regulations is worth mentioning here.

4.2.3.1 Features of the Depositories Act

The Act provides for the creation of one or more depository institutions registered under the Indian Companies Act 1956 and predominantly owned by the market participants. The governance of depositories is carefully framed to reflect the need for objectivity in serving the diverse users in the financial community. The SEBI has proposed that the minimum net worth of a depository should be Rs.100 crores.

The Act envisages that a depository will interface with the users through a set of depository participants who are persons dealing directly with the depository or their own account or for their clients. The depository participant is a crucial link between the investor and
the depository. The Act envisages that a depository participant will be deemed an agent of the depository. The depository will therefore be responsible for the acts of omission and commission on the part of the depository participants. The participant shall maintain the securities account balances of the clients and intimate the status of their holdings from time to time.

The SEBI has proposed certain entities that could be permitted to be registered as depository participants, namely, commercial banks, financial institutions, stock exchanges, financial services companies owned to the extent of 75 per cent by any of the above mentioned institutions as well as companies registered abroad providing custodial, clearing or settlement services in the securities market and approved by the Central Government.

An investor is given the option between holding physical securities as at present and having a depository based ownership record. The investor has the freedom to switch from the depository mode to non-depository mode and vice versa.

\[^{23}\text{Ibid.}\]
4.2.3.2. Free Transferability

The securities issued by a public company have been made freely transferable under the Act. For the securities in the depository mode, no transfer deed is required and the procedural requirements under Sec. 108 of the Companies Act have been dispensed with. The Act provides that the transferee of a security is entitled to all the rights including voting rights associated with the security.

The Act has done away with stamp duty on secondary market transactions in the depository mode. All transactions outside the depository mode will attract stamp duty as at present.

Ownership records in a depository will be accepted as prima facie evidence in legal proceedings. The depository records will receive the same treatment as available to banks under the Banker’s Book Evidence Act. A depository allows for the creation of pledge or hypothecation in respect of securities left in the depository mode.

The first depository to be accorded recognition by the SEBI under the Depositories Act is the National Securities Depository Limited (NSDL) which has been promoted by leading institutions such as IDBI and UTI.
4.2.3.3. Dematerialisation

It is a process by which the physical certificates of an investor are taken back by the company and actually destroyed and an equivalent number of securities are credited in the electronic holding of that investor. This is done at the request of the investor.

4.2.3.4 Depository Process

The shareholder will have to first open an account with a depository participant which is similar to opening a savings bank account with a bank. Thereafter, he will have to make a request for dematerialisation of the shares, to the depository participant.

The depository participant in turn will forward the request along with the share certificates to the company concerned. Once the dematerialisation takes place the depository participant will intimate the shareholder that his shares are now in an electronic form.

4.2.4 Pledging of Securities

Loans can be raised by pledging stock certificates. Depending upon the value of the specific stocks, loans can be obtained from private and public sector banks and other financial institutions. Banks advance loans to the extent of 50 to 65 per cent of the market value of

---

the security. Lending institutions are maintaining a reference table containing the market price of securities for this purpose.

Banks generally prefer dematerialised securities for the purpose of lending. As per the directive of the Reserve Bank of India, dematerialised securities can get loan facility to the extent of Rs.20 lakhs. As against this, securities in physical form can get loan facility subject to a maximum of Rs.10 lakhs only. The interest rate charged varies between 16.5 per cent and 18.5 per cent per annum. The loan can be repaid at any time irrespective of time limit.

If the market price of pledged securities comes down, bank will recover the difference in value from the client. On the contrary if the market price goes up, the bank will raise the ceiling limit of loans which will help the client to expand the loan facility.

When the market price of pledged securities goes up to the desired level, banks can be approached to sell these securities and banks will execute it against a small fees. However, there is a risk in doing so. If the seller wants to sell the pledged securities an application shall be submitted to the bank before 48 hours. Meanwhile, by the time the seller completes the formalities, the share prices may tend to come down.

<table>
<thead>
<tr>
<th>Institutions</th>
<th>Mode of Valuation</th>
<th>Maxi. Loan Limit (% of Market Value)</th>
<th>Rate of Interest (%)</th>
<th>Processing Fee</th>
<th>Loan Limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>City Bank</td>
<td>BSE – Friday’s closing price</td>
<td>60</td>
<td>16.5 – 18.5</td>
<td>1.50%</td>
<td>3 lakh onwards</td>
</tr>
<tr>
<td>Industrial Development Bank of India</td>
<td>NSE – Thursday’s closing price</td>
<td>65</td>
<td>16.5</td>
<td>1.00%</td>
<td>1 lakh to 20 lakh</td>
</tr>
<tr>
<td>Standard Chartered Bank</td>
<td>BSE – Monthly average price</td>
<td>65</td>
<td>18.5</td>
<td>0.75%</td>
<td>1 lakh to 20 lakh</td>
</tr>
<tr>
<td>Canara Bank</td>
<td>NSE – Monthly average price</td>
<td>50</td>
<td>16.5</td>
<td>Rs.500</td>
<td>Up to Rs.20 lakh</td>
</tr>
<tr>
<td>SBI</td>
<td>Lending dates’ NSE closing price</td>
<td>50</td>
<td>17</td>
<td>Rs.100</td>
<td>Upto Rs.20 lakh</td>
</tr>
<tr>
<td>Cholamandalam Finance</td>
<td>NSE – 45 day’s average price</td>
<td>50</td>
<td>16.5</td>
<td>1.00%</td>
<td>10 lakh onwards</td>
</tr>
<tr>
<td>ABN Amro</td>
<td>BSE – Tuesday’s closing price</td>
<td>60</td>
<td>17</td>
<td>1.50%</td>
<td>50,000 to 20 lakh</td>
</tr>
</tbody>
</table>

Source: “Shares need not be sold, can be pledged”, Mathrubhumi – Dhanakaryam, Kochi, November 27, p.2.
4.2.5 Rolling Settlement

The emergence of our market from an open-cry to electronic trading system; from a physical delivery to a dematerialised system and from a fortnightly settlement to a daily or rolling settlement system in a relatively short time has been truly steady, smooth and impressive.

The Securities and Exchange Board of India decided to introduce rolling settlement in stock exchanges in India with effect from January 10, 2000. Accordingly, 10 scrips were selected for trading on a trial basis. A rolling settlement is one in which trades outstanding at the end of the day have to be settled (Payments made for purchases or deliveries in the case of sale of securities) at the end of the settlement period.26

Though, there are settlement modes like T+2, T+3 etc. in Western Stock Markets, we have adopted T+5 mod ‘T’ represents the trade day and ‘T+5’ implies settlement on the 5th trading day.27 In a T+5 rolling settlement, a transaction entered into on Monday has to be settled on the fifth working day, which will be the subsequent Monday, when either pay in or pay out takes place. As opposed to this, in a weekly settlement, the transactions made during any of the five trading days are permitted to be squared up (Purchases offset against

---

sales) during the same settlement period. Only those transactions which are outstanding at the end of the last trading day are required to be settled by payments or deliveries.

4.2.5.1 Implications of Rolling Settlement

Rolling settlements could not be introduced in India earlier because we had no depositories. Rolling settlements necessarily require electronic transfers of funds and demat facilities in respect of securities being traded. This is because handling large volumes of paper on a daily basis is extremely difficult for the clearing houses of stock exchanges. It is only now that India has adequate facilities for electronic delivery of shares which facilitates trading and clearing large volumes on a daily basis.

In rolling settlements, payments are quicker than in the weekly settlements. Thus, investors benefit from increased liquidity. Currently, in India, in the weekly settlement, sale proceeds of transactions done on the first trading day are available on the twelfth day and on the eighth day if the trade takes place on the last day of the trading cycle.

A negative aspect of the rolling settlement is that one cannot short sell a scrip. This would create an impact on liquidity. SEBI has
acknowledged that speculation is the driver of liquidity and if liquidity goes away, it would impact the price discovery mechanism as well as the ability of market participants to transact easily.\(^{28}\) In Indian markets, operators and day traders account for a high percentage of total volumes. Weekly settlements and badla allow them to keep their positions open for a minimum on one week and time their exit, based on their perception about movement of particular scrips over this period of time. Putting any scrip in rolling settlement takes away this particular set of players leading to low volumes based on actual delivery based transactions.\(^{29}\)

Though the market response to rolling settlement is not encouraging, the SEBI introduced another list of 158 companies to be compulsorily traded under the rolling settlement from May 2000.

4.2.5.2 Continuous Net Settlement (CNS)

Most developed markets have adopted CNS to inject liquidity through a speculative element. The system, as approved by the SEBI allows a seller, who is not in a position to fully deliver his shares, to defer the same till the next day. It will also allow a buyer to defer the payment till the next day.\(^{30}\)


The CNS is a daily badla mechanism as an alternate to weekly badla. It allows carry forward of both purchase and sale positions to a day on payment of a badla charge. The SEBI has set the margin requirements similar to that adopted for the current weekly settlement.

The system is helpful for investors as it can work as a preventive mechanism against failure of deliveries. It ensures continuous settlement as investors can accomplish their delivery obligations even though they fail to give or take deliveries of shares on the required day. With the introduction of the CNS, investors can have an advantage of settling positions on T+2 or T+3 basis depending on the other party's preference.31

4.2.6 Internet Trading

Internet trading or online trading is one of the most dynamic innovations in our capital market. On the Internet one will be able to trade instantly and transparently, from any part of the world.

The country's two largest exchanges - the Bombay Stock Exchange and the National Stock Exchange are embracing the Internet in an effort to leverage the power of this medium to reach out to the hitherto untapped masses.32 "Our internet initiative is in line with our basic thrust which we have been following from day one, when we

---


were conceived as a national exchange with a mission to spread everywhere to be as close to investors as possible”, says the NSE Managing Director R.H. Patil.

Online trading has shown astounding growth in the U.S., where roughly 40 percent of retail stock brokerage business is conducted through the Internet. On the Nasdaq, for instance, close to 30 per cent or roughly 10bn of e-broking business is done on the Internet.

4.2.6.1 How net trading works?

First and foremost, the basic equipment required by an investor to start Internet trading is a computer, modem and a telephone connection. The client will have to fulfill certain minimum criteria to get himself registered with the broker. Naturally, the brokers will not entertain every client, only those who are of high networth and capable of depositing sufficient margins with the broker will be considered. Both the BSE and NSE will provide a central web server, which will help investors have a direct access to the trading platform.

The investor will have to simply go to the exchange’s website and enter his broker’s code along with his own client code and password to enter his broker’s webpage and start trading. This will benefit investors, as they will have a wide gamut of stockbrokers to

---

choose from in terms of product offerings, services, information and cost of transactions.

The costs involved in Internet trading can be high for an investor taking into account the costs of telephone and Internet connection. Assuming the client stays online each day during market hours, the cost of the telephone plus internet connection can add up to Rs.50,000 per year.

4.2.6.2 Role of the exchanges in net trading

In the online environment the real-time risk management functions of stock exchanges will increase. The nature of risks would be fake orders, backtracking from e-contracts, bad delivery, payment problems arising from large positions etc. However, the onset of e-banking, dematerialisation and e-commerce laws would, to a very large extent help to mitigate such risks.

4.2.6.3 Role of brokers in net trading

As far as the broking outfits are concerned, the focus of the traditional broking outfits will have now to undergo a sea change. Building up and strengthening the client base is the main aim of any broker. The means to achieve the same will have to shift from building
up sub-broker net work or putting up additional terminals to being able to branding and marketing their own websites. In today's time, more and more investors enjoy the feel of being on-line in an internet environment as they are able to make their own informed decisions based on broader array of information available in the form of research reports, online quotations, mutual fund data, company information and financial results.

The main advantages of Internet trading for the brokers will be lower transaction costs, saving in office costs set-up, wider client reach, ability to concentrate on core business and offering a wide spectrum of services.

In some more years, the technology of the online brokers will enable them to deliver customers just as much than an average broker at a traditional firm. So, there will always be a danger of many of the traditional brokers getting marginalized. If they do not act soon, there is a danger that they will end up falling victims to the electronic revolution.

4.2.7 Derivatives Trading

With the Parliamentary Standing Committee on Finance putting its stamp of approval on the Securities Contracts (Regulation) Amendment
Bill, albeit with some changes, the stage is set for the introduction of derivatives in India. The parliamentary committee has more or less endorsed the view of the SEBI-appointed L.C. Gupta Committee on derivatives that could go a long way in boosting the market as they provide the tools needed for hedging and mitigating risk.34

Derivatives are financial instruments, which derive their value from the underlying asset, which could be a commodity, foreign exchange, treasury bills, debt instruments, equity or share index.35 Some of the common derivative instruments are futures and options.

4.2.7.1 Futures

A futures contract contains an agreement to buy or sell a specific commodity, asset or security at a pre-decided price. The contract is legally binding on both the parties. Such contracts are standardised according to the quantity, delivery time and location for each commodity or financial asset. The only variable is the price, which is discovered on an exchange trading floor. The exchange or the clearing house guarantees execution of the contract.

The working of the futures contract can be explained by means of an illustration. Suppose A&B enters into a futures contract on June 1, 2000. B agrees to purchase 100 shares of XYZ Ltd. at a price of Rs.100 after two months i.e., on August 1 from A. Even if the price of the security comes down to Rs.50, B has to settle the contract at Rs.100, incurring a loss of Rs.50 per share. On the contrary if the market price rises to Rs.150, B will receive Rs.50 per share as profit.

4.2.7.2 Options

Options are contracts that give the buyer the right, but not the obligation, to buy or sell a specified asset at a specified price on or up to a particular date. For acquiring this right, the buyer has to pay a premium to the seller.

The distinction between a future contract and an option contract is that the owner of a future contract is committed to make the exchange at the agreed price whereas the owner of the option has the right but not the obligation to make the exchange. Options may be exercised only if the option holder feels it is in his best interest, whereas the holder of the future contract has no option.

Following the above illustration, if A&B decide to enter into option contract, instead of futures, then B has to pay option premium. Let the option premium be Rs.10. After 2 months, if the price comes down to Rs.80 per share, B has to incur a loss of Rs.20 per share. But, since it is an option contract, B has the right to cancel it. In that case, the loss is limited to the option premium of Rs.10 per share. An option contract may be a call option or a put option.

4.2.7.2.1. Call Option

A call option means the buyer has the right to buy a fixed quantity at a fixed price on a fixed date.37 For example, a call option may be to buy 100 shares of XYZ Ltd., at a price of Rs.100 and the expiry date is August 1.

4.2.7.2.2. Put Option

A put option gives the holder the right to sell a fixed quantity at a fixed price on a fixed date.

The Securities & Exchange Board of India has recently taken a decision to expand trading in derivatives to futures and options on stock market indices and on individual stocks. Such instruments allow investors to hedge their risk or even take speculative positions. The asset

---

in the case of index futures is an index – it can be the S&P CNX Nifty index or even the BSE sensex.

The system of hedging risks works like this. If we feel the market is going to fall and the value of our portfolio is going to diminish, we take a short position on the index futures market. If it rises, then eventhough there is a loss on the futures position, the underlying cash portfolio rises and this helps minimise risk. It is for this reason that indices, which mirror closely a very wide basket of stocks, prove successful in index futures trading.

Currently both the stock exchanges, the BSE and NSE have come out only with three contracts: one month, two month and three month contracts. Each expires on the last Friday of the respective month.

The leverage that derivatives offer to any trader, investor or speculator is tremendous. With a small sum an investor could participate in the stock market. Volatility of the market also gets neutralised. However, analysts have diverse opinions about this, with some claiming that derivatives make the market more volatile and some swearing otherwise. But it has been observed that the cumulative effect of derivatives is more stabilising than otherwise.

---

The Indian stock markets have evolved significantly in the last few years. This is a result of financial sector liberalisation and also of significant micro level changes in the working of the stock exchanges. The introduction of shorter settlement cycles and paperless trading and increased checks and balances through enhanced regulation have been very significant developments. The broking community and the investors overall have responded positively to reforms and structural changes in the capital market. Initially, though there had been some hesitancy about these changes and reforms, they were to catch up with it in due course.