Chapter 3
Securities Trading
An Overview

In general way securities are claims on money and trading in them involves passing of contracts or entering into agreements. The contracts of general nature are regulated by Indian Contract Act 1872 but 'contracts in securities are governed' by the special Act, namely, Securities Contract (Regulation) Act 1956. This special Act supersedes the general Act but where there are no provisions in the special Act; the Indian Contract Act will apply.

As we have discussed in previous chapter that securities market consists of primary market and secondary market. The market where existing securities are traded is referred to as secondary market or stock market. Securities, which are issued in primary markets, are traded in secondary market i.e. stock exchanges. Secondary market is made up of buyers and sellers of securities, brokers, mutual funds, stock exchanges and OTCEI (Over the Counter Exchange of India). The primary issue market helps the investors only to buy the securities; they can not sell it in the primary market. It is only the secondary market, which provides the market for the investors to sell their securities. In this chapter we will discuss origin of stock market in India, functions and role of stock exchanges, management and membership of stock exchanges, transactions at stock exchanges, procedure for listing the securities at stock exchange, regulation of stock exchanges, etc.
A. Origin and Evolution of Indian Securities Market

Section 2(j) of the Securities Contracts (Regulation) Act, 1956 defines a 'stock exchange' as "any body of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities." Further section 2(f) of the Act defines recognized stock exchange as "a stock exchange, which is for the time being recognised by the central government under section 4 of the Act".

The stock exchanges are authorised to make byelaws for the regulation and control of the contract. However, these byelaws are subject to the approval of the central government.

Thus the term "stock market" refers to the market provided by different stock exchanges to the securities, which include shares, debentures, bonds, and other government securities.

It is a market place, where buyers and sellers of shares and other securities admitted to dealings. They can do business at competitive open prices. The entry of general public to this market i.e. trading floor is prohibited. Investing public has to do business through the members of the stock exchange only. This market is developed from two basic and complementary needs i.e. companies need for funds and an individual’s need to invest surplus money efficiently for a certain period.

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1 Securities contracts (Regulation) Act, 1956
2 Section 9 (1), Ibid
3 Powers are exercisable by SEBI also.
Therefore, the history of the stock market is the history of stock exchanges.

The securities market in India has a long trade record of organized trading. The history of the stock market in India is related to the establishment of East India Company. Towards the close of the 18th century the East India Company started doing business in loan securities. This company was in fact dominating those days in dealing with loan securities. By 1830's a significant increase in the volume of business was evident not only in loans but also in corporate stocks and shares. In Bombay the business was prominent in shares of banks like the Commercial Bank, the Chartered Bank, the Oriental Bank and the Old Bank of Bombay.\(^4\)

In that period the size of the broking community was very small. Between 1840 and 1850 there were half a dozen brokers recognized by the banks and merchants in Bombay. In 1850 the concept of “limited liability” was introduced by Companies Act enacted in 1850. It brought a revolution in establishment of joint stock enterprises. The enactment of this important Act provided the necessary stimulus to the activities of the Indian securities market.

(a) Premchand – Roychand Era 1850 to 1860

In 1850, Premchand Roychand was the first broker who could speak and write English. He was very prominent broker who became a legend in his lifetime by earning the acronym the Napoleon of Finance for his financial acumen. He was instrumental in the promotion of many enterprises during

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\(^4\) Dr. Prabhu V. Dev – Liquidity of Corporate Securities, 1st Edition 1997
those days and owned many banks. This period witnessed rapid commercial developments and organization of Hundi business and concept of brokerage.\(^5\)

**(b) Share Mania of 1860-65**

Share mania had certain lasting effects. The share mania actually started or becoming evident only in 1860-61 when American Civil War broke out. Due to that War America had totally stopped the supply of cotton to Europe. As a result Europe looked at India in fact the Bombay presidency, which alone had the largest stocks of cotton. The demand for cotton from India became unlimited. The exports doubled in four years. The price for cotton increased five folds and the payment for cotton was made in bullion. The total import of bullion amounted to Rs.85 crores between 1861-62. The import of all this bullion was in addition to the wealth of city and served a fresh capital for a number of new ventures.

That additional fresh capital had produced the excessive speculation in the market, which was the natural result of that addition in capital. New companies were started for every imaginable purpose. New ventures included banks and financial associations, trading, cotton cleaning, pressing and spinning hotel companies, and shipping companies etc. Huge capital of Rs.30 crores was attracted towards these ventures, which enjoyed hefty premiums. Speculation was rife and almost everyone in Bombay was gripped by it. People were seized by madness. The people only woke up when the American Civil

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War came to an end. Then all rushed to sell their securities but there were no buyers and the entire wealth acquired during the Civil War period and invested in shares became almost un-saleable in absence of takers. So that was the very depressing period in such a way. One thing is good regarding it i.e. a special legislation was enacted to deal with mass failures. In this way share mania helped the establishment of regular market in securities that gradually made Bombay what it is today the chief center of money and capital market.

(c) Period of 1866-1900

The American Civil War, which resulted share mania period witnessed considerable increase in the number of brokers, they grew in number to about 200 to 250 from around 60 in 1860. During this period, the brokers were considered to be a privileged class. Being privileged class people, the brokers enjoyed good standing in the society. The end of the American Civil War brought an end to their picture also. After struggling for a long period, the brokers then organized an “Association and prepared “Article of association” on the exchange on 9th July, 1875. For the interest of the native share and stockbrokers, some brokers resolved to form a Bombay Association that was also known as “the stock exchange”. The membership of this exchange was 318 in 1875.

Accordingly, the Bombay stock exchange was established in 1875, in the premises in “Dalal Street”. The Bombay stock exchange grown over the years into the largest stock exchange but now being threatened by the newly
established National Stock Exchange. Being the oldest stock exchange, it was the first to be recognized by central government under the SC (R) Act 1956. It was given the permanent recognition.

On the other side, in Ahmedabad number of cotton textile industries and cotton mills were established after 1880. The need for trading in the shares of these mills necessitated efforts by few Ahmedabad businesses to venture into stock dealing. The result was the setting up of “the Ahmedabad share and stock brokers association” in 1894 on the BSE model. The stock market of Ahmedabad initially concentrated its business of the shares of local textile mill and of the Managing Agency Houses controlling these companies. With the end of the First World War, the trading volume of the Ahmedabad stock exchange increased in a big way. It is one of the major stock exchanges in the country.

(d) 1901-1938

The beginning of the 20th century heralded the entry of the Industrial revolution in India. The Swadeshi movement took birth during this period. The movement marked by high degree industrial enthusiasm.

During the period of share mania in 1861-65 in Bombay, Calcutta experienced jute boom. There were many coal companies and mines also. The foundation of Calcutta Stock Exchange was laid down during this period, when there was a coal boom in Calcutta. Finally, it was on 15th June 1908 when an association was formed by the brokers titled as “the Calcutta stock exchange
association”. The Calcutta stock exchange is now one of the premier stock market of the country.

In 1934, a new stock exchange was established in Lahore, which ultimately merged with the “Punjab Stock Exchange Ltd,” incorporated in 1936. In 1939, there were eight stock exchanges in India i.e. two each in Bombay, Calcutta and Ahmedabad and one each at Lahore and Madras.

(e) 1939-1955

The Second World War that broke out in 1939 brought prosperity to Indian Industry. Many new stock exchanges were formed in Gujrat and Bombay. In Lahore there were three more stock exchanges including “All India Stock Exchange Ltd” set up. In Calcutta, also a third stock exchange under the name of “Stock Exchange Association of Bengal Ltd.” was formed. In that period, two new stock exchanges namely “Delhi Stock and Share Brokers Association” and the “Delhi stock and share exchange Ltd. were established. Subsequently these two institutions were finally amalgamated in the present stock exchange that is “the Delhi Stock Exchange Association Ltd” on 25th June 1947. The stock exchange at Lahore was closed during partition and later on merged with the Delhi stock exchange association.

The “UP Stock Exchange Ltd”, was incorporated in Kanpur in 1940. Another stock exchange was formed in Nagpur named as “Nagpur Stock Exchange Ltd. In 1944 the Hyderabad Stock Exchange Ltd was incorporated at
Hyderabad as a company limited by guarantee. During this period another stock exchange was also formed in Banglore.

(f) 1956-1992

On 20th Feb 1957 Securities Contract (Regulation) Act 1956, came into force. This Act permits only those stock exchanges, which have been recognized by the government of India to function in any notified area. Initially, under the Act stock exchanges at Bombay, Calcutta, Madras, Ahmedabad, Delhi, Hyderabad and Indore were recognized. At present there are 23 recognised stock exchanges including OTC exchange and the National Stock Exchange in India. All these stock exchanges operating under the regulatory framework of the SC (R) Act 1956 constitute an organized market for the securities.

The most significant development during this period was the enactment of Foreign Exchange Regulation Act 1973 (FERA).

(g) 1992-2003

Developments during this period have been discussed under reforms after SEBI.

B. Functions and Role of Stock Exchanges

The stock exchange is a very important institution in a capitalist economy. It is a place where enormous capital is rose, which is generally
required to operate the industrial and commercial enterprises of a country. It is an institution, which provides mechanism for trading of securities.

In this way stock market is a system of chennalising the savings of common masses and directing them to the industrial section of an economy. The securities traded in the stock market are freely transferable from one person to another. The stock exchanges perform the following important functions:

(a) Stock Exchanges ensure liquidity of investments

Liquidity is an important consideration for the investor in his investment decision. The convertibility of stock into cash at a price and at a time, which is acceptable to the holder of the stock and vice versa, is an innate attribute of liquidity. High liquidity is characterised by the quickness of its sale at a price which is more or less equal to its previous market price which may be represented by the price at which the stock was transacted last or by an average of the prices at which the last few transactions occurred. A stock is said to be illiquid when it is difficult for an investor to sell it quickly at its previous market price. In absence of the stock exchanges it would be very difficult for an investor to search a buyer. In this way the stock exchanges perform a very important function. Stock exchanges by providing marketability will help the investors in his portfolio management. Therefore, in the stock exchanges the investors can buy and sell the securities freely at the time whenever they required.
“With a secondary market any investor who buys shares when they are issued is free to sell those shares any time the market is open at the predetermined price. And any investor who did not purchase shares when they were issued is free to buy them, at the market determined price.”

Therefore, wherever investor requires funds he simply approach to a broker and dispose of his shares at the prevailing market prices. But all this is possible because of stock exchanges that provide marketability of investments. It helps not only the investors but also companies and the economy as a whole.

(b) It provides ready and continuous market

Stock exchange is a place that provides a ready and continuous market for buying and selling of securities. It enables fixed capital investment to become negotiable. There is no way by which the investors can withdraw their savings once they are invested in the shares of the company except through a stock exchange. The existence of continuous market is indicated by the presence of certain factors. According to Richard J. and Edward S, four tests may be used to indicate continuity in the market for a given stock.

- Frequency of sales
- Narrow spread between bids and offer
- Prompt execution of orders and

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• Minimum price changes between transactions as they occur.

Therefore, the creation of continuous market depends on many factors like the name and size of company, number of shareholders etc. Thus stock exchange provides a place where the investors can buy and sell securities of their choice and of different industries and companies. Stock exchanges enable an investor to exchange his investment in a company with those who are willing to become investors.

(c) It enables the investors to sell or purchase the security at a fair price

The price in market is determined by the supply and demand factors. The fair price for securities on an exchange is determined by matching buy and sell orders. Stock exchanges by providing place for the buyers and sellers of the securities help in the determination of the prices. Free competition in the securities market will help in determination of fair prices for securities. Therefore the stock exchange brings about the fairest and the most accurate prices of the securities.

(d) Services to investors

Stock exchanges render useful services to the investors also. Firstly it enables investors to shift from one business to another. The stock exchanges work under a code of well-defined rules and regulations. Therefore, it minimizes the dangers inherent in speculative dealings and manipulations.
Investors who buy and sell securities in an organized stock exchange have a sense of fair dealing because of high degree of professional morality and efficiency, which the stock exchanges attempt to bring out. The stock market quotations enable the investors to know the approximate worth of securities. The stock exchange regulations that are aimed at both the listed companies and the stockbrokers will protect the investors. It is possible to delist a defaulting company and to suspend a broker involving in irregularities. Stock exchanges normally have investor grievances cell for protecting the interest of investors.

(e) Valuation of securities is made possible through stock exchanges

The listed securities when admitted for trading in the stock exchange will be priced by the market forces. The securities issued in primary market is valued by the firm which manages the issues. For listed security the secondary market provides the basis for valuation. Stock exchanges provide a place i.e. trading floors for the dealers to assemble and strike deals in securities. "As traders meet and exchange shares according to their individual desires to buy and sell at market prices, two things happen simultaneously: (1) individual share holdings are adjusted, and (2) share prices attain market clearing values". The market determined prices are often the indication of the assessment of the performance of a company in the eyes of the investors and traders. This makes companies to monitor their share price movements in the

8 Supra note 6
stock exchange. The increasing prices of the securities of a company may speak or indicate its success in its performance.

Besides performing above functions the stock exchanges have many other functions some of them are as follows:

- An efficient stock exchange helps in bringing about price stability. An efficient market is one where sellers and buyers locate each other without difficulty and where there is effective dissemination of information. Stock exchanges provide regulation to ensure transparency, fairness and proper competition.

- It plays a very important role in capital formation. Surplus funds which would either remain idle or would have been locked up in commercial or savings banks getting substantially low interest rates are mobilized by the stock exchange for investment in corporate securities.

- The stock exchanges not only mobilize the surplus funds of the community but also facilities distribution of funds between different firms and industries, and in certain cases, between different countries of the world.

- The stock exchanges are also important because it provides an opportunity to the new companies to get its shares listed on the stock exchange after completion of certain formalities.
The stock exchanges play educative role by arranging seminars, conferences, training institutions that is also laudable.

Stock exchanges have made possible wide distribution of the investor population. The increase in the investor's population will facilitate a high degree of mobilization of the savings of the public. "The people of the country are provided with an opportunity to participate in the nation building by having a stake in the countries industries. This accelerates the mobilization of savings. An efficient capital market will channel liquid capital quickly and accurately to where in will do the community most good."

Therefore on the basis of above discussion we can say that stock exchanges are contributing effectively to the development of the economy of a country.

C. Management and Membership of Stock Exchanges

(a) Management of Stock Exchanges

The stock exchanges have a supreme body that is the Council of Management or Governing Council for the management of its activities. It directs and manages the activities of the stock exchanges in accordance with rules and regulations framed and approved by SEBI/ the government under the provisions of the Securities Contract (Regulation) Act 1956 and rules framed

there under and other guidelines issued by the central government from time to
time. This body consists of president, executive director and secretary. The
day-to-day administration is looked by the executive director or by the
secretary as the case may be.

The position of the president is very important in the stock exchange. He
is nominated by the central government each year amongst the elected
directors. A director can continue for a maximum period of three years
continuously but for this purpose his term is to be renewed every year by the
central government. The powers and functions of the president are given in the
Article of Association of the stock exchanges. He has to work in accordance
with the byelaws and articles of the stock exchanges. In various maters of the
stock exchanges and execution of decision he is assisted either by executive
director or the secretary as the case may be. In his absence, his functions are
discharged by the vice president.

Next is executive director. He is appointed by the stock exchanges with
the prior approval of the Ministry of finance, Govt. of India / SEBI. The day-
to-day administration is looked after by the executive director who will
implement and execute the decisions of the council of management and that of
the central government /SEBI. The executive director is to report to the council
of management and also to the central govt. Powers and duties of the executive
directors are also given in the Articles of Association of the stock exchanges.
The small stock exchanges are looked after by the secretary. He is appointed by the council of management with the prior approval of central government. He has to report to the council of management and to the govt. both. His jobs are specified in the article of association of the stock exchanges and he will perform other powers as are delegated to him by the council of management.

The stock exchanges are governed by their respective governing boards. The constitution of Governing Boards of Indian Stock Exchange is undergoing a change with the changing scenario of the securities market world over. There is a move to induct more of non-broker directors on the board. Under SEBI directive, the constitutions of the governing Boards of the stock exchange were changed to restrict the representation of member brokers to 50%. The balance 50% of members of the governing boards comprises persons who are not brokers. Generally they comprise members of the judiciary, academician, and professionals, such as chartered accountants, representatives of department of company affairs, representative of state government and SEBI officials. The governing body of recognized stock exchange has wide governmental and administrative powers and is the decision making body. Therefore it has wide powers such as election of office bearers, setting up of committees like listing committee, arbitration committee, defaulter’s committee, etc., admission and expulsion of members, management of the properties and finances of the exchange, framing and interpretation of rules, bye-laws etc. for regulation of stock exchange, adjudication of disputes among members or outsiders,
management of the affairs of the exchange in the best interest of the investors and public interest etc.

(i) Demutualisation of Stock Exchanges

As we have discussed the history of stock exchanges, they were earlier formed as mutual organizations, i.e. formed by trading members themselves for their common benefit. Ownership rights and trading rights were clubbed together in membership and they were primarily working for themselves and not in the interest of the general public. To curb this practice SEBI introduced the compulsory demutualization of stock exchanges. But it was lacking the statutory force. Now the SC (R) Act has been amended for this purpose. The word demutualization means the segregation of ownership and management from trading rights of the members of a recognized stock exchange in accordance with a scheme approved by SEBI.¹⁰

(b) Membership of Stock Exchanges

To become a member of a recognized stock exchange, a person must possess the following qualifications:

(a) He should not be less than 21 years of age,

(b) He should not have been adjudged bankrupt or insolvent.

(c) He should not have been convicted for an offence involving fraud or dishonesty.

¹⁰ Section 2 (aa) of Securities Contracts (Regulation) Act, 1956 as amended by Securities Laws (Amendment) Ordinance, 2004
(d) He should not be engaged in any other business except dealing in securities,

(e) He should not have been expelled by any other exchange or declared a defaulter by any other stock exchange.

The govt./ SEBI has also prescribed new norms for selection of members for the guidance of duly constituted selection committee. The criteria which is to be followed includes:

1. Professional and other educational qualifications.

2. Experience relevant to securities market

3. Financial status

4. Performance in the interview

5. Written test

With a view to ensure that stockbrokers are made fully aware of the intricacies of the securities market, the Bombay and Calcutta stock exchanges have already set up training institutes for stockbrokers.\textsuperscript{11}

\section*{D. Trading Procedure at Stock Exchanges}

The procedure for buying and selling of securities at stock exchange is not uniform at various stock exchanges as there are differences in membership, and settlement of transaction in various stock exchanges. But there are some inter common stages, which we will discuss here in brief.

\textsuperscript{11} Supra note 5
In a stock exchange only members are allowed to transact business and outsiders are totally prohibited from entering on the stock exchange. Therefore, the outsiders interested in buying or selling of securities must get the transaction carried out through a member broker. The intending client will place his order with the broker either to buy or sell or both at fixed prices or as best market prices and so on. The client should furnish bank or other references regarding his financial position, honestly and integrity and also open an account with the broker. There are various types of orders such as fixed order limit orders, immediate or cancel orders, stop loss orders, discretionary orders, at best orders, open orders and so on. Each such order has a clear-cut and definite meaning and the brokers have to execute the orders as given by the clients. For example, when price is not specified in order by the client it is called “at the market order” or “at best order”. Such orders are immediately executed by the broker agent without leaving any thing for his discretion. On the other hand, a fixed order is an order that is executed at the price indicated or specified by the client, or below it if it is for buying and above it if it is for selling. In limit orders the client set a definite limits beyond which brokers can not go. Whatever may be the form of orders given they should be precise, clear and unambiguous and any orders given, orally or through phone, should be confirmed immediately.

Immediately after the receipt of the orders they are transmitted to the floor for execution. The broker or his authorized clerk, who received an order, goes near the trading post and calls the name of the scrip in which he want to
deal without disclosing his intention. The other brokers who may be prospective buyers or sellers may 'bid' a price or 'offer' them at a particular price. In between 'taravaniwala' who trades in the market on his own account, makes a price by quoting two prices on which he is ready to buy or sell and the spread between two prices is his profit. His aim is to buy shares so as to sell them at a profit, or sell them first in order to replace them or cover them at a profit. The stock market moves "to a great extent on difference of opinion" and it is difference of opinion that makes some people buy and some others to sell shares at the same time and at the same price.

The haggling between brokers and between brokers and taravaniwals helps in putting the best foot foremost and the prices at which the bargains are settled represents the fairest price for all concerned. The bargain is struck by word of mouth and only short notes are made in small note book as regards the numbers, description of securities and the name of the party from whom or to whom securities are bought and sold.

As soon as the business is transacted, the details of the transactions are recorded in the books of the brokers, after which a contracts note is prepared and sent to the client. The contract note gives details of the security bought and or sold, the prices, the broker's commission, cost of the revenue stamp and the date of settlements.

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Lastly, settlement of transaction made on the stock exchange. There are two methods of settlement of transaction depending upon the nature of the transactions that is ready delivery or cash transaction and the forward delivery contracts. In case of ready delivery, payment has made immediately on the transfer of the securities. For this purpose SEBI has introduced rolling settlement system that we will discuss ahead. The settlement may be made either through the clearinghouse or by hand delivery between the members without the intervention of the clearinghouse.

In case of forward delivery contracts, the settlement is made on a fixed day. Forward trading has been banned by SEBI after recent securities market scam.

We have discussed above how the transactions are carried out in stock exchanges. The transactions are initiated by client and executed by broker.

With the development of technology now the exchanges provide an online, fully automated screen based system. The system electronically matches orders on a strict price and time priority and hence cuts down on time, cost and risk of errors as well as on fraud resulting in improved operational efficiency. This system enables distant participants to trade with each other and consequently improves liquidity of investments.

(a) Factors that influence the Price of Securities

There are various factors that are responsible for the securities market movements and they directly influence the prices of securities. But it is very
difficult to give an exhaustive list of these factors. However, here we will discuss it in brief. This is more or less relates to economics and possibly to psychology, but there are certain fairly obvious influences, of which the most important is supply and demand. If demand for a particular security is high the supply become restricted and the price go up, alternatively, if demand for the securities is low, the price goes down.

There are many factors, which directly or indirectly influence investor’s decision to buy or sell the securities. For buying securities, the following factors are note worthy:

- The expectation that the price of the security will rise because of company’s previous good performance, financial results and skilled management.

- A company’s successful development and production of new and desirable products.

- A company’s successful cost cutting and efficiency measures.

- The winning or advantageous settlement by a company of court cases. This means either that the company becomes entitled to disputed funds or assets, or that the company’s liability to creditors or potential creditors is reduced or eliminated.

- More favourable taxation treatment, which may stimulate demand for the company’s products or services.
- If a company has been doing badly, the belief that the worst has been weathered.

- The possibility of successful takeover bid.

- A better political climate both at home and in any countries to which the company exports or where its products are made etc.

Therefore above are some factors in which the investors takes a decision of buying the securities. For selling of security there are following reasons:

- The expectation that the price will fall as a result of incompetent management on previous poor performance.

- Political instability in countries where the company’s products are exported or made.

- Less favourable taxation treatment resulting in a decline in the demand for the company’s products or services.

- Bad publicity for the company.

- Unfavourable change in government attitude or regulatory legislation.

- Substantial litigation against the company etc.\(^\text{13}\)

On the basis of above discussion we can say that every development has an impact on the securities market and therefore one has to keep a constant watch on national and international developments. For the purpose of

\(^{13}\) Grier Nicholas- UK Company Law, 1999 Edition
investment one has to see social, political developments both in India and abroad such as:

In 1990

- Iraq occupies Kuwait
- Mandal commission resulted riots in India
- Fall of the V.P. Singh Govt.

In 1991

- Gulf war
- Fall of ChandraShekar Govt.
- Assassination of Rajiv Gandhi
- Introduction of economic reforms

In 1992

- Capital Issues Control Act abolished
- Unprecedented boom in stock market.
- Arrest of Harshad Mehta and Bhupen Dalal
- Destruction of Babri Masque followed by riots etc.

In 1993

- Riots in Bombay
- Bomb Blast in Bombay
• Allegation by Harshad Mehta about payments to Prime Minister etc.\textsuperscript{14}

In 1994

• Strong industrial recovery

• Large inflow of funds from foreign Institution investors (FIIs) for portfolio investment.

• Heavy buying of stocks by domestic financial institutions, specially mutual funds etc.

Sept 1994 to Dec 1995

• Outbreak of plaque in Western India in Sept 1994.

• Election to state assembly in which the ruling congress party suffered serious reverse.

• Change in Govt. priorities,

• Reduced foreign inflow both through FIIs portfolio investment and direct foreign investment etc.\textsuperscript{15}

Thus, each and every event or development, national or international, has some impact on the securities market.

(b) Listing of Securities on Stock Exchanges

Listing of securities on stock exchange is first step taken by the companies for the purpose of dealing with their securities on the stock

\textsuperscript{14} Yasasway J.N.- Stock Market Analysis: Intelligent Investor, 1994 Edition
\textsuperscript{15} Gupta L.C. – India’ s Stock Market Crisis, 1997 Edition
exchange and is a main function of stock exchange to provide for listing of securities of companies with a view to facilitate trading in them. Listing means admission of securities for dealing on the stock exchange and to make available the facilities of an organized and regulated market. Transaction in the securities of any company can not be conducted on stock exchange unless they are listed by the concerned companies. Therefore, listing is first requirement for the purpose of transaction on stock exchange. After the listing of securities on stock exchanges it get the trading privileges of the stock exchange concerned. In fact securities become eligible for trading only through listing. It is not obligatory by statute for companies to list their shares on the stock exchange however; listing is compulsory for those companies, which intend to offer their securities to public for subscription by means of issuing a prospectus. Companies Act in this regard provides that “every company intending to offer shares or debentures to the public for subscription by the issue of prospectus shall, before such issue, make an application to one or more recognized stock exchanges for permission for the shares or debentures intending to be so offered to be dealt with on the stock exchange or each such stock exchange”16. Further if a company declares its intention in the prospectus as mentioned above that an application has been made to recognized stock exchange or exchanges for listing of the shares and the permission has not be granted by the stock exchange or each such stock exchange as the case may be within the

16 Section 73(1) of Indian Companies Act, 1956
prescribed period, the allotment made on application in pursuance of such prospectus shall be void.

Thus, unless the permission is granted by each or everyone of all the stock exchanges named in the prospectus for listing of shares to which application is made by the company the consequences is to render the entire allotment void. In other words, if permission has not been granted by any one of the several stock exchanges named in the prospectus, the consequences is to render the entire allotment void and the grant of permission by one or more of them is inconsequential.\(^\text{17}\)

Moreover, the government as matter of policy in the public interest can compel a company to enlist its shares in the stock exchange.\(^\text{18}\)

From the above discussion one thing is clear that though there is no statutory obligation on the companies for listing of securities but indirectly listing of securities on stock exchange becomes an unavoidable one today. Here we will discuss procedure for listing of securities, criteria, advantages, drawbacks etc.

**(i) Procedure for Listing of Securities**

A company has to fulfill certain requirements in order to get its securities listed on the stock exchange. The listing requirements are uniform to all the stock exchanges in India. Rule 19 of the Securities Contract (Regulation) Rules 1957 governs the listing of securities. Various listing requirements are

\(^{17}\) \textit{Ibid, 73(1A)}

\(^{18}\) \textit{Section 21 of Securities Contracts (Regulation) Act, 1956}
enumerated under the SC(R) Rules. In addition to this the byelaws of the stock exchange enable the stock exchanges to formulate regulations relating to listing. The company concerned should meet the relevant stock exchange and have consultation regarding the listing requirements. The company has to apply for listing to the concerned stock exchange and the application for listing is to be accompanied with various documents and details such as:

- certified copies of memorandum and articles of association, prospectus, or statement in lieu of a prospectus, underwriting agreements, etc.
- copies of offers for sale and circulars or advertisements offering any securities, for subscription or sale during the last 5 years,
- particulars of dividends and bonuses paid during the last 10 years,
- a statement showing dividends or interest in arrears if any,
- a brief history of the company since its incorporation, giving details of its activities,
- particulars of securities for which permission to deal is applied for and their issue, and
- a statement showing the distribution of shares along with a list of highest 10 holders of each class or kind of securities of the company stating the number of securities held by them etc.

The stock exchange concerned will scrutinize the application of applicant company and will ensure its requirements.
(ii) Eligibility for Listing

For listing of securities on stock exchange the company should offer at least 10% of each class or kind of securities issued by it, to the public for subscription through advertisement in newspapers for a period not less than two days. The applicant company should satisfy the stock exchange that the application received in pursuance of such offer were allotted in compliance with the following conditions:

- that the minimum 20lakh securities excluding reservations firm allotments and promoter’s contribution was offered to the public,

- that the size of the offer to the public, i.e. the offer price multiplied by the number of securities offered to the public was minimum Rs. 100 crores and

- that the issue was made only through book building method with allocation of 60 % of the issue size to the qualified institutional buyers as specified by SEBI.

If the company does not fulfill the above conditions, in alternate it will offer at least 25 % of each class or kind of security to the public for subscription through advertisement in newspapers for a period not less than two days.\(^{19}\)

The above requirements can be relaxed by stock exchange in respect of

\(^{19}\) Rule 19 (2) (b) of the Securities Contract (Regulation) Rules1957, as substituted by the Amendment Rules, 2001 w.e.f. 7.6.2001
the government companies however; prior approval of SEBI in this regard is essential.

The articles of association of the applicant company must provide for the following:

- a common form of transfer shall be used.
- fully paid shares will be completely free from lien.
- partly paid up shares will be subject to lien only to the extent of call money due at the fixed time.
- unclaimed dividends shall not be forfeited before claim becomes time barred.
- the right to call of shares shall be given only after the necessary sanction by the general body meeting etc.

(iii) Listing Agreement

This is an agreement which is executed between the company and the concerned stock exchange. Listing agreement contains a wide list of conditions and obligations, which the company should adhere or observe strictly, in contravention of these conditions the securities of the company, may be delisted by the stock exchange. A listed company has compulsorily notify the stock exchange the date of the board meeting at which the declaration or recommendation of dividend or the issue of right or bonus shares will be considered, any change in the company’s capital structure, or its directors or
managerial personnel. The listed company has to forward to the stock exchange:

- copies of all notices and circulars sent to the shareholders including the proceedings of ordinary and extraordinary general meetings,

- certified copies of all resolutions passed by the company as soon as such resolutions become effective, and

- copies of statutory and annual reports and annual audited accounts as soon as they are issued as well as director’s report, etc.

In this regard G.S. Patel committee on stock exchange has recommended that, every listed company should be required to furnish un-audited financial results in the prescribed format on a half yearly basis within two months. Consequently clause-41 that was added to the listing agreement requires a listed company or a company, which has applied for listing to furnish to the stock exchange un-audited financial results within the expiry of two months from each of the six months period of the accounting year. The company is also required to publish half-yearly un-audited financial results in at least one English daily newspaper circulating in the whole or substantially whole of the India and in a newspaper published in regional language where the registered office of the company is situated. Thus the listing agreement works or regulates the day-to-day activities of the company indirectly.

20 By a Ministry of Finance Notification dated Sep.6, 1991
(iv) Advantages and Disadvantages of Listing

There are various advantages of listing of securities on stock exchange. The most important is the listing provides liquidity to the securities. It provides marketability and free transferability of securities. The listed security of any company more attracts to the investing public as it provides ready and continuous market. The dealing in securities is made subject to proper supervision and control. The regular and latest reports on listed companies help the investors in saving for investment in the securities of the company that are listed on the stock exchange. The interest of investing public is safeguarded or protected.

Listed companies enjoy certain concession under the direct tax laws and official quotations are accepted by the tax authorities. Listing assures fair trading practices for the investors. Further, listing assures disclosure of information on all listed companies in respect of their working and performance. The transactions in listed securities are published widely in the leading periodicals and journals and therefore corporate details like the results, dividend announcements, and expansion and diversification plan of the listed companies are published from time to time.

Moreover, the companies are under an obligation in terms of listing agreement to inform its investors about various corporate information.

The interest of the investors is protected on account of proper supervision and control in the dealing in the corporate securities. The standard
listing agreement contains clauses aimed at protecting the interest of investors from certain undesirable practices. Further, listed securities enjoy a special status. The trading activities take place under a well defined code, bye laws and regulation of the exchange and due publicity to the transactions are given. As a result, listed securities have a better status and command better demand and serve as a collateral for bank advances and other lending operations.

The listed company has high image and thereby impressed the investors. Listing helps the company to raise the necessary funds easily. A listed company will do a lot to the investing public by furnishing information regarding its financial performance, dividends, rights issues etc. It helps the investors to take more logical and correct decision regarding the concerned company. A listed company is subject to lot of discipline. Richard Teweles and Edward Bradeley has nicely presented and sums up the importance of listing in the following manner:

"Listing tends to create lower financing costs when additional capital is raised in future. Again, a company obtains a certain amount of publicity and advertising from having its securities listed. Consumers associate the company's product with its stock. Frequent sales on the exchange keep the company's name before the public. In many cases, however, the brand name bears no relationship to the company's name and the publicity value is non-existent desire to obtain more stock holders. Many corporations consider this  

21 Supra note 4  
one of their most important reasons. More shareholders tend to create more
customers, improve public relations, aid future financing, diversify the
company ownership and advertise the organisation... listing helps to determine
fair prices for the company stock. It is believed that the auction market for the
stock will give to it a fair value based on effective interaction of demand for
and supply of the stock".23

As we have seen that the listing of securities on the stock exchange or
exchanges has various advantages to the investors and the company but at the
same time listing brings some bad effects also like listed securities offer wide
scope for the speculators to manipulate the values in such a way as may be
detrimental to the interests of the company. In such a situation, artificial forces
play a more dominant role than the free market forces. The stock market may
not reflect the true picture of a listed security. The chances of insider trading
become high. The managerial personnel may indulge in speculative activities
with regard to listed security by misusing the inside information available to
them and which is not available to the outsiders and therefore the interest of the
genuine investors will be effected badly.

Secondly listed securities are subject to wide fluctuations in their values.
They may become a victim of depression. Any such fluctuation or movement
in the value of listed securities immediately reflected on the stock exchange
whereas unlisted securities escape from this misery. These types of fluctuations
in their values have the effect of degrading the company’s reputation and image

23 Supra note 7
in the eyes of the investors, general public, as well as the financial intermediaries.

Thirdly, at the time of listing of securities in the stock exchange the concerned company has to disclose various type of information such as dividends and bonuses declared, a brief history of the company, sales, remuneration to managerial personnel etc. It sometimes amounts to leaking of secrecy of the company's operation to trade rivals. Even trade unions may demand higher wages and bonuses on the basis of these informations. Therefore, sometimes listing may prove disadvantageous to a company.²⁴

On the basis of above discussion one may rightly say that the listing of securities in stock has more advantages than draw backs and without listing of securities it is impossible for a company to raise the funds from the public.

(v) Central Listing Authority

SEBI has constituted a regulatory authority called Central Listing Authority that scrutinizes the listing applications made by the different companies. After constitution of this authority now it is mandatory for the company wishing its securities to be listed in the stock exchange, to obtain a Letter Precedent to Listing (LPTL) from CLA and after that it shall approach to the concern stock exchange. Therefore, now the company can not apply or approach directly to the stock exchange for listing.

²⁴ Gorden E. Natrajan K.- Capital Market of India, 1999 Edition
The idea of setting up of central listing authority was given by the Pratikkar committee, which was constituted by SEBI. The recommendation of the committee was accepted by SEBI and consequently, it issued the first set of SEBI (CLA) regulations in Feb 2003 which was subsequently replaced by SEBI’s\(^{25}\) notification. The same notification has introduced SEBI (CLA) regulations\(^{26}\) thereby established a regulatory body for listing of securities on stock exchange which is called Central Listing Authority.

These regulations provide that there will be eleven members of CLA including the president and vice president. Besides president and vice-president there will be nine other members out of these three members shall be representatives of the stock exchanges and the remaining six shall be from amongst eminent persons of demonstrated integrity and outstanding technical and professional ability and drawn from the judiciary, the legal profession, the academia, investors association, experts in securities market etc.

SEBI itself has taken the task to make the working of authority effective and it will provide support to CLA whenever it required. In this regard regulations provides as follows:

- SEBI to advise CLA regarding the appointment of the CEO who shall also be the ex-officio member secretary to CLA and who shall comply with all the administrative formalities related to the meetings of CLA.

\(^{25}\) Notification No SO 954(E) dated Aug. 21, 2003
\(^{26}\) SEBI (CLA) Regulations 2003
- SEBI to enable CLA to open branch offices throughout India for flexibility in its operations.

- SEBI to provide infrastructure and manpower to CLA as and when required.

(1) Factors responsible for constitution of CLA

As discussed above the Pratip Kar committee has recommended for the constitution of CLA. The recommendations of the committee were based on the various reasons or factors. Some of them are as follows:

- As discussed earlier, for listing of security the company has to make an application complying all the requirements in this regard, which was scrutinized by the stock exchange authority. But it has been noticed by the committee that the regional stock exchanges or the small stock exchanges have no adequate infrastructure and expert manpower to deal with this complicated issue related to public offering and consequently failed to enforce the listing agreements in the right directions. The company takes the benefit of this week pre-issue scrutiny by such regional stock exchanges and manages to get its shares listed on regional stock exchanges. Next step is rigging up of their share prices and gradually get their security listed on the BSE and NSE.

- There is a lack of uniformity among the stock exchanges and this becomes quite obvious when permission for listing of securities is
granted by one stock exchange but refused by the other when the similar requirements are laid down by the statutes for all the stock exchanges.

- It has also been noticed by the committee that the regional stock exchanges have failed to redress the grievances of the investors.

- The regional stock exchanges have failed to provide the required information to the investors.

- There has been a clear-cut conflict of interest when the exchange is run by the brokers themselves and it adversely effects the interest of the investors.\(^{27}\)

(2) Procedure for obtaining the letter precedent to listing (LPTP) from CLA

Letter Precedent to Listing mean a “letter issued by Central Listing Authority under Regulation 12 permitting the applicant to make a listing application to any exchange including an application for re-listing and listing of an already listed security at an exchange otherwise than the exchange where it is presently listed”.\(^{28}\)

Thus, it is clear that no company can get its securities listed on any stock exchange unless it obtains LPTL from CLA. The regulations in this regard provides that no applicant unless it has obtained a LTPL from CLA shall (a)

\(^{27}\) SEBI (CLA) Regulations: New Horizons for Listing of Securities, CS, Feb. 2004
\(^{28}\) Regulation 2(1) (b) of SEBI (CLA) Regulations, 2003
make an issue of securities proposed to be listed on any exchange or (b) make a listing of its securities to any exchange.\(^29\)

For obtaining the LPTL an applicant has to make an application to CLA in the prescribed form, and manner. The application shall be accompanied by such documents as may be prescribed by CLA and along with such fee as may be prescribed by SEBI in consultation with CLA.

The application made to CLA for obtaining LPTL shall specify the exchange or exchanges in which the applicant is desirous of its securities listed.

The regulation provides that "Notwithstanding anything contained in any regulation or the guidelines issued by SEBI an applicant seeking listing of securities shall file only with CLA draft offer documents in respect of the public and rights issues by companies and bodies corporate or draft offer documents of schemes of mutual funds or collective investments/schemes and SEBI may offer its observation, if any to CLA on such offer documents."\(^30\)

Subsequently, after receiving the application CLA may call for further information, additional documents or any clarifications if needed in this regard within 30 days from the receipt of the application. CLA before issuing LPTL to the applicant will have to consider or regard to various aspects like:

- compliance with the provisions of the Companies Act 1956 pertaining to issue of securities,

\(^{29}\) Ibid, Regulation 9 (1)

\(^{30}\) Regulation 10 (1) to (4), Ibid
• compliance with the regulations and guidelines of SEBI applicable in this regard, and

• compliance with the listing conditions specified under SEBI Act 1992 and the SC(R) Act 1956 and the rules made there under and such other aspects as CLA may consider relevant in this regard such as interest of investors, etc.\textsuperscript{31}

CLA after carefully scrutinizing or examining the application and the information may either grant the LPTL or may refuse to grant the LPTL within the prescribed period. CLA while granting LPTL may impose such conditions as it may consider fit in the prevailing circumstances. It may relate to the quality of disclosures in the offer documents and advertisements.\textsuperscript{32}

CLA after giving an opportunity of hearing to the applicant may refuse to grant LPTL. There are various circumstances in which CLA may refuse to grant LPTL or can withdraw the LPTL; some of them are as follows:

• if the applicant has suppressed any material information or has misrepresented facts to CLA,

• if the applicant has failed to supply such information or documents as required by CLA,

\textsuperscript{31} Regulation 11 (1) to (6), \textit{Ibid}
\textsuperscript{32} \textit{Ibid}, Regulation 12 (1) to (10)
• if the applicant has failed to inform CLA of any relevant or material
development that took place subsequent to the filing and during
pending of the application,

• if the applicant changes the terms and conditions of the issue after
obtaining the LPTL,

• if the application has failed to comply with the conditions imposed by
CLA, and

• if CLA think that withdrawal of LPTL is in the interest of investors at
large and the securities market.

CLA can exercise its power of withdrawing the LPTL only if the
securities are not listed in the stock exchange after obtaining the LPTL. If it has
been listed in the stock exchange CLA can only inform to SEBI and the
concerned stock exchange for taking the necessary steps against the applicant.
Orders of CLA are appeal able to the SAT.

(3) Functions of CLA

The main functions of CLA are as follows:

• to receive and process applications for LPTL from applicants and issue a
LPTL if it deems fit,

• to make recommendations to SEBI on issues pertaining to the protection
of the investors, development and regulation of the securities markets
including the listing agreement, listing conditions and the disclosures to be made in the offer documents, and

- to undertake such other functions as may be delegated to it by SEBI.\textsuperscript{33}

In this way it can be said that the constitution of CLA is a good effort made by SEBI with regard to listing of securities on the stock exchange. No doubt the setting up of this regulatory body shall bring uniformity in listing. But on the basis of above discussion it is clear that CLA is not an independent body and it may be called as the subsidiary of SEBI. The authority has to work under the control of SEBI. As discussed earlier the managerial personnel of CLA shall be appointed after the prior approval of SEBI. In many other important matters CLA has to consult with SEBI. SEBI time to time may also give advice or will support to CLA. This is the day- to- day interference by SEBI in the working of CLA.

Another weakness is that even if a company or applicant is granted LPTL, it again has to approach to the stock exchange for listing of securities that amounts duplication of efforts.

Moreover, if the applicant company has obtained LPTL from CLA and its securities are listed on the stock exchange, CLA loses control over the company even if it contravenes the terms and conditions of LPTL, violates any rules, regulations regarding listing of securities etc. Therefore, CLA should be authorized to take actions against such companies even after its securities are

\textsuperscript{33} Regulation 8, \textit{Ibid}
listed on the stock exchange. At present, it may either inform to the concerned stock exchange or to SEBI about such contraventions or violations.

E. Reforms Made in Secondary Market After Constitution of SEBI

(a) General Reforms

We have already discussed the evaluation and origin of secondary market. Here we will discuss the reforms introduced in secondary market in order to develop a healthy market. The Government of India has taken several steps in this regard during ninety’s which lead gradual globalisation of the Indian securities market. The decade of 1980’s witnessed a phenomenal growth and development of the securities in India. For the first time, the Indian securities market demonstrated its potential not only to mobilise the savings of the household sectors but also to allocate it with some degree of efficiency for industrial development. By the end of the decade, the securities market in India came to be firmly integrated with the financial system of the country. With the corporate sectors increasingly relying on the securities market competed on equal terms with the development of financial institutions, which were the traditional purveyors of long-term capital. This brought some notable changes in the capital structure of the companies across industries, gave birth to intermediaries and institutions in the securities market and created a new awareness and interest in the investment opportunities in the securities market among investors. In spite of these developments the regulatory framework of
market was not very effective. There was absence of adequate professionalism and fair competition among the various players in the market. There was many trading malpractices and structural inadequacies prevailing in the market; the govt. therefore felt the need of setting up of an apex body for the first time, exclusively for investor's protection and for the protection of orderly and healthy growth of the securities market i.e. Securities Exchange Board of India (SEBI). Till then many steps have been taken by it to reform the secondary market so that it may function efficiently and effectively. Steps are also taken to broaden the market and make it function with greater degree of transparency and in the best interest of the investors.

(i) Regulation of Intermediaries

For the purpose of improving the functioning of intermediaries in the securities market, SEBI has introduced various regulations in this regard. Strict control is being exercised on them by SEBI. No person or institution can act as the intermediary in the securities market unless it has been registered with SEBI. The intermediaries such as merchant bankers, underwriters, brokers, sub-brokers, bankers to the issue, registrar to the issue, share transfer agent etc. must be registered with SEBI. There are various conditions or requirements that should be fulfilled by such intermediaries before seeking the registration from SEBI for acting as an intermediary. The registration granted by SEBI is not a permanent kind and it has to be renewed from time to time or the time
prescribed by SEBI. SEBI has powers to suspend them or cancel their registration if found by it guilty after enquiry.

(ii) Change in the Management Structure of the Stock Exchanges

In the earlier period the governing boards of the stock exchanges were dominated by the brokers and their interests were clashes with the interest of the investors. Their decisions were not fair and transparent. To curb this practice or to provide transparency in the decisions of the boards of stock exchanges SEBI required that 50% of directors of board must be non-broker directors or government representatives. Further, it is obligatory that a non-broker professional shall be appointed as the executive director. Now demutulisation of stock exchanges has been proposed by SEBI.

(iii) Encouragement of Market Making

There is greater transparency in the dealings of market makers and the securities with market-makers command higher level of liquidity. Market makers offer two ways quotations one the purchase price and other for sale price in respect of the same security. The market makers have to comply with many rules and regulations strictly with regard to minimum number of scrip for market making, timely payment of margins, adequate financial strength, and adequate turn over etc. Therefore the market making is compulsory on OTCEI at least for a period of 18 months from the date of opening of the offer by the sponsors or designated members.
Further the companies seeking listing, with paid up capital ranging between Rs.3 crores and Rs.5 crores and without a track record of commercial production of at least two years, shall have to appoint a market maker compulsorily. There is also a provision for voluntary market making on OTCEI.

(iv) Curbed Price Manipulations

SEBI is taking all the steps to prevent price manipulation in all stock exchanges. It has instructed to all stock exchanges to keep special margins in addition to the normal ones on the scrip that are subject to wide price fluctuations. SEBI itself insists upon a special margin of 25% or more in addition to the regular margin on purchase of scrip, which are subject to rise in prices. This margin money should be retained by the stock exchange concerned for a period of one two three months. SEBI has also directed all stock exchanges to suspend trading in the scrip in which any one of the stock exchanges suspends trading in that scrip due to price manipulations or fluctuations.

(v) Introduction of concept of Buy Back of Shares

With a view to arresting heavy fluctuations in the prices of shares and to adjusting the demand and supply of shares in the market Companies Act permitted the companies to buy back their own shares on certain conditions.

34 SEBI notified norms for market makers in Oct. 1995
35 Companies (Amendment) Act, 1999
(vi) Introduction of Rolling Settlement

SEBI introduced rolling system, which implies that, any outstanding transaction at the end of the day will necessarily result in delivery. For example, if one has purchased, say, 1000 shares of Reliance, and the transaction remains outstanding at end of the day, he would have to make payment on the settlement day. The settlement day would be T+2 as specified by SEBI. It has been called “millennium move” by the newspaper.\(^\text{36}\) Thus, the rolling settlement has been introduced to shorten the trading cycle. In this process, trades done on a given day are independently settled from the trades entered into on other day.

(vii) Introduced Trading in Derivatives

SEBI has banned ‘badla’ and other deferred products\(^\text{37}\) and to compensate for the absence of hedging mechanism in the market SEBI introduced trading in derivatives, which includes (a) a security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for difference or any other form of security (b) a contract which derives its value from the prices, or index of prices, of underlying securities.\(^\text{38}\)

(viii) End of Badla System

The Badla system was banned in March 1994 that was again introduced after the G.S. Patel committee recommendations in March 1995. SEBI in July

\(^{36}\) Economic Times, dated 22 Sep. 1999
\(^{37}\) On 14th May 2001
\(^{38}\) Section 2 (aa) inserted by the Securities Laws (Amendment) Act, 1999 w.e.f. 22.2.2000
1995 introduced a modified Badla system. Again in 2001 due to Ketan Parakh scam on share market Badla trading was banned. It is a step towards a better and smooth functioning of the market. This change should focus on factors like efficiency, transparency and integration with international practices.

(xi) Option Trading

In option trading a buyer enters into a contract to buy a certain quantity of stock at predetermined prices after a certain period by paying a premium. A buyer in such contracts has a call option; conversely, a seller enters into an agreement, or a put option, with the buyer for a certain time period by paying a premium. In such transactions the predetermined prices called the strike price. Further, only a small amount compared to the underlying assets cost i.e. premium is paid by the parties. Therefore, an option is a right to buy or sell something at a specified price on a specified date. If the option holder is not inclined to make the purchase or the sale he can not be compelled to do so.\(^{39}\)

(b) Institutional Strengthening of Securities Market

A study group was set up under the Chairmanship of Shri M.J. Pherwani, for evolving a policy for establishment of new stock exchanges and other agencies.\(^{40}\) The group made the following recommendations\(^{41}\):

- Exchanges for New Bombay, Nagpur, Gwalior and Candigarh. The New Bombay center will be a model exchange that will also act as a National

\(^{40}\) Established in Feb. 1991
Stock Exchange (NSE) that will provide access to investors from all over the country.

- Creation of three-tier National Stock Market System involving...

- The principal stock exchange at Bombay, Delhi, Calcutta, Ahmedabad and Madras.

- Regional stock exchanges in smaller cities and urban centers,

- Additional trading floors (ATFS) each sponsored and managed by a principal or regional exchange.\(^{42}\)

- Establishment of a National Clearing and Settlement Corporation that will arrange for payments against delivery as a counter guarantor to participating members.

- Establishment of Central Depository Trust. The stock Holding Corporation of India Ltd (SHCIL) has already been mandated to evolve into a Central Depository. It will also promote electronically inter-linked regional depositories.

- Additional mutual funds on regional basis. They will invest in specific industries in specific regions.

- Uniform constitution for all exchanges with a statutorily empowered body to oversee its enforcement.

\(^{42}\) Supra note 24
(i) Setting up of National Stock Exchange (NSE)

Implementing the recommendations of the committee, the NSE was incorporated on 27th Nov 1992 with an equity capital of Rs.25 crores promoted by IDBI, ICICI, LIC, and its subsidiaries etc. NSE started its trading operation from 30th June 1994. The main agenda of NSE was to strengthen the move towards professionlisation of the capital market as also to provide nation-wide securities trading facilities to investors through an appropriate communication network. NSE also seeks to impart fairness, efficiency and transparency to securities, shorter settlement and meet international securities standards.43

The NSE is a national, ring less, and computerized exchange. The trading on NSE is over the counter, through the telex, telephone, and through electronic media. Due to its electronic screen based trading system, members have equal access and equal opportunity of trade irrespective of their location in different parts of the country as they are connected through a satellite network. So it is a step taken in right direction. During the year 2000-2001 NSE had a market share of 59.3% in the Wholesale Debt Market (WDM) segment, 45.3% in the Capital Market (CM) segment. The year 2000-01 witnessed a total number of Rs.17.70, 457 crore against a turn over of Rs.11,43, 268 crores in the preceding year. The annual growth rate of turnover

of NSE over five years from 1995-96 to 2000-01 has been 86\%\(^4\). This shows the effective working of the NSE.

(ii) Creation of Over the Counter Exchange of India (OTCEI)

OTCEI was incorporated in 1990 following the G.S. Patel committee report on stock exchange and the Abid Husain report on capital markets. It was incorporated in 1990 as a company incorporated under Companies Act 1956, with a paid up capital of Rs. 5 crores. It was promoted by financial institutions, namely, ICICI, UTI, IFCI, IDBI, SBI capital market Ltd. etc. It was recognized by Govt. of India.\(^5\) OTCEI became fully operational on 1\(^st\) Sept 1992 with opening of a counter in Bombay. The companies listed on it enjoy the same listing status as available to other companies listed on other stock exchanges in India, except that a company listed on OTCEI can not be listed/traded on any other stock exchange in India. OTCEI is a regulatory body, which will supervise, monitor-trading activities on the exchange.

OTCEI market is a floorless security trading system equipped with electronic or computer network through which nationally and internationally scattered buyers and sellers can conduct business more efficiently and economically.

Thus, OTCEI is a way of doing business rather than a place. It is a way of trading securities rather than an organized stock exchange. This is a step

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\(^4\) Report of Joint Committee (Parliament) on Stock Market Scam and Matters Relating thereto, 13\(^th\) Lok Sabha, V - I, 19\(^th\) Dec. 2002

\(^5\) Under section 4 of the Securities Contracts (Regulation) Act, 1956
favourable to small investors, and small companies as they were facing the listing problems. Under Companies Act 1956 and under listing Guidelines a public company should have a minimum issued capital of Rs.3 crores. The trading documents of OTCEI are:

- **Counter Receipt (CR)**- This is issued to an investor who is buying a script it contains all the information, which appear on a share certificate.

- **Sale Confirmation Slip (SCR)**- This is issued to an investor who is selling the script and it is an acknowledgment of the transaction and payment will be made to the investor against the SCR and

- **Transfer Deed**

The companies with a paid up capital from 30 lakhs to Rs.25 crores are eligible for listing on OTCEI. These companies must be sponsored by a member of the OTC.

(iii) National Securities Depository Ltd. (NSDL)

The NSDL was registered with SEBI and launched on 7th Nov. 1996, as India’s first depository to facilitate trading and settlement of security in dematerialised form. This organization is promoted by the IDBI, UTI and the NSE to provide electronic depository facilities for stock traded in the equity and debt market. Therefore depository is an organization where the securities of a shareholder are held in the electronic form through a process of

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46 Chalam Gopal – How’s And Why’s of OTC Exchange Trading, Comp.LJ, V-1, 1993
47 Shirali Jaideep - OTC Exchange, CS, July 1993
dematerialisation. Depository means a company formed and registered under the Companies Act 1956 and which has been granted a certificate of registration under sub-section 12 of SEBI Act 1992. The term depository means a place where something is deposited for safekeeping, a bank in which funds or securities are deposited by others, usually under the term of a specific depository agreement.

This has been introduced to curb the weakness in the stock market due to the physical movement of share certificates and registration with the company concerned like lengthy paper work, long delays, bad deliveries, loss of share certificate etc. The depositories in securities are required to create and maintain computerised entry of records of securities to effect transfer of ownership based on delivery of securities against cash payment in listed or to be listed companies. They will be required to create and maintain computerised book entry of transactions involving pledge of securities. It will reduce the time and cost of processing securities and will promote efficiency, accuracy, safety and speed in the security transfers.

To make the process of share transfer and delivery easier and quicker the regulator introduced materialisation where the shareholders were asked to trade shares in the demat form. The legal framework for depository system

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48 Section 2 (c) of Depositories Act, 1996
49 Agarwal Sanjiv – Scripless Trading: Regulation and Avenues, CS, March 2000
52 Business Times, Nov. 24, 2004
has been laid down by the Depository Act, 1996 and is regulated by SEBI. For the purpose of using the facility of depository the investor has to just open an account with the depository through a depository participant. The account will be credited with the purchase of securities and debited with the sale of securities.

In Sep. 1995, the Government had accepted in principle the proposed law for settling up of depositories and of a central depository for immobilization of physical certificates. A central depository was set up by the NSE in collaboration with IDBI and UTI to take care of depository functions to investors trading on NSE and other exchanges. The emergence of two depositories, NSDL and Central Depository is likely to bring about competition and has already started bringing down costs for holding shares in the electronic form.

(iv) National Securities Clearing Corporation Limited (NSCCL)

NSCCL is entrusted with the task of guaranteeing settlement of trades in the capital market segment of the NSE. It has made considerable progress in enhancing clearing facilities in the other regions by establishing regional clearing facilities. The setting up of Delhi regional clearing house and other regional clearing facilities of the NSCCL will enable the regional relocation of the settlement facilities.
(v) Credit Rating Agencies

Credit rating agencies have been set up for awarding credit rating to the money market instruments, debt instruments, deposits and even to equity shares also. Now, all debt instruments must be compulsorily credit rated by credit rating agencies so that the investing public may not be deceived by financially unsound companies. It is a healthy trend towards a developed capital market. There are many credit rating agencies like Credit Rating and Information Services of India Ltd. (CRISIL)\(^5\) Investment Information and Credit Rating Agency of India (ICRA) \(^4\) and Credit Analysis and Research Ltd (CARE)\(^5\) etc.

(vi) Starting of Self-regulatory Organisations (SROs)

SEBI is encouraging the starting of SROs following the recommendations of Dave Committee\(^6\) for the purpose of implementation of the SC(R) Act, SEBI Act, Regulations and Guidelines issued by the Govt./SEBI from time to time. This would certainly reduce the work of the regulatory authorities. For this purpose, SEBI is encouraging the various market intermediaries like merchant bankers, stockbrokers, underwriters, mutual funds etc. to start organizing themselves into SROs and to get recognition from SEBI. SEBI has already granted recognition to the SRO of merchant bankers registered as the Association of Merchant Bankers of India (AMBI).

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\(^5\) CRISIL set up in 1988 jointly by financial institutions like ICICI, UTI, and LIC etc.
\(^4\) ICRA was set up in 1991 sponsored by IFCI & other financial institutions
\(^5\) CARE set up in 1993, Duff & Phelps Credit Rating Agency in the private sector, set up in 1995-96
\(^6\) Dave Committee Report on Infrastructure of Capital Market, issued by AMBI on 30th June 1997
(vii) Introduction of Ombudsman in Securities Market

SEBI has recently introduced the post of Ombudsman for the redressal of investor's complaints or grievances regarding non-receipt of refund orders, non-receipt of share certificates or unit certificates and any grievance in respect of issue or dealing in securities against an intermediaries or a listed companies.

The word Ombudsman has been defined as "a public official appointed to investigate citizen's complaints against govt. agencies or officials that may be infringing on the rights of individuals." The office of Ombudsman has already been established by RBI. The joint parliamentary committee in its report recommended that the concept of Ombudsman, which has already been introduced in banking sector, should also be extended to the capital market. The legal advisory committee has also suggested for framing the regulations in this regard.

Following the above suggestions and recommendations SEBI issued regulations in this regard on 21st Aug. 2003 more or less similar to that of banking scheme. Accordingly, the Ombudsman in securities market can be understood as an office (person) appointed to redress investor's complaints against a listed company, company intending to get its securities listed or a capital market intermediary. The Ombudsman will have to perform various

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57 See Webster's New Words Dictionary
58 See Banking Ombudsman Scheme, 1995
59 Supra note 44
60 Legal Advisory Committee constituted by SEBI headed by Justice M.N. Venkatachaliah
61 SEBI (Ombudsman) Regulations, 2003
62 Supra note 58
functions like... The ombudsman shall receive complaints with respect to non-receipt of refund orders, allotment letters in respect of the public issue of securities, non-receipt of share certificates, non-receipt of dividend etc. against any intermediary, a listed company or company intending to get its securities listed or all of them. On receipt of complaint the Ombudsman will consider it and will try to facilitate the amicable settlement of the dispute between the parties. If no conclusion made out of amicable settlement or if Ombudsman fails in this regard, he shall adjudicate such complaints. He will try to give the award on adjudication within a period of three month from the date of filing of the complaint and the award will be send to the parties. The award passed by Ombudsman is final and binding on parties and persons claiming under them respectively however, the aggrieved party can file with SEBI within one month from the receipt of award a review petition on certain conditions like substantial miscarriage of justice, or if there is an error on the face of the award. From the orders of SEBI on review petition, an appeal lies before the SAT.

Legal practitioners are not allowed to represent the parties at the proceedings before the Ombudsman except by the permission of Ombudsman itself.

63 For grounds see Regulation 13 of SEBI (Ombudsman) Regulations, 2003
F. Regulatory Framework of Securities Market

As discussed, in earlier period the stock exchanges were not governed by any effective legislation. The proper reforms in this regard started after the constitution of the Atlay Committee. Here we will discuss the brief history of legislation governing the stock market system and the present position in this regard. Proper regulation of the securities market is important in order to achieve continuous expansion in the share holding population of the country. The institution of stock exchanges can function efficiently and effectively only when it is subject to certain rules, regulations and Bye-laws.

(a) Historical Background

The earliest legislation governing the stock market can be traced to the 19th Century when in 1865 the Government of Bombay passed an Act of XXVIII of 1865 to deal with the situation arises out of the outbreak of the American Civil War.

(i) The Bombay Securities Contract Act 1925

The Bombay Securities Contract Act was passed on 29th Oct 1925, following the rejection of the Bombay stock exchange to accept charter that was based on the recommendation of Atlay committee, which was constituted on 14th Sept 1923 under the chairmanship of Lord Atlay. The committee was constituted for regulating the operations of the Bombay stock exchange. In this regard the committee codified the rules, bye laws and regulations in the interest
of investing public and the trade itself. Based on the recommendations of the committee the Govt. of Bombay offered a charter to Bombay stock exchange on 21st July 1925. But unfortunately or one may say fortunately (as special legislation was enacted) the BSE rejected the charter. This led to a special legislation for controlling the stock exchanges in India with the passing of Bombay Securities Contracts Act 1925. So these were the reasons for passing the first legislation in India. The Act came into operation on 1st Jan 1926.

The government was empowered by the Act to grant recognition to a stock exchange and also to withdraw the recognition. Further the Act provided that the rules, regulations and bye-laws of the stock exchange will not be operative until it get the approval of the Government. Moreover without the prior permission of the government the stock exchange was not permitted to amend its rules, regulations and bye-laws. Therefore, the Act more or less was controlling the functioning of the stock exchanges.

Accordingly, the BSE applied for recognition to Government that was granted to it on 14th May 1927.

(ii) The Bombay Forward Contracts Control Act 1947

The ambiguities or defects in the Bombay Securities Contract Control Act led to the passing of Bombay Forward Contracts Control Act 1947. For this purpose a committee was constituted specially to study the rules relating to the listing requirements and admission of securities for dealing on the pattern

Committee is known as ‘Morison Stock Enquiry Committee’, constituted on 24th Nov. 1936
of the Bombay stock Exchange. The committee submitted its report in 1937 and also codified the regulations to be revised by the exchange, which were finally approved by the Government.

(iii) Defence of India Rules 94(C)

The Defence of India Rules 94(c) was promulgated in 1943. The main object of these rules was to counter the speculative operations. The Defence of India Rules prohibited stock exchanges from indulging in facilities for carry over transactions. Further, the Rules defined the ready delivery transactions as those transactions, which had to be fulfilled by delivery and payment within seven days of the contract.

The Rules promulgated as temporary measures continued in force by an Act of parliament, the Capital Issues Control Act 1947. The objective of the CCI Act was to fasten rational and healthy growth of corporate sector and to control or regulate the issue of capital by companies. Under the CCI Act companies were prohibited to make any public offer of securities for sale except with the prior consent of central govt. The sale and purchase of securities by any person and the advertisement making public or private offer for subscription or purchase of securities were prohibited without the consent of central govt. An office of Controller of Capital Issues was established for implementation of the Act. A study of the provisions of the CCI Act reveals that the CCI Act did not work towards monitoring healthy and efficient growth of regulated organizations but tended to restrict entry and competition.
Moreover, the CCI Act was found insufficient to monitor or check malpractices of the stock market.

The new constitution of India came into force on Jan 26, 1950. Consequently the stock exchange and future markets became exclusively a central subject under item 48 of the union list. A draft (Bill for stock exchange regulation was prepared by Govt. in 1951 which was referred to an expert committee under the chairmanship of A.D. Gordwala and other members were the president of Bombay, Madras, and Calcutta stock exchanges.

Based on the recommendations of the Gorwala Committee the Securities Contracts Bill 1954 was introduced in parliament, which was passed by Lok Sabha on 16th July 1956. The Securities Contract (regulation) Act 1956 came into force on 20th Feb. 1957 throughout India.

Before passing of the SC(R) Act the securities market has the following main problems:

- Lack of uniformity and control over the stock exchanges
- No restrictions on membership of stock exchange
- No check on unhealthy speculation
- No rules, regulations on listing of shares

(b) Present Position

At present, four main legislations are governing the securities market, which are:
The Securities Contracts (Regulation) Act 1956,
The Depositories Act, 1996,
The Securities Exchange Board of India Act, 1992 and
The Companies Act 1956.

(i) The Securities Contracts (Regulation) Act, 1956

This Act provides direct or indirect control of virtually all aspects of securities trading and the running of stock exchanges. It aims to prevent undesirable transactions in securities. Under the Act wide powers have been given to Central Govt., now mostly delegated to SEBI, to have strict, and continuous control over the stock exchanges. The Central Govt./SEBI exercise its control over the stock exchanges in the following manners:

(1) Control on Stock Exchanges through a process of recognition and continued supervision

The Act provides that any stock exchange i.e. any body of individuals whether incorporated or not constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities, is desirous of being recognized under the Act may make an application to Central Govt./SEBI\(^66\) in the prescribed form. On receipt of the application if the Govt./SEBI satisfied that all the requirements prescribed by them in this regard have been fulfilled by the concerned stock exchange and it is also ready to

\(^{66}\) Section 3 of Securities Contracts (Regulation) Act, 1956
comply with all the conditions that may be imposed on it by the Govt./SEBI time to time. Further if the Central Govt./SEBI satisfied that it would be in the interest of the trade and public at large it may grant recognition to it and may also impose the conditions in this regard as it think fit.

The Govt. / SEBI whenever it thinks that it will be in the interest of the trade or in public interest to withdraw the recognition of stock exchange it can withdraw it after giving an opportunity of hearing to the governing board of the stock exchange.

The periodical returns relating to its affairs shall be furnished to the Govt./SEBI. The Act authorizes Govt./ SEBI to make inquiries in the affairs of the recognized stock exchanges and its members. The Act further provides that the rules, bye-laws and the regulations made or amended by the recognized stock exchange will not be effective or operative until and unless they have been approved by Govt./ SEBI. Moreover, the Govt./ SEBI may also direct to stock exchanges to make or amend the rules in a directed manner. SEBI itself may make or amend bye-laws of stock exchanges whether on the request of the governing board of the exchange or on its own motion. The most important thing regarding this is that the Govt./ SEBI may supersede the governing body of the stock exchange whenever it is in the opinion that it should be

67 Section 4, Ibid
68 Section 5, Ibid
69 Section 7and 8, Ibid
70 Section 10, Ibid
superseded. It can also suspend the business of stock exchange. Thus the Govt./SEBI has a complete control over the working of the stock exchanges.

(2) **Regulation of contracts in Securities**

The Act empowers the Govt./SEBI to regulate the contracts in securities. The contract means a contract for or relating to the purchase or sale of securities. The Act provides that if the Govt./SEBI/RBI is of opinion that it is necessary to prevent undesirable speculation in specified securities and in a specified area, it can prohibit contracts to be made except with the prior permission of the govt. The contracts made in contravention to this shall be illegal.

(3) **Regulation of listing the securities on stock exchanges**

The stock exchanges determine their own listing regulations but the regulations must confirm the minimum listing criteria set out in the Securities Contract (R) Rules 1957 made by Govt. under the powers given to it by SC(R) Act 1956. And moreover the regulations made by stock exchanges should be approved by SEBI.

Various new provisions like definitions of corporalisation, demutulization, stock exchange, procedure for corporalization and

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71 Section 2(a), *Ibid*
72 Section 16, *Ibid*
demutalisation of stock exchanges, provisions for delisting of securities etc. have been added in SC (R) Act by an ordinance.

(ii) The Depositories Act, 1996

Depositories Act provides for electronic maintenance and transfer of ownership of demat securities. It ensures free transferability of securities with speed, accuracy and security by making securities of public limited companies freely transferable subject to certain conditions. It provides for dematerialising of the securities in the depository mode. Though the Act makes it optional to hold security with depository but SEBI guidelines makes it obligatory to enter into an agreement with the depository for dematerialisation of the securities before making any public issue of securities. Therefore, indirectly it is obligatory to hold the security with the depository. The Dhanuka Committee recommended the compulsory dematerialisation for new issue of securities exceeding Rs.10 crores in value.

(iii) The Securities Exchange Board of India Act, 1992

The Act provides SEBI statutory powers for protecting the interest of investors and promoting the development of the securities market. Its regulatory jurisdiction extends over corporate in the issuance of securities and

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73 The Securities Laws (Amendment) Ordinance, 2004, Promulgated by president in the 55th year of the Republic of India
74 Section 8 of Depositories Act, 1996
75 Clause 2.1.5.1 of SEBI (DIP) Guidelines 2000
76 Report of the Committee Pertaining to Review and Reform of Securities Laws under the chairmanship of Dr. Justice Dhanuka appointed on 28th Feb. 1997
transfer of securities in addition to all intermediaries and persons associated with securities market.

(iv) The Companies Act, 1956

It deals with issue, allotment, and transfer of securities and disclosures to be made in public issue etc. that have already discussed in the previous chapter.

Recapitulation

Thus, securities trading involve purchase and sale of securities in stock exchange. However, the entry of general public is prohibited on the trading floor. The transactions in the stock market are made through intermediaries i.e. brokers. The history of the stock market in India is related to the establishment of the East India Company as during 18th century East India Company started business in loan securities. During 1830's a significant increase in the volumes of business was evident not only in loan but also in corporate stocks and shares. The need for regulation of securities market was felt after the American Civil War that resulted share mania of 1860-65. A special legislation to deal with mass failures was enacted. The Bombay Stock Exchange (established in 1875) is the oldest stock exchange in India. The number of stock exchanges gradually increased. At present there are 23 stock exchanges, which mainly regulated by SC (R) Act 1956.

There are various functions of the stock exchanges. They ensure liquidity of investments; provide ready and continuous market etc. This is the only place where existing securities is purchased or sold.
The stock exchanges initially were formed as the mutual organizations i.e. formed by trading members themselves for their common benefit. During that period it was the interest of trading members i.e. brokers which was protected and the investor’s interests were left unprotected. The stock exchanges were running by the trading members themselves and for their own benefits. Now demutulisation of stock exchanges are proposed.

The trading of securities in stock exchange is possible only if the securities are listed on it. There are certain requirements that must be complied with by applicant companies for being eligible for listing. Regarding stock exchanges various reforms have been made by SEBI. It established CLA to bring uniformity in the listing rules however, it has not been adequately empowered to perform its duties. At present, SC (R) Act, Depositories Act, SEBI Act and Companies Act govern securities market.