Self Learning Material

Securities Market Operations
(MCOP-FA-405)

Course: Master of Commerce
Semester-IV

Distance Education Programme
I.K. Gujral Punjab Technical University
Jalandhar
Syllabus

MCOP-FA-405 SECURITIES MARKET OPERATIONS

OBJECTIVE AND EXPECTED OUTCOME OF THE COURSE:

This course aims at giving a comprehensive understanding of stock market operations in terms of structure, trading and settlement procedures, instruments, processes and related components as also emerging challenges in the area.

UNIT-I


UNIT-II


UNIT-III

Legal Framework of Securities Market: SEBI Guidelines Relating to the Functioning of the New Issue Market; Stock Exchanges and Intermediaries; SEBI and Investor Protection; Securities Contract Regulation Act and Listing of Securities; Regulations and Guidelines for FIIs.

UNIT-IV

Trading Pattern in OTCEI : Meaning, Significance and Functions; Procedure of Listing and Trading on OTC; NSE-Functioning and Trading Pattern in NSE-Capital Market Segment and Wholesale Market Segment; Security Market Indicators-Need and Importance; BSE Sensex, NSE, NIFTY and other Index Numbers. Demat Trading. FIIs : Participation in Indian stock market and RBI regulations. Introduction to Commodity Exchanges in India.

SUGGESTED READINGS/ BOOKS :

2. V. A. Avadhani, Investment and Securities Market in India, Himalaya Publishing House.
5. Ravi Puliani and Mahesh Puliani, Manual of SEBI, Bharat Publication
## Table of Contents

<table>
<thead>
<tr>
<th>Lesson No.</th>
<th>Title</th>
<th>Page No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Indian Securities Market</td>
<td>1</td>
</tr>
<tr>
<td>2</td>
<td>Stock Exchanges and Intermediaries</td>
<td>15</td>
</tr>
<tr>
<td>3</td>
<td>National Stock Exchange</td>
<td>29</td>
</tr>
<tr>
<td>4</td>
<td>Dematerialization</td>
<td>42</td>
</tr>
<tr>
<td>5</td>
<td>Foreign institutional investment</td>
<td>56</td>
</tr>
<tr>
<td>6</td>
<td>SECURITIES CONTRACTS (REGULATION) ACT, 1956</td>
<td>78</td>
</tr>
<tr>
<td>7</td>
<td>OTCEI</td>
<td>101</td>
</tr>
</tbody>
</table>
Chapter 1
Indian securities Markets

Structure:
1.1 Objectives
1.2 Introduction
1.3 Professional participants
1.4 Regulatory Framework of Indian Securities Market
1.5 Key strengths of the Indian securities markets
1.6 Financial markets
1.7 Types of financial markets
1.8 Market segment
1.9 Market participants
1.10 Regulatory Framework of Indian Securities Markets
1.11 Summary
1.12 Answers to Check your Progress
1.13 Test/Model Questions
1.14 Suggested Readings

1.1 Objectives
After going through this chapter, you will be able to:

- Define the Indian securities market
- explain the concept and functions of financial markets
- distinguish between capital market and money market;
- Explain the body regulates an Indian securities markets
- Understand the various types of security markets
- Identify the new dimensions in the area of commerce in light of the state of research in commerce.

1.2 Introduction
The last decade (2000-2010) has been the most eventful period for the Indian securities market during which it took major strides to carve a niche for itself in the global securities markets. **Securities market** is a component of the wider financial market where securities can be bought
and sold between subjects of the economy, on the basis of demand and supply. Securities markets encompass equity markets, bond markets and derivatives markets where prices can be determined and participants both professional and non-professionals can meet. A securities market is used in an economy to attract new capital, transfer real assets into financial assets, determine price which will balance demand and supply and provide a means to invest money both short and long term.

**Conditions of security markets**

A securities market is a system of interconnection between all participants (professional and non-professional) that provides effective conditions:

- to attract new capital by means of issuance new security (securitization of debt),
- to transfer real asset into financial asset,
- to invest money for short or long term periods with the aim of deriving profitability.
- commercial function (to derive profit from operation on this market)
- price determination (demand and supply balancing, the continuous process of prices movements guarantees to state correct price for each security so the market corrects mispriced securities)
- informative function (market provides all participants with market information about participants and traded instruments)
- regulation function (securities market creates the rules of trade, contention regulation, priorities determination)
- Transfer of ownership (securities markets transfer existing stocks and bonds from owners who no longer desire to maintain their investments to buyers who wish to increase those specific investments.
- Insurance (hedging) of operations though securities market (options, futures, etc.)

Q:- 1.1 Define security market

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1.3 Professional participants

Professional participants in the securities market - legal persons, including credit organizations, and also citizens registered as business persons who conduct the following types of activity:

1. **Brokerage** shall be deemed performance of civil-law transactions with securities as agent or commission agent acting under a contract of agency or commission, and also under a
power (letter) of attorney for the performance of such transactions in the absence of indication of the powers of agent or commission agent in the contract.

2. **Dealer** activity shall be deemed performance of transactions in the purchase and sale of securities in one's own name and for one's own account through the public announcement of the prices of purchase and/or sale of certain securities, with an obligation of the purchase and/or sale of these securities at the prices announced by the person pursuing such activity.

3. **Activity in the management of securities** shall be deemed performance by a legal person or individual business person, in his own name, for a remuneration, during a stated period, of trust management of the following conveyed into his possession and belonging to another person, in the interests of this person or of third parties designated by the person:

4. **Clearing** activity shall be deemed activity in determining mutual obligations (collection, collation and correction of information on security deals and preparation of bookkeeping documents thereon) and in offsetting these obligations in deliveries of securities.

5. **Depositary** activity shall be deemed the rendering of services in the safekeeping of certificates of securities and/or recording and transfer of rights to securities.

### 1.4 Regulatory Framework of Indian Securities Market

The regulatory framework has been strengthened. The corporation and demutualization of stock exchanges was mandated through amendments in SCRA 1956 in the year 2004. In the same year, amendment to SCRA was also made to provide for clearing and settlement by a clearing corporation. It provided that an exchange with the approval of SEBI could transfer the duties and functions of a clearing house to a recognized clearing corporation. In addition to the introduction of new products, an endeavour was made to strengthen the existing products which had not gained momentum. Notable among them were the corporate bonds and interest rate futures. Simplification of corporate bond issuance norms and introduction of repos in corporate bonds were some of the measures taken to resurrect this market segments. Indian exchanges are entering into cross border agreements with overseas exchanges for introducing their products on their trading platform. By providing an opportunity to the investors to diversify their portfolios internationally, this could add another dimension to the Indian securities markets. For example: in March 2010, NSE and Chicago Mercantile Exchange (CME) had announced cross-listing arrangements. Under the cross-listing arrangements, the S&P CNX Nifty Index (Nifty 50), the leading Indian benchmark index representing 22 sectors of the Indian economy, has been made available to CME for the creation and listing of U.S. dollar denominated Nifty futures contracts for trading on CME. Keeping in view the increased integration of global markets, the market regulator also allowed Indian stock exchanges to extend their trade timings from 9:55 a.m.-3:30 p.m. to 9:00 a.m.-5:00 p.m.

The securities market is endeavouring to make equity finance available for small and medium enterprises. In May 2010, SEBI has permitted setting up of a stock exchange or trading platform for SMEs by stock exchanges having nationwide trading terminals. In addition to this, various
initiatives have been taken by SEBI to strengthen the corporate governance among the listed companies.

Clause 49 has been amended from time to time to improve disclosures, strengthen the responsibilities of audit committees and include provision for whistle blower policy and restrict the term of independent directors etc.

Clause 35 of the Listing Agreement has also been amended to provide for disclosure of details of shares held by promoters and promoter group entities in listed companies which are pledged or otherwise encumbered. This was done with a view to ensure that while deciding to invest in the company, the investors may factor in information about the pledged or otherwise encumbered shares held by promoter/promoter group in the company, as the extent of pledge/encumbrance may have a significant impact on the price of the shares.

In a major move aimed at bringing in more accountability and enhancing investor participation, the government has made it mandatory for all listed companies, other than listed public sector enterprises (PSEs), to raise public shareholding to 25%; listed PSEs must maintain public shareholding of at least 10%. Any listed company which falls short of these prescribed limits on the commencement of the Securities Contracts (Regulation) (Amendment) Rules, 2010, shall increase its public shareholding to the stipulated level within a period of three years. Companies coming out with initial public offers to get listed, must adhere to the above public shareholding limits at the time of their listing. This move would reduce price manipulation by creating large and diversified public shareholdings. In a recent initiative on the regulatory front, a Financial Stability and Development Council (FSDC) has been created to strengthen and institutionalize the mechanism for maintaining financial stability and monitoring macro prudential supervision of the economy.

1.5 Key strengths of the Indian securities markets

The securities markets in India have made enormous progress in developing sophisticated instruments and modern market mechanisms. The key strengths of the Indian capital market include a fully automated trading system on all stock exchanges, a wide range of products, an integrated platform for trading in both cash and derivatives, and a nationwide network of trading through over 4,6184 corporate brokers. A significant feature of the Indian securities market is the quality of regulation. The market regulator, Securities and Exchange Board of India (SEBI) is an independent and effective regulator. It has put in place sound regulations in respect of intermediaries, trading mechanism, settlement cycles, risk management, derivative trading and takeover of companies. There is a well designed disclosure based regulatory system. Information technology is extensively used in the securities market. The stock exchanges in India have the most advanced and scientific risk management systems. The growing number of market participants, the growth in volume of securities transactions, the reduction in transaction costs, the significant improvements in efficiency, transparency and safety, and the level of compliance with international standards have earned for the Indian securities market a new respect in the world.

1.6 Financial markets
We know that, money always flows from surplus sector to deficit sector. That means persons having excess of money lend it to those who need money to fulfill their requirement. Similarly, in business sectors the surplus money flows from the investors or lenders to the businessmen for the purpose of production or sale of goods and services. So, we find two different groups, one who invest money or lend money and the others, who borrow or use the money.

Now you think, how these two groups meet and transact with each other. The financial markets act as a link between these two different groups. It facilitates this function by acting as an intermediary between the borrowers and lenders of money. So, financial market may be defined as ‘a transmission mechanism between investors (or lenders) and the borrowers (or users) through which transfer of funds is facilitated’. It consists of individual investors, financial institutions and other intermediaries who are linked by a formal trading rules and communication network for trading the various financial assets and credit instruments.

So, it can be said that, Financial market is a market where financial instruments are exchanged or traded and helps in determining the prices of the assets that are traded in and is also called the price discovery process.

1. Organizations that facilitate the trade in financial products. For e.g. Stock exchanges (NYSE, Nasdaq) facilitate the trade in stocks, bonds and warrants.

2. Coming together of buyer and sellers at a common platform to trade financial products is termed as financial markets, i.e. stocks and shares are traded between buyers and sellers in a number of ways including: the use of stock exchanges; directly between buyers and sellers etc.

Before reading further let us have an idea about some of the credit instruments.

A bill of exchange is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to or to the order of a certain person, or to the bearer of the instrument. To clarify the meaning let us take an example. Suppose Gopal has given a loan of Rs. 50,000 to Madan, which Madan has to return. Now, Gopal also has to give some money to Madhu. In this case, Gopal can make a document directing Madan to make payment up to Rs. 50,000 to Madhu on demand or after expiry of a specified period. This document is called a bill of exchange, which can be transferred to some other person’s name by Madhu.

A promissory note is an instrument in writing (not being a bank note or a currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to or to the order of a certain person or to the bearer of the instrument. Suppose you take a loan of Rs. 20,000 from your friend Jagan. You can make a document stating that you will pay the money to Jagan or the bearer on demand. Or you can mention in the document that you will pay the amount after three months. This document, once signed by you, duly stamped and handed over to Jagan, becomes a negotiable instrument. Now Jagan can personally present it before you for payment or give this document to some other person to collect money on his behalf. He can endorse it in somebody else’s name who in turn can endorse it further till the final
payment is made by you to whosoever presents it before you. This type of a document is called a Promissory Note.

The main functions of financial market.

(a) It provides facilities for interaction between the investors and the borrowers.
(b) It provides pricing information resulting from the interaction between buyers and sellers in the market when they trade the financial assets.
(c) It provides security to dealings in financial assets.
(d) It ensures liquidity by providing a mechanism for an investor to sell the financial assets.
(e) It ensures low cost of transactions and information.

1.7 Types of financial markets

A financial market consists of two major segments: (a) Money Market; and (b) Capital Market. While the money market deals in short-term credit, the capital market handles the medium term and long-term credit.

Let us discuss these two types of markets in detail.

1.7.1 Money market

The money market is a market for short-term funds, which deals in financial assets whose period of maturity is upto one year. It should be noted that money market does not deal in cash or money as such but simply provides a market for credit instruments such as bills of exchange, promissory notes, commercial paper, treasury bills, etc. These financial instruments are close substitute of money. These instruments help the business units, other organisations and the Government to borrow the funds to meet their short-term requirement.

Money market does not imply to any specific market place. Rather it refers to the whole networks of financial institutions dealing in short-term funds, which provides an outlet to lenders and a source of supply for such funds to borrowers. Most of the money market transactions are taken place on telephone, fax or Internet. The Indian money market consists of Reserve Bank of India, Commercial banks, Co-operative banks, and other specialised financial institutions. The Reserve Bank of India is the leader of the money market in India. Some Non-Banking Financial Companies (NBFCs) and financial institutions like LIC, GIC, UTI, etc. also operate in the Indian money market.

1.7.2.1 Money market instruments

Following are some of the important money market instruments or securities.

a. **Call Money:** Call money is mainly used by the banks to meet their temporary requirement of cash. They borrow and lend money from each other normally on a daily basis. It is repayable on demand and its maturity period varies in between one day to a fortnight. The rate of interest paid on call money loan is known as call rate.
b. **Treasury Bill**: A treasury bill is a promissory note issued by the RBI to meet the short-term requirement of funds. Treasury bills are highly liquid instruments that mean, at any time the holder of treasury bills can transfer or get it discounted from RBI. These bills are normally issued at a price less than their face value; and redeemed at face value. So the difference between the issue price and the face value of the treasury bill represents the interest on the investment. These bills are secured instruments and are issued for a period of not exceeding 364 days. Banks, Financial institutions and corporations normally play major role in the Treasury bill market.

c. **Commercial Paper**: Commercial paper (CP) is a popular instrument for financing working capital requirements of companies. The CP is an unsecured instrument issued in the form of promissory note. This instrument was introduced in 1990 to enable the corporate borrowers to raise short-term funds. It can be issued for period ranging from 15 days to one year. Commercial papers are transferable by endorsement and delivery. The highly reputed companies (Blue Chip companies) are the major player of commercial paper market.

d. **Certificate of Deposit**: Certificate of Deposit (CDs) are short-term instruments issued by Commercial Banks and Special Financial Institutions (SFIs), which are freely transferable from one party to another. The maturity period of CDs ranges from 91 days to one year. These can be issued to individuals, co-operatives and companies.

e. **Trade Bill**: Normally the traders buy goods from the wholesalers or manufactures on credit. The sellers get payment after the end of the credit period. But if any seller does not want to wait or in immediate need of money he/she can draw a bill of exchange in favour of the buyer. When buyer accepts the bill it becomes a negotiable instrument and is termed as bill of exchange or trade bill. This trade bill can now be discounted with a bank before its maturity. On maturity the bank gets the payment from the drawee i.e., the buyer of goods. When trade bills are accepted by Commercial Banks it is known as Commercial Bills. So trade bill is an instrument, which enables the drawer of the bill to get funds for short period to meet the working capital needs.

<table>
<thead>
<tr>
<th>Q:- 1.2 Differentiate between Money Market and Capital Market:</th>
<th>On the basis of</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Time period / Term</td>
<td>2. Instrument dealt in</td>
</tr>
<tr>
<td>3. Participants</td>
<td>4. Regulatory body</td>
</tr>
</tbody>
</table>

1.7.3 **Capital market**

Capital Market may be defined as a market dealing in medium and long-term funds. It is an institutional arrangement for borrowing medium and long-term funds and which provides facilities for marketing and trading of securities. So it constitutes all long-term borrowings from banks and financial institutions, borrowings from foreign markets and raising of capital by issue
various securities such as shares, debentures, bonds, etc. In the present chapter let us discuss about the market for trading of securities.

The market where securities are traded is known as the Securities market. It consists of two different segments namely primary and secondary market. The primary market deals with new or fresh issue of securities and is, therefore, also known as the new issue market; whereas the secondary market provides a place for purchase and sale of existing securities and is often termed as stock market or stock exchange.

1.7.4 Distinction between capital market and money market

Capital Market differs from money market in many ways. Firstly, while money market is related to short-term funds, the capital market related to long-term funds. Secondly, while money market deals in securities like treasury bills, commercial paper, trade bills, deposit, certificates, etc., the capital market deals in shares, debentures, bonds, and government securities. Thirdly, while the participants in money market are Reserve Bank of India, commercial banks, non-banking financial companies, etc., the participants in capital market are stockbrokers, underwriters, mutual funds, financial institutions, and individual investors. Fourthly, while the money market is regulated by Reserve Bank of India, the capital market is regulated by Securities Exchange Board of India (SEBI).

Q1.3 In 2006, Reserve bank of India had set up a panel under Shri S C Gupta to recommend the legislations related to regulation of which of the following?
(A) Capital markets
(B) Money lending
(C) Financial Inclusion

Q1.4 Which among the following helps RBI to manage liquidity conditions in the economy with banks having an avenue to surplus funds or avail funds?
(A) Repos
(B) Reverse repos
(C) Money market Mutual Funds

1.8 Market Segments

The securities market has two interdependent and inseparable segments, the new issues (primary) market and the stock (secondary) market.

1.8.1 Primary market

The primary market provides the channel for creation and sale of new securities, while the secondary market deals in securities previously issued. The securities issued in the primary market are issued by public limited companies or by government undertakings. The resources in
this kind of market are mobilized either through the public issue or through private placement route. It is a public issue if anyone can subscribe it, whereas if the issue is made available to a selected group of persons it is termed as private placement. There are two major types of issuers of securities, the corporate entities who issue mainly debt and equity instruments and the government (central as well as state) who issue debt securities (dated securities and treasury bills).

Primary market facilitates government as well corporates in raising capital to meet their requirements of capital expenditure and/or discharge of other obligation such as exit opportunity for venture capitalist/PE firm. The most common primary mechanism for raising capital is an Initial Public Offer (IPO), under which shares are offered to common public as a precursor to the trading in secondary market of an exchange. The price at which the shares will be issued is decided with the help of book building mechanism and in case of oversubscription the shares are allotted on a pro-rata basis. When securities are exclusively offered to the existing shareholders of company, as opposed to the general public it is called ‘Rights Issue’. Another mechanism whereby a listed company can issue equity shares, fully and partly convertible debentures which can be converted into equity shares later on, to a Qualified Institutional Buyer (QIB) is termed as Qualified Institutional Placement. Apart from raising capital in domestic market, companies can also issue securities in international market through ADR/GDR/ECB route and raise capital.

1.8.2 Secondary Market

The secondary market enables participants who hold securities to adjust their holdings in response to changes in their assessment of risks and returns. Once the new securities are issued in the primary market they are traded in the stock (secondary) market. The secondary market operates through two mediums, namely, the over-the-counter (OTC) market and the exchange-traded market. OTC markets are informal markets where trades are negotiated. Most of the trades in the government securities are in the OTC market. All the spot trades where securities are traded for immediate delivery and payment take place in the OTC market. The other option is to trade using the infrastructure provided by the stock exchanges. The exchanges in India follow a systematic settlement period. All the trades taking place over a trading day (day=T) are settled together after a certain time (T+2 day). The trades executed on exchanges are cleared and settled by a clearing corporation. The clearing corporation acts as a counterparty and guarantees settlement. A variant of the secondary market is the forward market, where securities are traded for future delivery and payment. A variant of the forward market is Futures and Options market. Currently only two exchanges viz., National Stock Exchange of India Ltd. (NSE) and Bombay Stock Exchange (BSE) provide trading in the equity futures & options in India.

Capital markets serve two purposes. Firstly, they bring together investors holding capital and companies seeking capital through equity and debt instruments. Secondly, and almost more importantly, they provide a secondary market where holders of these securities can exchange them with one another at market prices. Without the liquidity created by a secondary market,
investors would be less inclined to purchase equity and debt instruments for fear of being unable to unload them in the future.

The main points of distinction between the primary market and secondary market are as follows:

1. Function: While the main function of primary market is to raise long-term funds through fresh issue of securities, the main function of secondary market is to provide continuous and ready market for the existing long-term securities.

2. Participants: While the major players in the primary market are financial institutions, mutual funds, underwriters and individual investors, the major players in secondary market are all of these and the stockbrokers who are members of the stock exchange.

3. Listing Requirement: While only those securities can be dealt within the secondary market, which have been approved for the purpose (listed), there is no such requirement in case of primary market.

4. Determination of prices: In case of primary market, the prices are determined by the management with due compliance with SEBI requirement for new issue of securities. But in case of secondary market, the price of the securities is determined by forces of demand and supply of the market and keeps on fluctuating.

<table>
<thead>
<tr>
<th>Q1.5 Markets comprised of securities with maturities of one year or less are generally referred to as:</th>
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<tbody>
<tr>
<td>(a) Money market</td>
</tr>
<tr>
<td>(b) Capital Market</td>
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<tr>
<td>(c) Stock Markets</td>
</tr>
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<td>(d) Bond Markets</td>
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<tr>
<th>Q1.6 Markets comprised of securities with maturities greater than one year are generally referred to as:</th>
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<tr>
<td>(e) Money market</td>
</tr>
<tr>
<td>(f) Capital Market</td>
</tr>
<tr>
<td>(g) Stock Markets</td>
</tr>
<tr>
<td>(h) Bond Markets</td>
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<tr>
<th>Q1.7 One of the main purposes of the capital markets is:</th>
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<tbody>
<tr>
<td>(a) to provide access to short-term funds</td>
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<td>(b) to provide access to long term funds</td>
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<td>(c) to allocate capital to the most efficient user</td>
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1.9 Market Participants

In every economic system, some units, individuals or institutions, are surplus units who are called savers, while others are deficit units, called spenders. Households are surplus units and corporate and Government are deficit units. Through the platform of securities markets, the savings units place their surplus funds in financial claims or securities at the disposal of the spending community and in turn get benefits like interest, dividend, capital appreciation, bonus etc. These investors and issuers of financial securities constitute two important elements of the securities markets. The third critical element of markets is the intermediaries who act as conduits between the investors and issuers. Regulatory bodies, which regulate the functioning of the securities markets, constitute another significant element of securities markets. The process of mobilisation of resources is carried out under the supervision and overview of the regulators. The regulators develop fair market practices and regulate the conduct of issuers of securities and the intermediaries. They are also in charge of protecting the interests of the investors. The regulator ensures a high service standard from the intermediaries and supply of quality securities and non-manipulated demand for them in the market.

1.10 Regulatory Framework of Indian Securities Markets

At present, the five main Acts governing the securities markets are (a) the SEBI Act, 1992; (b) the Companies Act, 1956, which sets the code of conduct for the corporate sector in relation to issuance, allotment and transfer of securities, and disclosures to be made in public issues; (c) the Securities Contracts (Regulation) Act, 1956, which provides for regulation of transactions in securities through control over stock exchanges (d) the Depositories Act, 1996 which provides for electronic maintenance and transfer of ownership of demat shares and (e) Prevention of Money Laundering Act, 2002.

Legislations SEBI Act, 1992: The SEBI Act, 1992 was enacted to empower SEBI with statutory powers for (a) protecting the interests of investors in securities, (b) promoting the development of the securities market, and (c) regulating the securities market. Its regulatory jurisdiction extends over corporates in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with securities market. It can conduct enquiries, audits and inspection of all concerned and adjudicate offences under the Act. It has powers to register and regulate all market intermediaries and also to penalise them in case of violations of the provisions of the Act, Rules and Regulations made thereunder. SEBI has full autonomy and authority to regulate and develop an orderly securities market.

Securities Contracts (Regulation) Act, 1956: It provides for direct and indirect control of virtually all aspects of securities trading and the running of stock exchanges and aims to prevent
undesirable transactions in securities. It gives Central Government regulatory jurisdiction over (a) stock exchanges through a process of recognition and continued supervision, (b) contracts in securities, and (c) listing of securities on stock exchanges. As a condition of recognition, a stock exchange complies with conditions prescribed by Central Government. Organised trading activity in securities takes place on a specified recognised stock exchange. The stock exchanges determine their own listing regulations which have to conform to the minimum listing criteria set out in the Rules.

*Depositories Act, 1996:* The Depositories Act, 1996 provides for the establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security by (a) making securities of public limited companies freely transferable subject to certain exceptions; (b) dematerialising the securities in the depository mode; and (c) providing for maintenance of ownership records in a book entry form. In order to streamline the settlement process, the Act envisages transfer of ownership of securities electronically by book entry without making the securities move from person to person. The Act has made the securities of all public limited companies freely transferable, restricting the company’s right to use discretion in effecting the transfer of securities, and the transfer deed and other procedural requirements under the Companies Act have been dispensed with.

*Companies Act, 1956:* It deals with issue, allotment and transfer of securities and various aspects relating to company management. It provides for standard of disclosure in public issues of capital, particularly in the fields of company management and projects, information about other listed companies under the same management, and management perception of risk factors. It also regulates underwriting, the use of premium and discounts on issues, rights and bonus issues, payment of interest and dividends, supply of annual report and other information.

*Prevention of Money Laundering Act, 2002:* The primary objective of the Act is to prevent money-laundering and to provide for confiscation of property derived from or involved in money-laundering. The term money-laundering is defined as whoever acquires, owns, possess or transfers any proceeds of crime; or knowingly enters into any transaction which is related to proceeds of crime either directly or indirectly or conceals or aids in the concealment of the proceeds or gains of crime within India or outside India commits the offence of money-laundering. Besides providing punishment for the offence of money-laundering, the Act also provides other measures for prevention of Money Laundering. The Act also casts an obligation on the intermediaries, banking companies etc to furnish information, of such prescribed transactions to the Financial Intelligence Unit- India, to appoint a principal officer, to maintain certain records etc.

1.11 Summary

1. Securities market is a component of the wider financial market where securities can be bought and sold between subjects of the economy, on the basis of demand and supply. Securities markets encompasses equity markets, bond markets and derivatives markets
where prices can be determined and participants both professional and non-professionals can meet.

2. Financial market is the market that facilitates transfer of funds between investors/ lenders and borrowers/ users. It deals in financial instruments like bills of exchange, shares, debentures, bonds, etc. It provides security to dealings in financial assets, liquidity to financial assets for investors and ensures low cost of transitions and information.

3. Financial Markets can be classified as (1) Money market and (2) Capital market.

4. Money market refer to the network of financial institutions dealing in short term funds through instruments like bills of exchanges, promissory notes, commercial paper, treasury bills etc.

5. Capital Market is an institutional arrangement for borrowing medium and long-term funds and which provides facilities for marketing and trading of securities. So it constitutes all long-term borrowings from banks and financial institutions, borrowings from foreign markets and raising of capital by issue various securities such as shares debentures, bonds, etc.

6. The securities market has two different segments namely primary and secondary market.

7. The primary market consists of arrangements for procurement of long-term funds by companies by fresh issue of shares and debentures.

8. The secondary market or stock exchange provides a ready market for existing long-term securities.

1.12 Answers to check your Progress

Ans:- 1.2 Point of Distinction Capital Market Money Market

1. Time period: Capital Market deals with Long term funds, whereas money market deals in short-term funds.

2. Instrument Dealt In Deals in shares: - Capital Market Deals in shares, debentures, bonds and government securities, whereas money market deals in securities like treasury bills, commercial paper, bills of exchange, certificate of deposits etc.

3. Participants Stock brokers: in Capital Market Participants are stock broker, underwriters, utual funds, financial institutions and individual investors, whereas in money market participants are commercial banks, non-banking finance companies, chit funds etc. and individual investors.

4. Regulatory body: - In capital market SEBI (Securities and Exchange Board of India) is the regulatory body, whereas in money market RBI (Reserve Bank of India) is the regulatory body.

Ans. 1.3 money lending

Ans. 1.4 Repo

Ans. 1.5 a
Ans.: 1.6 b
Ans.: 1.7 c

1.13 Test/ Model Questions

1. What is security market? Discuss its characteristics.
2. Explain the key strengths of the Indian securities markets.
3. Define money market and explain its importance in a modern economy.
4. What is capital market? How does it differ from money market?
5. Distinguish between primary market and secondary market.
6. Give four examples of credit instruments of the money market.
7. How the stock exchange does help in mobilizing savings and capital formation?
8. Describe the measures taken by SEBI to regulate the secondary market.
Lesson 2

Stock Exchanges and Intermediaries

Introduction

Stock exchanges are an essential element of the financial markets of every economy. They are the manor of capital and stronghold of finance. They are the platforms of trading in securities and they facilitate and control the buying and selling of stocks. Securities and Exchange Board of India has defined stock exchanges defined as, “an association of body of individuals whether incorporated or not, established for the purpose of facilitating, regulating and controlling business in buying, selling and dealing in securities.” In short, stock exchanges comprise a market where securities are traded that is issued by the central and state governments, public bodies and joint stock companies. The elementary organized stock exchange in India was instituted in Bombay in 1875 with the establishment of the ‘Native Share and stock Broker’s Association’. Thus, the Bombay stock exchange is the primeval one in the country.

Functions of stock exchanges

The stock market in India has occupied an important position in the financial system. It percolates various economic functions and provides valuable services to the individual investors, corporate, and to the whole economic system. The various functions of stock exchanges in India are explained as follows:

(i) Liquidity and marketability of Securities:

Stock exchanges supplies liquidity to securities so that securities can be easily converted into cash as per the decision of the investor by selling the stocks at the listed prices. They assist buying and selling securities at the listed prices. They assist buying and selling of securities at listed prices by initiating consistent marketability to the investors in regard to securities they hold or wish to hold. Thus, they provide a ready platform for dealing in securities.
(iii) **Supply of long term funds:**

The securities that are traded in the stock exchanges are negotiable and exchangeable in nature and they can be transferred with minimum of formalities from one party to another. Therefore, when a security is transacted ownership of investors are substituted by each other but long term availability of funds are assured by corporate.

(iv) **Profitability:**

The profitability and prevalence of companies are mirrored through stock prices. The prices that are quoted show relative profitability and performance of corporate. Funds likely to be attracted towards securities of profitable companies and this assist in the uninterrupted flow of capital into profitable ventures.

(ii) **Protection of funds:**

Stock exchanges provide protection of funds invested by the investors because they do their day to day operations under stringent rules and regulations and the bye-laws are formulated to ensure safety of funds of investors. Over-trading, insider trading etc. are obviated through carefully designed set of rules. This would bolster the investor’s confidence and promote larger investment.

(v) **Helpful in improved performance:**

The performance of a company is mirrored on the prices listed in the stock market. These prices are more attracted to the eyes of public. Stock exchanges provide platform for the price quotation for those stocks listed by it. This public disclosure makes a company more attentive of its status in the market and motivates the companies to improve its performance consistently.

(vi) **Capital formation:**

Stock Exchanges channelize the savings of the public and foster investment through capital formation. But in order to achieve this objective by the stock exchanges, surplus funds available
with investors both individuals and institutions would have been utilized in productive and remunerative projects.

(vii) **Marketing of new issues:**

If the new issues are listed, they are promptly acceptable by the public, since, companies evaluate their listing by concerned stock exchange authorities. Through this Costs of underwriting for issues would be less. Public response to such new issues would be almost high. Thus, a stock exchange helps in the marketing of new issues also.

(viii) **Miscellaneous functions:**

Stock exchange provides securities of different kinds with different maturities periods and yields. It empowers the investors to diversify their risks by different portfolio of investment. It also develops saving habits among the community and provides the way for capital formation. It advises the investors in selecting stocks by providing the daily pricing of listed securities and by revealing the trends of dealing on the stock exchange. It empowers companies and the government to raise funds by providing a platform of ready market for their securities.

**Management of stock exchange in India**

The recognized stock exchanges are administered by, “Governing Board.” The governing boards consist of directors that are elected members from stock broker firms, public representatives and government nominees nominated by the Securities and Exchange Board of India. The government also has powers to elect presidents and vice-presidents of stock exchanges and to approve the appointment of the Chief Executive and public representatives. The stock exchanges are managed by the Chief Executive Director as an apex authority.

The governing boards of stock exchanges have wide powers such as:

(a) Appointment of office bearers and setting up of committees like Listing Committee, Arbitration Committee, Defaulter committee, etc.

(b) Certification and expulsion of members,
(c) Management of the assets and finances of the exchange,

(d) Constituting and interpretation of rules, bye-laws etc. for the regulation of stock exchanges.

(e) Settlement of disputes among members or outsiders.

(f) Management of the day to day functioning of the exchange.

**Membership of stock Exchanges**

To become a part as a member of a recognized stock exchange, a person should have the following qualification:

(a) a person should be a citizen of India,

(b) A person should not be less than 21 years of age,

(c) A person should not have been declared bankrupt or insolvent,

(d) A person should not have been convicted any offence involving fraud or dishonesty,

(e) A person should not be engaged in any other business except dealing in securities,

(f) A person should not have been removed by any other stock exchange or declared a defaulter by any other stock exchange.

**Methods of trading in Stock Exchanges**

The stock exchange activities at floor level are highly vocational in nature. Non-members are not having permission to enter into the stock market. Therefore, various stages have to be completed in behead a transaction at a stock exchange. The stages involved in the methods of trading have been mentioned below:

(i) **Choice of a Broker:**
The potential investor who wants to buy shares or the investor who wants to sell his shares cannot enter into exchange of shares and transact business through member brokers. They can also appoint their bankers for this objective, since, bankers also become members of the recognized stock exchange as per the current regulations. So, the first imperative in transacting business on a stock exchange is to choose a broker of good repute or a banker. Such persons alone can assure precise and quick implementation of a transaction at the best possible and profitable price.

After selecting the broker, one has to see whether the broker is interested to transact business on his behalf that is whether he will open an account of investor in brokerage house. Only when the broker is satisfied with the financial position of the party, he will be interested to act on behalf of him.

(ii) **Order placement:**

The next step is the placing of order for buying and selling of securities with the broker. The order is usually placed by telephone or in person. In order to avoid delay, it is placed generally over the phone. To reduce the cost also, it is placed short abbreviations that is “Buy 100 HDFC @ Rupees. 862.” It means that it is an order for the purchase of 100 shares of HDFC Bank @Rupees. 862. This order may take any one of the following forms:

(iii) **At Best Order**

It is an order which does not specify any specific price. It must be executed immediately at the best possible price. The client may also fix a time frame within which the order has to be executed. E.g. “Buy 100 L&T shares at best.”

(iv) **Immediate or cancel order**

It is an order for the purchase or sale of securities immediately at the price quoted by the client. If the order could not be executed at the quoted prices immediately, it should be treated as cancelled. Eg. “Buy 100 DSW @ 65 immediate.”

(v) **Limit Order**
It is an order for buying and selling of securities at a fixed price specified by the client. For example, “Sell 200 ABC Ltd. shares @ Rupees 1286.”

(VI) **Discretionary Order:**

It is an order to purchase or sale shares at whatever price the broker thinks reasonable. This is possible only when the client has complete faith on broker.

(VII) **Limited discretionary Order:**

It is an order to purchase or sale securities within a specified mentioned price range and /or within the given time period as per the best judgment of the broker.

(VIII) **Open Order:**

It is an order to purchase or sale of shares without fixing any specified time limit or price limit on the execution of the order. It is similar to discretionary order.

(ix) **Stop Loss Order:**

It is an order to sell as soon as the price falls up to a particular level or to buy when the price rises up to a stipulated level. This is mainly to protect the clients against a heavy fall or rise in prices so that they may not suffer more than the pre-specified amount.

On receiving the orders, they are first recorded in a rough memo book and then they are transferred to the ‘Order Book.’

(X) **Execution of orders:**

The Bombay Stock Exchange has introduced screen – based trading from March, 1995, called BOLT (BSE on Line Trading). It has been designed to get the best bids and offers from the order book. If the price does match with buyer and seller price, the order will remain in the system for the whole day, until it gets executed.

(Xi) **Preparation of Contract Notes:**
Usually, the authorized dealers enter the particulars of the business transacted during a particular day through e-contracts (emailed on the same day of his/her trading after market hours) and physical delivery of contracts at client’s address within two days from his order execution.

(Xii) Settlement of transactions:

Settlement is on a rolling basis, i.e. there is no account period settlement. Each order has a unique settlement date specified upfront at the time of order entry and used as a matching parameter. It is mandatory for trades to be settled on the predefined settlement date. The Exchange currently allows settlement periods ranging from same day (T+0) settlement to a maximum of (T+2) for non-government securities while settlement of all outright secondary market transactions in government securities was standardized to T+1. In case of repo transactions in government securities, first leg can be settled either on T+0 basis or T+1 basis. The above guidelines came into effect from May 24, 2005.

(xiii) Clearing settlement:

In this method, the transactions are cleared and settled through the clearing corporations. Normally, those securities which are regularly traded and are ordinarily in demand are cleared through the clearing house. These transactions are also known as the transactions for ‘the account.’ In case of delay of settlement or cancellation of trade, participants are required to take prior approval from the Exchange. For any dispute arising in regard of the trades or settlement, the exchange has rooted arbitration mechanism for resolving the same.

Stock Exchanges in India

In India, there are mainly two exchanges and that are:

(a) National Stock Exchange
National stock exchange

National Stock Exchange of India before its inception in 1992, it has been at the forefront of change in the Indian securities market. This period has seen significant changes in markets, from how capital is raised and traded and also how transactions are cleared and settled. The markets have expanded in scope and scale in a way that could not have been fancied at the time. On an average daily trading volumes have risen from ‘17crores in 1994-95 when NSE started its Cash Market operations ‘16,959crores in 2009-10. In the same way, market capitalization of listed companies went up from ‘364,350 crores at the end of March 1995 to ‘7,009,173 crores at end March 2010. Indian capital markets are at present among the most wide and vigorous markets in the world. NSE offers a wide range of products for multiple markets, including equity shares, Debt instruments, Mutual Funds, Index futures and options, Stock futures and options, currency futures and interest rate futures, Exchange Traded Funds (ETF). Our Exchange has more than 1,500 companies listed in the Capital Market and more than 94% of these companies are actively traded. The debt market has 4,240 securities that are available for trading. Index futures and options trade on four different indices and on 194 stocks in stock futures and options as on 31st March, 2011. Currency futures contracts are traded in more than four currency pairs.

Incorporation and Management

NSE was started in November 1992, and received acceptance as a stock exchange under the Securities contracts (Regulation) Act, 1956 in April, 1993. It is administered by professionals who do not directly or indirectly participate in trading of the Exchange. The trading rights are with trading members who gives their services to the investors. The structure of Board of NSE consists of senior executives from promoter institutions and esteemed professionals, without having any representatives from trading members. While the NSE Board deals with the broad
policy matters, the executive Committees (ECs), which consist of trading members, formed under the Articles of Association and the regulations of NSE for different market segments, establish different rules and parameters to administer the day-to-day affairs of the Exchange. The day-to-day administration of the Exchange is designated to the Managing Director who is supported by a group of professional staff. As a result, though the role of trading members at NSE is having the intensity of providing only trading facilities to the investors, the Exchange involves trading members in the proceedings of consultation and participation in integral inputs towards decision making.

Technology has been the heart of the Exchange. Supplying the services to the investors and the other market participants using technology at the economical possible cost has been its main gist. NSE chose to strap technology in creating a new market model. It assumes that technology provides the necessary momentum for the organization to hold an edge and provide opportune and satisfaction in customer service. In acknowledgement of the fact that technology will continue to redesign the shape of the securities industry, NSE stresses on innovation and sustained investments in technology to remain antecedent of competition. NSE is the pioneer exchange in the world to use satellite communication technology for trading purpose. It uses satellite communication technology to enforce participation from about 2,593 VSATs from nearly 187 cities spread all over the country. NSE trading system is called as National Exchange for Automated Trading (NEAT), is a state of-the-art client server based system. At the server end all trading information is resumed in an in-memory database to achieve minimal response time and maximum system availability for clients. It has uptime record. For order filled by the user, the response revert time within trading system is around 5ms. National Stock Exchange in India has been continuously endeavor capacity enrichment measures so as to efficiently meet the requirements of increased users and conjoined trading loads. NSE has also put in place NSEs Internet Based Information System for on-line real-time dissemination of trading information over the internet platform. As part of its continuity plan, NSE has established a disaster back-up site at Chennai along with its entire architect design that also have the satellite earth station and the high-speed optical fiber link with its main site at Mumbai. This site at Chennai is a imitation of the production environment at Mumbai. The transaction data is backed by real
time basis from the main site to the disaster back-up site through high-speed links to keep both the sites all the time to integrate with each other. There are many application systems that NSE uses for its trading, clearing, settlement and other operations for the backup for the Exchange. The application systems used for the day-to-day operations of the Exchange can be segregated into

(a) Front end applications and

(b) Back office applications.

Recent Developments

Some of the recent changes in the developments of stock exchanges in India are as following:

(i) Management of intermediaries:

To enhance the functioning of intermediaries in the capital market, stringent control is being exercised on them by SEBI. The Intermediaries like merchant bankers, brokers, sub-brokers, underwriters, bankers to the issue etc. must be registered with the SEBI. It is recommended that the registration required renewal from time to time in spite of making it a constant one. SEBI has authority to suspend them after conducting an enquiry. To enhance their financial adequacy, capital adequacy criteria have been fixed.

(ii) Demand of Quality Securities:

For efficient and efficient working of a stock exchange, quality securities are absolutely vital. Attaining this fact, the SEBI has announced recently amended criteria for companies accessing the capital exchanges. Participation of financial institutions in the capital is vital for entry into the capital market. These measures ensure that only quality securities into the market.

(iii) Use of blocked amount (ASBA) facility in public issues and right issues:

In its attempt to make the existing public issue facility more efficient SEBI has launched the ASBA facility as on July 30th 2008. Such facility is made accessible to retail investors also. ASBA is an application that is used as an authorization to bar the application money in the bank
account, for subscribing to an issue. If an investor is exercising through ASBA, his application money shall be taken from the bank account only, if his/her application is selected for allotment.

(iv) **Change in the management composition:**

In the early years, the boards of stock exchanges were domineering by brokers whose decisions were not fair and transparent. But now SEBI requires that 50 percent of the directors must be non-brokers directors or government representatives. Moreover, it is essential that non-broker professional shall be appointed as the executive Director.

(iv) **Injunction of insider trading:**

Prior, insiders can easily enter into manipulative dealings contrary to the interest of the public on the basis of any unpublished price conscious information available to them because of their position in the company. Now, there is a prohibition on insider trading and therefore, an insider is prohibited from dealing in securities of any listed companies on the basis of any unpublished price sensitive information.

But now onwards, SEBI (Insider Trading) Amendment Regulations, 2002 have been established that is giving more authority to SEBI to control insider trading. The Government also thinks that defining insider trading in the SEBI Act itself will make it more firmly enforceable in a court of law.

(v) **Quarterly informing by Foreign Venture Capital Investors:**

With effect from 31st March 2010, all FVCI operating in India have to submit quarterly reports to SEBI. That report need to be displayed in the SEBI portal within 7 days from the end of each calendar quarter. This measure can be seen as one taken for bringing more fairness in the operations of FVCI. Indian markets had recorded strict volatility at the close of 2007-08. However, towards the starting of 2008-09, the market started improving and registered gains during April –May 2008. One of the main reasons for that prompt recovery was because of timely regulations and policies introduced by various market controllers.
(vi) Prohibition of price rigging:

More powers have been given to SEBI under SEBI (Prohibition of fraudulent and unfair trade practices relating to security markets) regulations, 1995 to control price rigging. In reality, the SEBI exercised its authority in 1996 for the first time by declare show-cause notices to the various parties- brokers, clients, promoters, and involved in price rigging. In addition, certain procedural changes have been planned in the auction route to control price rigging. Therefore, all efforts are being taken to protect the interest of genuine investors.

Interpreting the term “associated with securities market” under SEBI regulations, 2008

Ambiguity arises while interpreting the residual category, i.e., (p), much of which depends on how the SEBI interprets “associated with securities market.” Although not in the context of intermediaries, courts have held that “persons associated with market” would include everyone who has something to do with the securities market. For instance, audit firms without any direct association with share market activities are reckoned to be “associated with securities market,” since the auditing accounts of a company has a direct impact on the investor’s interest and market stability. While this issue is currently pending in appeal before the Supreme court of India, a study of decided cases indicates that the SEBI interprets “associated with market” to include all persons having any direct or indirect link with the securities market.

SEBI RULES AND REGULATIONS GOVERNING STOCK MARKET INTERMEDIARIES

The SEBI designed a comprehensive regulatory framework covering all intermediary categories that include the intermediary Regulations. Moreover, most of the provisions are need to be notified, except those dealing with enforcement orders and processes.

At present, intermediaries continue to be administered by the specific regulations governing each and every category of intermediaries, which includes:

- The SEBI (Stock Brokers and Sub-brokers) Regulations, 1992;
- the SEBI (Merchant Bankers) Regulations, 1992;
The SEBI (Registrar to an Issue and Share Transfer Agents) Regulations, 1993;

The SEBI (Underwriters) Regulations, 1993.

The SEBI (Bankers to an Issue) Regulations, 1994;

The SEBI (Depositories and Participants) Regulations, 1996;

The basic framework of all regulations includes the registration requirements; eligibility conditions, consistent legal requirements, appear powers, renewal of registrations, disclosures, maintenance of books/records, inspection and disciplinary proceedings, code of conduct, investigation, enquiry, adjudication, and enforcement orders.

**Emergence of stock market intermediaries**

In the age of closed markets, middlemen were not common because buyers and sellers do their business in close contiguity to one another. However, as financial markets widened and matured, it was no longer possible for buyers and sellers to have direct business dealing; thus, present capital markets are essentially dependent on market intermediaries. To understand this reliance, to envision how market middlemen are driving the market today, and to determine the regulatory outline of India’s securities market regulator- the Securities and Exchange Board of India (SEBI)- with regard to its intermediary governance, it is essential to understand who these market intermediaries are.

It can be concluded that market intermediaries operate as the bridge between capital savers and capital seekers. According to this, any person functioning in the capital markets other than the issuer and the investor may be considered as market intermediary.

**Conflict of Interest**

The term “conflict of interests” is commonly used to identify situations where competing interests prohibit a party from acting in a specified manner, which would otherwise be legally or ethically relevant; nevertheless, there is no specifically accepted for the same. A conflict of interest situation can generally be understood as a situation where the all-round interests of an individual are in *inter se* conflict. In regard to of market intermediaries, those
conflicts are intensified by the vast and diversified client base, continual product innovations, undisclosed and complex market systems, and concurrent operations in multiple intermediary services.

(i) **Client financing by intermediary:** Where the intermediary has lengthened finance facility (loans/credit) to any of its investors, it will tend to invest the client’s funds in such a manner that facilitates the speedy recovery of the loan/credit, regardless of the investment intent of the client.

(ii) **Churning:** Churning refers to a system in which a broker for the sole goal of generating commissions and maximizing its returns is involved in excessive trading on a client’s account, even when such trading emphasize unprofitable investments or unnecessary transaction costs for the investor.

(iii) **Use of clients’ funds for proprietary trades:** Intermediaries may give suggestion to their clients that is opposite to what the real situation demand, and the use of funds earned by commission to trade as per the real market circumstances on the proprietary account. This is more prevalent when the intermediary is managing in different capacities; for example, as a market analyst and investment advisor for the investor and also as a stock broker undertaking proprietary trades.

(iv) **Accumulation of orders:** Accumulation of orders placed by clients with proprietary accounts, initiated primarily for reducing administrative costs and enhanced convenience that may benefit the intermediary at a client’s cost.

(v) **Competitive actions:** Intermediaries may involve in unfair competitive practices, such as approaching and inducing other intermediaries’ clients, which is imperative for investors and market functions.
Chapter 3
National Stock Exchange

Structure:
5.1 Objectives
5.2 Introduction
5.3 Objectives of National Stock Exchange
5.4 NSE- A paradigm shift in financial market
5.5 Evolution of NSE
5.6 Functions of NSE
5.7 Participants in NSE
5.8 Role of NSE in Indian securities markets
5.9 Technology and application in NSE
5.10 Advantages of national stock exchange
5.11 Limitation of national stock exchange
5.12 Summary
5.13 Answers to Check your Progress
5.14 Test/Model Questions
5.15 Suggested Readings

5.1 Objectives
After going through this chapter, you will be able to:

- Define the national stock exchange
- Evolution of national stock exchange in India
- Explain the participants and body regulates an Indian securities markets
- Understand the functions and technology used in National Stock Exchange
- Discuss the various advantages and limitations of national stock exchange

5.2 Introduction
The National Stock Exchange of India Limited (NSE) is India's largest financial market. The exchange was established in 1992 as a tax-paying company, which was recognized as a stock exchange in 1993 under the Securities Contracts (Regulation) Act, 1956, when P. V. Narasimha Rao was the Prime Minister of India and Manmohan Singh was the Finance Minister. NSE commenced operations in the Wholesale Debt Market (WDM) segment in June 1994. The capital
market (equities) segment of the NSE commenced operations in November 1994, while operations in the derivatives segment commenced in June 2000. The NSE has developed into a sophisticated, electronic market, which ranks third in the world for transacted volume. It conducts transactions in the wholesale debt, equity and derivative markets and set up by leading institutions to provide a modern, fully automated screen-based trading system with national reach. The Exchange has brought about incomparable transparency, speed and efficiency, safety and market integrity. It has set up facilities that serve as a model for the securities industry in terms of systems, practices and procedures.

National Stock Exchange of India Limited (NSE) is an electronic exchange with a nationwide presence. It offers trading facility through its fully automated, screen based trading system. A variety of financial instruments, which includes, equities, debentures, government securities, index futures, index options, stock futures, stock options, currency futures, Interest Rate Futures etc. are traded on its electronic platform. NSE is the largest stock exchange in India, with a significant market share in equities and in derivatives equities/equity indices/currency. It is also one of the leading global exchanges. NSE uses a state of the art telecommunication network to provide investors an efficient and transparent market. NSE has created new benchmarks in technology infrastructure, risk management systems, clearing and settlement systems, investor services and best market practices. It has been in the forefront offering newer products in equities and derivatives and also new asset classes for the investors to choose from.

National stock exchange has played a catalytic role in reforming the Indian securities market in terms of microstructure, market practices and trading volumes. The market today uses state-of-art information technology to provide an efficient and transparent trading, clearing and settlement mechanism, and has witnessed several innovations in products & services viz. demutualisation of stock exchange governance, screen based trading, compression of settlement cycles, dematerialisation and electronic transfer of securities, securities lending and borrowing, professionalisation of trading members, fine-tuned risk management systems, emergence of clearing corporations to assume counterparty risks, market of debt and derivative instruments and intensive use of information technology.

National stock exchange is the term commonly used for a secondary market, which provide a place where different types of existing securities such as shares, debentures and bonds, government securities can be bought and sold on a regular basis. A stock exchange is generally organised as an association, a society or a company with a limited number of members. It is open only to these members who act as brokers for the buyers and sellers. The Securities Contract (Regulation) Act has defined stock exchange as an “association, organisation or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling business of buying, selling and dealing in securities”.

The main characteristics of a national stock exchange are:

1. It is an organised market.

2. It provides a place where existing and approved securities can be bought and sold easily.
3. In a stock exchange, transactions take place between its members or their authorised agents.

4. All transactions are regulated by rules and by laws of the concerned stock exchange.

5. It makes complete information available to public in regard to prices and volume of transactions taking place every day.

It may be noted that all securities are not permitted to be traded on a recognised stock exchange. It is allowed only in those securities (called listed securities) that have been duly approved for the purpose by the stock exchange authorities. The method of trading nowa-days, however, is quite simple on account of the availability of on-line trading facility with the help of computers. It is also quite fast as it takes just a few minutes to strike a deal through the brokers who may be available close by. Similarly, on account of the system of scrip-less trading and rolling settlement, the delivery of securities and the payment of amount involved also take very little time, say, 2 days.

Q: 5.1 Enumerate the main characteristics of a stock exchange

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5.3 Objectives of National Stock Exchange

Following are the main objectives of national stock exchange:

(i) To ensure equal access for investors all over the country with the help of appropriate communication network.

(ii) To provide fair, efficient and transparent trading of securities through electronic system.

(iii) To set up a nationwide trading facility for all types of securities.

(iv) To enable book entry settlement and short settlement cycles.

(v) To meet international benchmarks and standards.

5.4 NSE- a paradigm shift in financial market

NSE was mainly set up to bring in transparency in the markets. Instead of trading membership being restricted to a group of brokers, NSE ensured that anyone who was qualified, experienced and met minimum financial requirements was allowed to trade. In this environment, NSE was ahead of its times when it separated ownership and management in the exchange under SEBI's supervision. The price information which could earlier be accessed only by a handful of people could now be seen by a client in a remote location with the same ease. The paper-based settlement was replaced by electronic depository-based accounts and settlement of trades was
always done on time. One of the most critical changes was that a robust risk management system was set in place, so that settlement guarantees could protect investors against broker defaults.

NSE was also instrumental in creating the National Securities Depository Limited (NSDL) which allows investors to securely hold and transfer their shares and bonds electronically. It also allows investors to hold and trade in as few as one share or bond. This not only made holding financial instruments convenient, but more importantly eliminated the need for paper certificates and greatly reduced the incidents of forged or fake certificates and fraudulent transactions that had plagued the Indian stock market. The NSDL’s security, combined with the transparency, lower transaction prices and efficiency that NSE offered, greatly increased the attractiveness of the Indian stock market to domestic and international investors.

5.5 Evolution of NSE

A high-powered study Group on the Establishment of New Stock Exchanges under the Chairmanship of Shri M. J. Pherwani has submitted its Report in June 1991. This Study Group has recommended some criteria for setting up of new Stock Exchanges and favored the licensing of additional trading floors (ATF) instead of multiplying the number of Stock Exchanges in the country. The Study Group has also recommended the setting up of a model National Stock Exchange at Navi Mumbai (NSE), which will develop the National Market System in the country. Any infrastructure in terms of space, Tele-communications, Computerization, On-line processing system, Library, Research facilities, Publicity Dept, etc. are all recommended for the "National Market" to be set up by NSE.

The market will have two types of members, viz., participating trading members, who can only trade on their behalf and intermediary trading members (dealers) who can deal on behalf of their clients. Trading members will have computer terminals connecting to the other trading members (PTM) and to the central computer system at the NSE. Trading orders to buy and sell securities or to borrow and lend are entered into the computer system and stocked in its memory in an order book. Trading being order driven, it will be matched with a matching counter order. If matched, both the buyer and seller are informed by the NSE computer system. By the end of the trading day, the Exchange System will give out rates and a list of completed transactions for each trading member.

The nature of National Market System are as follows:

- Completely automated system in terms of both trading and settlement procedures to be provided through the Securities Facilities Support Corporation.
- Compulsory market makers/jobbers to provide liquidity and ready market (in the form of Principal Trading Members, i.e., PTM).
- The members are large Corporate and Institutional members and Professionals, drawn from various parts of the country and to represent the professionals on an All India Basis.
- Only large and medium size companies and PSUs are listed on this Exchange and it will complement the existing Exchanges.
• The NSE would have a separate trading facility and time allotted for debt instruments in order to have the beneficial effect of creating an active secondary market in debt instruments particularly of Government debt

5.6 Functions of a stock exchange

The functions of stock exchange can be enumerated as follows:

1. **Provides ready and continuous market**: By providing a place where listed securities can be bought and sold regularly and conveniently, a stock exchange ensures a ready and continuous market for various shares, debentures, bonds and government securities. This lends a high degree of liquidity to holdings in these securities as the investor can encash their holdings as and when they want.

2. **Provides information about prices and sales**: A stock exchange maintains complete record of all transactions taking place in different securities every day and supplies regular information on their prices and sales volumes to press and other media. In fact, now-a-days, you can get information about minute to minute movement in prices of selected shares on TV channels like CNBC, Zee News, NDTV and Headlines Today. This enables the investors in taking quick decisions on purchase and sale of securities in which they are interested. Not only that, such information helps them in ascertaining the trend in prices and the worth of their holdings. This enables them to seek bank loans, if required.

3. **Provides safety to dealings and investment**: Transactions on the stock exchange are conducted only amongst its members with adequate transparency and in strict conformity to its rules and regulations which include the procedure and timings of delivery and payment to be followed. This provides a high degree of safety to dealings at the stock exchange. There is little risk of loss on account of non-payment or nondelivery. Securities and Exchange Board of India (SEBI) also regulates the business in stock exchanges in India and the working of the stock brokers.

Not only that, a stock exchange allows trading only in securities that have been listed with it; and for listing any security, it satisfies itself about the genuineness and soundness of the company and provides for disclosure of certain information on regular basis. Though this may not guarantee the soundness and profitability of the company, it does provide some assurance on their genuineness and enables them to keep track of their progress.

4. **Helps in mobilisation of savings and capital formation**: Efficient functioning of stock market creates a conducive climate for an active and growing primary market. Good performance and outlook for shares in the stock exchanges imparts buoyancy to the new issue market, which helps in mobilising savings for investment in industrial and commercial establishments. Not only that, the stock exchanges provide liquidity and profitability to dealings and investments in shares and debentures. It also educates people on where and how to invest their savings to get a fair return. This encourages the habit of saving, investment and risk-taking among the common people. Thus it helps mobilising surplus savings for investment in corporate and government securities and contributes to capital formation.

5. **Barometer of economic and business conditions**: Stock exchanges reflect the changing conditions of economic health of a country, as the shares prices are highly sensitive to changing
economic, social and political conditions. It is observed that during the periods of economic prosperity, the share prices tend to rise. Conversely, prices tend to fall when there is economic stagnation and the business activities slow down as a result of depressions. Thus, the intensity of trading at stock exchanges and the corresponding rise on fall in the prices of securities reflects the investors’ assessment of the economic and business conditions in a country, and acts as the barometer which indicates the general conditions of the atmosphere of business.

6. Better Allocation of funds: As a result of stock market transactions, funds flow from the less profitable to more profitable enterprises and they avail of the greater potential for growth. Financial resources of the economy are thus better allocated.

5.7 Participants

Recognized members of NSE are called trading members who trade on behalf of themselves and their clients. Participants includes trading members and large players like banks who take direct settlement responsibility.

5.8 Role of NSE in Indian Securities Market

National Stock Exchange of India (NSE) was given recognition as a stock exchange in April 1993. NSE was set up with the objectives of (a) establishing a nationwide trading facility for all types of securities, (b) ensuring equal access to all investors all over the country through an appropriate communication network, (c) providing a fair, efficient and transparent securities market using electronic trading system, (d) enabling shorter settlement cycles and book entry settlements and (e) meeting the international benchmarks and standards. Within a short span of time, above objectives have been realized and the Exchange has played a leading role in transforming the Indian Capital Market to its present form. NSE has set up infrastructure that serves as a role model for the securities industry in terms of trading systems, clearing and settlement practices and procedures. The standards set by NSE in terms of market practices, products, technology and service standards have become industry benchmarks and are being replicated by other market participants. It provides screen-based automated trading system with a high degree of transparency and equal access to investors irrespective of geographical location. The high level of information dissemination through on-line system has helped in integrating retail investors on a nation-wide basis. NSE has been playing the role of a catalytic agent in reforming the market in terms of microstructure and market practices. Right from its inception, the exchange has adopted the purest form of demutualised set up whereby the ownership, management and trading rights are in the hands of three different sets of people. This has completely eliminated any conflict of interest and helped NSE to aggressively pursue policies and practices within a public interest framework. It has helped in shifting the trading platform from the trading hall in the premises of the exchange to the computer terminals at the premises of the trading members located country-wide and subsequently to the personal computers in the homes of investors. Settlement risks have been eliminated with NSE’s innovative endeavors in
the area of clearing and settlement viz., reduction of settlement cycle, professionalisation of the trading members, fine-tuned risk management system, dematerialisation and electronic transfer of securities and establishment of clearing corporation. As a consequence, the market today uses the state-of-art information technology to provide an efficient and transparent trading, clearing and settlement mechanism. NSE provides a trading platform for all types of securities-equity, debt and derivatives. On its recognition as a stock exchange under the Securities Contracts (Regulation) Act, 1956 in April 1993, it commenced operations in the Wholesale Debt Market (WDM) segment in June 1994, in the Capital Market (CM) segment in November 1994, and in Equity Derivatives segment in June 2000. The Exchange started providing trading in retail debt of Government Securities in January 2003 and trading in currency futures in August 2008. The Wholesale Debt Market segment provides the trading platform for trading of a wide range of debt securities. Its product, which is now disseminated jointly with FIMMDA, the FIMMDA NSE MIBID/MIBOR is used as a benchmark rate for majority of deals struck for Interest Rate Swaps, Forwards Rate Agreements, Floating Rate Debentures and Term Deposits in the country. Its ‘Zero Coupon Yield Curve’ as well as NSE-VaR for Fixed Income Securities have also become very popular for valuation of sovereign securities across all maturities irrespective of its liquidity and facilitated the pricing of corporate papers and GOI Bond Index. NSEs Capital Market segment offers a fully automated screen based trading system, known as the National Exchange for Automated Trading (NEAT) system, which operates on a strict price/time priority. It enables members from across the country to trade simultaneously with enormous ease and efficiency. NSEs Equity Derivatives segment provides trading of a wide range of derivatives like Index Futures, Index Options, Stock Options and Stock Futures. NSEs Currency Derivatives segment provides trading on currency futures contracts on the USD-INR which commenced on August 29, 2008. In February 2010, trading on additional pairs such as GBP-INR, EUR-INR and JPY-INR was allowed while trading in USD-INR currency options were allowed for trading on October 29, 2010. The interest rate futures trade on the currency derivatives segment of NSE and they were allowed for trading segment on August 31, 2009

The NSE yet again registered as the market leader with 87.64% of total turnover (volumes in cash market, equity derivatives and currency derivatives) in 2009-10. NSE proved itself as the market leader contributing a share of 74.98% in the equity trading and nearly 100% share in the equity derivatives segment in the year 2009-10 (Table 1-9). Not only in Indian Markets, but also in the global Markets, NSE has created a niche for itself in terms of derivatives trading in various instruments (discussed in detail with statistics in chapter 6 of this publication).

5.9 Technology and Application Systems in NSE

Technology has been the backbone of the Exchange. Providing the services to the investor community and the market participants using technology at the cheapest possible cost has been its main thrust. NSE chose to harness technology in creating a new market design. It believes that technology provides the necessary impetus for the organisation to retain its competitive edge and ensure timeliness and satisfaction in customer service. In recognition of the fact that technology will continue to redefine the shape of the securities industry, NSE stresses on innovation and
sustained investment in technology to remain ahead of competition. NSE is the first exchange in the world to use satellite communication technology for trading. It uses satellite communication technology to energize participation from about 2,500 VSATs from nearly 200 cities spread all over the country. Its trading system, called National Exchange for Automated Trading (NEAT), is a state-of-the-art client server based application. At the server end, all trading information is stored in an in-memory database to achieve minimum response time and maximum system availability for users. It has uptime record of 99.9%. For all trades entered into NEAT system, there is uniform response time of less than 1.5 seconds. NSE has been continuously undertaking capacity enhancement measures so as to effectively meet the requirements of increased users and associated trading loads. NSE has also put in place NIBIS (NSEs Internet Based Information System) for on-line real-time dissemination of trading information over the Internet. As part of its business continuity plan, NSE has established a disaster back-up site at Chennai along with its entire infrastructure, including the satellite earth station and the high-speed optical fibre link with its main site at Mumbai. This site at Chennai is a replica of the production environment at Mumbai. The transaction data is backed up on near real time basis from the main site to the disaster back-up site through the 2 STM-4 (1.24 GB) high-speed links to keep both the sites all the time synchronized with each other. The various application systems that NSE uses for its trading as well clearing and settlement and other operations form the backbone of the Exchange. The application systems used for the day-to-day functioning of the Exchange can be divided into (a) Front end applications and (b) Back office applications.

The exchange also provides a facility to its members to use their own front end software through the CTCL (computer to computer link) facility. The member can either develop his own software or use products developed by CTCL vendors. In the back office, the following important application systems are operative:

The exchange operates and manages a nationwide network. This network of over 2400 VSATs and 3000+ Leased Lines has been migrated from X.25 to IP in early 2009. In the new IP network, members have an advantage of a more generic and latest IP protocol and an overall better design, in terms of bandwidth and resilience. Currently, the network has over 2400 VSATs, 3000+ Leased Lines and 9 POPs (Point of Presence) across the country.

Q: - 5.2 Identify if the following statement about stock exchanges are ‘True’ or ‘False’. If the statement is ‘False’, rewrite it in the correct form.

(a) Stock Exchange provides a ready market for sale and purchase of gold and silver.

(b) In the stock exchange, transactions take place between companies and their shareholders directly.

(c) Stock exchange transactions facilitate flow of funds from less profitable to more profitable enterprises.

(d) It becomes difficult for investors to raise loans from banks against collateral of their holdings in securities traded at the stock exchange.
5.10 Advantages of stock exchanges

Having discussed the functions of stock exchanges, let us look at the advantages which can be outlined from the point of view of (a) Companies, (b) Investors, and (c) the Society as a whole.

To the Companies:

(i) The companies whose securities have been listed on a stock exchange enjoy a better goodwill and credit-standing than other companies because they are supposed to be financially sound.

(ii) The market for their securities is enlarged as the investors all over the world become aware of such securities and have an opportunity to invest

(iii) As a result of enhanced goodwill and higher demand, the value of their securities increases and their bargaining power in collective ventures, mergers, etc. is enhanced.

(iv) The companies have the convenience to decide upon the size, price and timing of the issue.

To the Investors:

(i) The investors enjoy the ready availability of facility and convenience of buying and selling the securities at will and at an opportune time.

(ii) Because of the assured safety in dealings at the stock exchange the investors are free from any anxiety about the delivery and payment problems.

(iii) Availability of regular information on prices of securities traded at the stock exchanges helps them in deciding on the timing of their purchase and sale.

(iv) It becomes easier for them to raise loans from banks against their holdings in securities traded at the stock exchange because banks prefer them as collateral on account of their liquidity and convenient valuation.

To the Society:

(i) The availability of lucrative avenues of investment and the liquidity thereof induces people to save and invest in long-term securities. This leads to increased capital formation in the country.

(ii) The facility for convenient purchase and sale of securities at the stock exchange provides support to new issue market. This helps in promotion and expansion of industrial activity, which in turn contributes, to increase in the rate of industrial growth.

(iii) The Stock exchanges facilitate realisation of financial resources to more profitable and growing industrial units where investors can easily increase their investment substantially.
The volume of activity at the stock exchanges and the movement of share prices reflect the changing economic health.

Since government securities are also traded at the stock exchanges, the government borrowing is highly facilitated. The bonds issued by governments, electricity boards, municipal corporations and public sector undertakings (PSUs) are found to be on offer quite frequently and are generally successful.

Q5.3 Give a specific term/name for the following:
(a) The prominent stock exchange enjoying nation wide coverage that commenced operations in 1994.
(b) The stock exchange that specially caters to small and medium-sized companies.
(c) The first organised stock exchange in India.
(d) The Act passed in the year 1956 for providing recognition of stock exchanges by the central government.
(e) The regulatory body of stock exchanges in our country granted statutory recognition in the year 1992.

5.11 Limitations of stock exchanges
Like any other institutions, the stock exchanges too have their limitations. One of the common evils associated with stock exchange operations is the excessive speculation. You know that speculation implies buying or selling securities to take advantage of price differential at different times. The speculators generally do not take or give delivery and pay or receive full payment. They settle their transactions just by paying the difference in prices. Normally, speculation is considered a healthy practice and is necessary for successful operation of stock exchange activity. But, when it becomes excessive, it leads to wide fluctuations in prices and various malpractices by the vested interests. In the process, genuine investors suffer and are driven out of the market.

Another shortcoming of stock exchange operations is that security prices may fluctuate due to unpredictable political, social and economic factors as well as on account of rumours spread by interested parties. This makes it difficult to assess the movement of prices in future and build appropriate strategies for investment in securities. However, these days good amount of vigilance is exercised by stock exchange authorities and SEBI to control activities at the stock exchange and ensure their healthy functioning, about which you will study later.

5.12 Speculation in stock exchanges
The buyers and sellers at the stock exchange undertake two types of operations, one for speculation and the other for investment. Those who buy securities primarily to earn a regular income from such investment and possibly make some long-term gain on account of price rise in future are called investors. They take delivery of the securities and make full payment of the price. Such transactions are called investment transactions. But, when the securities are bought with the sole object of selling them in future at higher prices or these are sold now with the intention of buying at a lower price in future, are called speculation transactions. The main
objective of such transactions is to take advantage of price differential at different times. The stock exchange also provides for settlement of such transactions even by receiving or paying, as the case may be, just the difference in prices.

Q:- 5.4 List any three primary market reforms initiated by SEBI.
(i) __________________________________________________________
(ii) __________________________________________________________
(iii) __________________________________________________________

Rolling Settlement: Earlier trading in the stock exchange was held face-to-face (called pit-trading) without the use of computers and the advanced computer software as it is today. In those times, transactions were settled (i.e., actual delivery of shares, through share certificates, by the seller and payment of money by the buyer) in the stock exchange, only on a fixed day of the week, say on a Saturday, or a Wednesday irrespective of which day of the week the shares were bought and sold. This was called ‘Fixed Settlement’.

Today, with the electronic / computer based system of recording and carrying out of share transactions, stock exchanges go in for ‘rolling settlement’. That means, transaction are settled after a fixed number of days of the transaction rather than on a particular day of the week. For example, if a stock exchange goes in for ‘T+2’ days of rolling settlement, the transaction is settled within two working days of occurring of the transaction, ‘T’ being the day of the transaction. In T+7’ days of rolling settlement, the transaction is settled on the 7th day after the transaction. This is facilitated through electronic transfer of shares, through Dematerialised Account or Demat Account i.e., the share does not have a physical form of a paper document, but is a computerised record of a person holding a share, and through transfer of money electronically or through cheques payment is settled.

Though speculation and investment are different in some respects, in practice it is difficult to say who is a genuine investor and who is a pure speculator. Sometimes even a person who has purchased the shares as a long-term investment may suddenly decide to sell to reap the benefit if the price of the share goes up too high or do it to avoid heavy loss if the prices starts declining steeply. But he cannot be called a speculator because his basic intention has been to invest. It is only when a person’s basic intention is to take advantage of a change in prices, and not to invest, then the transaction may be termed as speculation. In strict technical terms, however, the transaction is regarded as speculative only if it is settled by receiving or paying the difference in prices without involving the delivery of securities. It is so because, in practice, it is quite difficult to ascertain the intention.

Some people regard speculation as nothing but gambling and consider it as an evil. But it is not true because while speculation is based on foresight and hard calculation, gambling is a kind of blind and reckless activity involving high degree of chance element. No only that, speculation is a legal activity duly recognised as a prerequisite for the success of stock exchange operations
while gambling is regarded as an evil and a punishable activity. However, reckless speculation may take the form of gambling and should be avoided

5.12 Summary

1. National Stock exchange is the secondary market, which provides a place for regular sale and purchase of different types of securities like shares, debentures, bonds & government securities. It is an organised market where all transactions are regulated by the rules and laws of the concerned stock exchanges.

2. The functions of a stock exchanges are to provide ready and continuous market for securities, information about prices and sales, safety to dealings and investment, helps mobilisation of savings and capital formation. It acts as a barometer of economic and business conditions and helps in better allocation of funds.

3. Stock exchanges provide many benefits to companies, investors and the society as a whole. But they also suffer from limitations like exclusive speculation and fluctuation in prices due to rumours and unpredictable events.

4. Along with genuine investment, at times, stock exchange transactions may be undertaken by persons as a speculation.

5. There are 23 stock exchanges in India presently, including BSE, NSE and OTCEI.

6. Stock Exchanges are regulated by the Securities Contracts (Regulation) Act and by SEBI. SEBI has initiated a number of reforms in the primary and secondary market to regulate the stock market. Documentary and procedural requirements for listing and trading have been made stricter and foolproof to protect investors’ interest.

5.13 Answers to Check your Progress

Ans:- 5.2

(a) False: Stock Exchange provides a ready market for sale and purchase of various shares, debentures, bonds and government securities.

(b) False: In the stock exchange, transactions take place between its members or their authorised agents.

(c) True

(d) False: It becomes easy for investors to raise loans from banks against collateral of their holdings in securities traded at the stock exchange.

(e) False: Speculation is different from gambling.

Ans:- 5.3

(a) National Stock Exchange (NSE)
(b) Over The Counter Exchange of India (OTCEI)
(c) Bombay Stock Exchange (BSE)
(d) Securities Contracts (Regulation) Act.
(e) Securities and Exchange Board of India (SEBI)

Ans.: 5.4

(i) Improved disclosure standards in public issue documents.
(ii) Introduction of prudential norms.
(iii) Simplification of the issue procedures.

5.14 Test/Model Questions

1. Define stock exchange and explain its functions.
2. Explain the importance of stock exchanges from the points of view of companies and investors.
3. Explain the role played by SEBI in protecting investors’ interests and controlling the business at stock exchange.
4. Give explanatory notes on (a) stock exchange in India; and (b) Regulations of stock exchanges.
Chapter 4
Dematerialization

Structure:
6.1 Objectives
6.2 Dematerialization
6.3 Depository system
6.4 Legal framework of depository system
6.5 Reasons for the dematerialization of Indian stock market
6.6 Types of Securities
6.7 Advantages of dematerialization
6.8 Parties in dematerialization
6.9 Process of dematerialization
6.10 Trading and Settlement of dematerialized shares
6.11 Agencies in dematerialisation
6.12 Documents required for demat account
6.13 Disadvantages of dematerialization
6.14 Initial public offer
6.15 Institutional structure
6.16 market microstructure
6.17 Summary
6.18 Glossary
6.19 Answers to Check your Progress
6.20 Test/Model Questions
6.21 Suggested Readings

6.1 Objectives
After going through this chapter, you will be able to:

- Define the dematerialization
- Discuss the objectives of dematerialization
- Understand the various types of security markets
6.2 Dematerialization

The history of online trading goes back to 1983, when the first online trade using e-trade technology took place. What began with a single click over 28 years ago has now taken the world by storm. The concept visualized by Bill Porter who provides online quotes and trading services to many US firms like fidelity, Charles Schwab, and Quick and Reilly. Bill happened to foresee that someday everyone would own computers and invest through them with unprecedented efficiency and control. And today his dream has become a reality.

The Indian capital market witnessed an explosive growth between mid-Eighties and mid Nineties. The total number of companies listed in the stock exchanges had grown by 72.3 percent. The market capitalization of the companies listed with stock exchanges had gone up from Rs.21, 000 crores in 1985 to more than Rs.4, 50,000 crores in 1995. The secondary market trading activity also gathered momentum. There has been tremendous growth in secondary market trading at BSE and NSE. Other regional exchanges like Calcutta and New Delhi have also become active players in the market. But the system used was not able to withstand the strain caused by the tremendous growth in the securities market. The entire securities market started experiencing a gridlock, posing obstacles in its growth. Moreover, this sudden growth has also magnified the risks that have always been plaguing the Indian system, viz., credit risk and systematic risk. The International institutional investors wanting to invest in India had become apprehensive about the reliability of the trade settlement mechanisms used in the country, which did not match international standards.

Besides affecting the inflow of foreign capital, the lack of efficient settlement systems had affected the institutional investors, individual investors and brokers in the stock market. The incidence of lost trading days (liquidity), lost scrips, improperly paid dividends, mistaken registration, unnecessary financing cost, failure of counter party and fraud were reported frequently. The awareness about the immense potential for growth made the Indian stock markets very dear to the global investors and the access to internet facility virtually at every part of the country made its momentum so fast. But the manual and paper based settlement system, caused series of problems for the purchaser as well as the seller. Delayed settlements, long settlement periods, high level of failed trade, high cost of transaction and bad deliveries are some among them. Interestingly, the stipulations contained in section 113 of Companies Act, 1956; section 22 A of the Securities Contracts (Regulations) Act, 1956 failed to trace the delay as illegal. Large number of bad deliveries, mismatch of signatures on transfer deeds, theft, forgery, multination of certificates and other irregularities also had become rampant. With the implementation of reforms measures, the Indian capital market has shown rapid growth in the recent past with foreign investors, more stock exchanges and increased market intermediaries. To eliminate paperwork, scrip less trading and electronic book entry for the transfer of securities, and settlement with the new and modern system of depositories came into operation.
Accordingly, the Government of India enacted the Depositories Act in 1996 for the orderly growth and development of the Indian capital market.

Depositories Act, 1996 provides for the establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security. The depositories make securities of public limited companies freely transferable, subject to certain exceptions. They dematerialise the securities in the depository mode and provide maintenance of ownership records in a book entry form.

The Indian capital market has witnessed phenomenal growth in the past decade and a half in terms of listed companies, number of stock exchanges, investor population and trade volumes. One of the major reasons behind this growth has been the emergence of Dematerialization of securities. Dematerialization in short form is known as 'demat is the process by which an investor can get physical certificates converted into electronic form maintained in an account with the Depository Participant. Prior to dematerialisation the Indian stock markets have faced several problems like delay in the transfer of certificates, forgery of certificates etc. Dematerialisation helps to overcome these problems as well as reduces the transaction time as compared to the physical segment. Dematted securities do not have any certificate numbers or distinctive numbers and are dealt only in quantity, i.e., the securities are replaceable. The investors can dematerialize only those share certificates that are already registered in their name and belong to the list of securities admitted for dematerialization at the depositories. It may include shares, scrips, stocks, bonds, debentures, stock or other marketable securities of a like nature in or of any incorporated company or other body corporate, units of mutual funds, rights under collective investment schemes and venture capital funds, commercial paper, certificate of deposit, securities debt, money market instruments and unlisted securities, underlying shares of American Depository Receipts and Global Depository Receipts issued to non-resident holders.

In economics, dematerialization refers to the absolute or relative reduction in the quality of materials required to serve economic functions in society. In common terms, dematerialization means doing more with less. This concept is similar to ephemeralization as proposed by Buckminster Fuller.

It is very important to consider that an investor who wants to dematerialise his shares needs to open a demat account with Depository Participant. Investor surrenders his physical shares and in turn gets electronic shares in his demat account. There are following pre-requisites are necessary for dematerialization of securities:

1. Investors should have a depository account.
2. Securities should be from the eligible list of securities issued by the depository.
3. Securities must be in the name of the account holders and owned by him.
4. Separate demat requisition form is required for each issuer company.
5. DRF should be signed by all the holders so as to match specimen signature.

Check your progress A:
6.3 Depository system

A depository is a file or set of files in which data is stored for the purpose of safekeeping or identity authentication. In general, a depository is a physical site where data is kept in the form of hard copies, magnetic disks, magnetic tapes, compact disks (CDs), and similar media. The concept of Depository is known to the world since 1949 when the first depository was set up in Germany.

The depository model in India is a competitive multi depository system. In India the system of dematerialisation is followed, wherein the securities will be cancelled as against the system of immobilization in which the securities are kept in custody.

6.4 Legal framework of depository system

The operations of the depositories are primarily governed by the Depositories Act, 1996, SEBI (Depositories & Participants) Regulations, 1996, Bye- Laws approved by SEBI, and Business Rules framed in accordance with the Regulations and Bye-Laws. The Act enables the setting up of multiple depositories in the country to see that there is competition in the service and there is more than one depository in operation. Only a company registered under the Companies Act, 1956 and sponsored by the specified category of institutions can set up a depository in India. Before commencing operations, depositories should obtain a certificate of registration and a certificate of commencement of business from SEBI.

Every depository must have adequate mechanisms for reviewing, monitoring and evaluating the depository's controls, systems, procedures and safeguards. It should conduct an annual inspection of these procedures and forward a copy of the inspection report to SEBI. The depository is also required to ensure that the integrity of the automatic data processing systems is maintained at all times and take all precautions necessary to ensure that therecords are not lost, destroyed or tampered with. In the event of loss or destruction, sufficient back up of records should be available at a different place. Adequate measures should be taken, including insurance, to protect

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Q 6.1. In context with the markets, what is dematerizlization of security?
   a. Shortening the of debt repayment on securities
   b. Electric holding of the shares replacing the paper securities

Q 6.2. Define Dematerialization.
the interests of the beneficial owners against any risks. Every depository is required to extend all such co-operation to the beneficial owners, issuers, issuers' agents, custodians of securities, other depositories and clearing organisations, as is necessary for the effective, prompt and accurate clearance and settlement of securities transactions and conduct of business. The depository should indemnify beneficial owners of securities for any loss caused to them due to the negligence of the DP. However, where the loss is caused due to the negligence of a DP, the depository shall have the right to recover it from such DPs.

Generally, the following securities are eligible for dematerialisation:

(a) Shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate.

(b) Units of mutual funds, rights under collective investment schemes and venture capital funds, commercial paper, certificates of deposit, securitised debt, money market instruments, government securities, national saving certificates, kisanvikaspatra and unlisted securities.

(c) Securities admitted to NSDL depository are notified to all DPs through circulars sent by email.

6.5 Reasons for the dematerialization of the Indian stock Market

There are following reasons for dematerialization of the Indian stock market are as below:

1. Bad deliveries due to signature difference
2. Mistakes in completion of transfer deeds
3. Tearing and mutilation of securities
4. Fake certificates
5. Fraudulent interception of certificate in transit
6. Transfer stamp duty
7. Extra consumption of time by the companies
8. Postal delays and extra charges

6.6 Types of securities

There are two types of securities exist: bearer and registered securities.

1. **Bearer securities**: A bearer security is a security whose owner is unknown. Possession of this type of security is deemed as evidence of ownership: the holder of the bearer security is assumed to be its owner of the security. Bearer securities exist in both physical form and book-entry form. Ownership of the security can be transferred by simply handing over the certificate (physical form) or by means of a transfer to the securities portfolio of another person.

2. **Registered securities**: A Registered r security is a security whose owner is known. The name of the holder is clearly indicated on such securities. They are listed in the register of
shareholders of the company in the name of a given individual and can only be transferred subject to specific procedures and following statutory provisions.

Check your progress A:

Q 6.3. What is the difference between Bearer Security and Registered Security

6.7 Advantages of dematerialization

Dematerialization of shares is beneficial for investors, brokers and companies and these are described as below:-

- Demat format reduces the risk of loss or theft.
- Time and money is saved as the transaction of the shares is done electronically. In this investor is need not go to the notary, broker for taking delivery or submitting the share certificate
- Liquidity is very high in case of demat format as whole process in automated.
- All the benefits of corporate action like bonus, stock split, rights etc. are managed through the depository leading to elimination of transit losses
- Interest on loan against demat shares are less as compared to physical shares
- Investors save stamp duty while transferring shares in demat format.
- One needs to pay less brokerage in case of demat shares
- From share issuing company’s perspective, issuance in demat format reduces the cost of new issue as papers are not involved

6.8 Parties of dematerialization

There are following parties involved in depository are as below:

1. **Depository Participant** – A depository participant (DP) is an agent of the depository who is authorized to offer depository services to investors. Financial institutions, banks. Custodian and stock brokers complying either requirements prescribed by SEBI/ Depositories can be regarded as DP. Similar to the brokers who trade on your behalf in and outside the Stock Exchange; a Depository Participant (DP) is the representative
(agent) in the depository system providing the link between the Company and the investor through the Depository. Depository Participant maintains investor’s securities account balances and intimates him the status of your holding from time to time. According to SEBI guidelines, Financial Institutions like banks, custodians, stockbrokers etc. can become participants in the depository. A DP is one with whom you need to open an account to deal in electronic form. While the Depository can be compared to a Bank, DP is like a branch of bank with whom one can have an account. Market Intermediary through whom investor avail the Services. These are usually Banks or financial organizations. Some of the examples are –Sharekhan, ICICI, HDFC in India.

2. **Investor** – Investor may individual, Partnership Firm, HUF and company. Beneficial owner is a person a demat account is opened with depository for the purpose of holding securities in the electronic form.

3. **Depository** – Which holds stocks in electronic format. In India these services are provided by two organizations – CDSL, NSDL.

### 6.9 Process of Dematerialisation

An investor can follow below steps for getting physical securities converted into Demat form:-

1. First of all, an Investor should submit the DRF (Demat Request Form) and physical certificates (to be dematted) to the depository participant. DP checks whether the securities are available for demat. Investor defaces the certificate by stamping ‘Surrendered for Dematerialisation’. DP punches two holes on the name of the company and draws two parallel lines across the face of the certificate. It ensures that his/her shares are not lost in transit or misused till credit is received by him/her in his/her demat account. The DP upon receipt of the shares and the DRF, will issue the investor an acknowledgement and will

2. In this step, DP enters the demat request in his system to be sent to NSDL.
3. DP dispatches the physical certificates along with the DRF to the R&T Agent.
4. NSDL records the details of the electronic request in the system and forwards the request to the R&T Agent.
5. R&T Agent, on receiving the physical documents and the electronic request, verify and check them. Once the R&T Agent is satisfied, dematerialization of the concerned securities is electronically confirmed to NSDL.

6. NSDL credits the dematerialised securities to the beneficiary account of the investor and intimates the DP electronically. Step: 8 The DP issues a statement of transaction to the client.

Check your progress

Q 6.4 For transfer of shares which of the following is used by demat account holder?

   a. Transaction Slip
   b. Delivery Instruction Slip (DIS)
   c. Cheque Book
   d. Demat Statement

Q 6.5 While applying for IPO through demat account, which product enables only blocking of funds in savings account and actual debit happens only after allotment of IPO?

   a. ECS
   b. ASBA
   c. RTGS
   d. NEFT

6.10 Trading and Settlement of dematted shares

One of the most important functions of the depositories is to provide the facility of transfer of shares. It basically means transfer of ownership from the seller to the buyer at the instruction of the account holder. Both the buyer (transferee) and the seller (transferor) have to give instructions to their respective depository participants regarding the transfer of ownership. A transferee is allowed to give Standing Instructions (SI) to the DP regarding the credit. But a beneficiary account can be debited only if the beneficiary owner has given the Delivery Instructions (DI) in the prescribed form.

Transfers can arise out of Off-market Trades or Market Trades. Any trade carried out without the participation of the clearing corporation is called off-market trade, i.e. trades cleared and settled without the intervention of NSCCL. Generally, bulk deals between institutions; trades between private parties, transfer of securities between a client and a sub-broker are off-market trades. On the other hand, a market trade is one which is settled through the clearing corporation. All the trades done in a regular manner on the exchange are a part of market trade. Even the negotiated trades done with the intervention of the clearing corporation are a part and parcel of market trades.
Settlement of Off-market Trades

1. Seller gives delivery instructions to his DP to move securities from his account to the buyer’s account.
2. Buyer automatically receives the credit of the securities into his account on the basis of standing instruction for credits.
3. Buyer receives credit of securities into his account only if he gives receipt instructions, if standing instructions have not been given.
4. DP needs to be extra careful in verifying the signature of the client if large quantities of securities are being debited to the account.
5. Funds move from buyer to seller outside the NSDL system.

In case of Off-market trades, all the funds related settlements are made outside the system of NSDL and NSCCL. Only the transfer of securities is done through the NSDL channel. Therefore, NSCCL is not responsible for the timely payment of funds.

Settlement of Market Trades

Market trades include all the trades done through the NSE system. Even the trades done through negotiation, wherein the buyers and sellers fix a deal on their own but want that the securities should move through the NSDL system, and the clearing and settlement through the NSCCL will also be a part of market trades.

1. Seller gives delivery out instructions to his DP to move securities from his account to his broker’s account.
2. Securities are transferred from broker’s account to CC on the basis of a delivery out instruction.
3. On the pay-out day securities are moved from CC to buying broker’s account.
4. Buying broker gives instructions and securities move to the buyer’s account.

6.11 Agencies in Dematerialisation

Presently, there are two depositories registered with SEBI, namely National Securities Depository Limited (NSDL), Central Depository Service (India) Limited (CDSL)

1. National securities depository limited (NSDL)

Based on the functions, NSDL enables the surrender and withdrawal of securities to and from the depository (dematerialisation and rematerialisation). NSDL is a public limited company incorporated under the Companies Act, 1956. Four renowned institutions participate in it, i.e. Unit Trust of India (UTI), Industrial Development Bank of India (IDBI), National Stock Exchange of India (NSE), and State Bank of India (SBI). UTI is the largest mutual fund of India and IDBI is the largest development bank, NSE is the largest stock exchange of India and SBI is the largest commercial bank of India having clearing facility. HDFC and Citibank also share in
this system. NSDL is managed by Board of directors headed by a managing director. It is governed by its bye-laws and its business operations are regulated by business rules. NSDL interfaces with the investors through players or business partners. The main constituents of depository compromise of clearing corporation, brokers, clearing member, registrar and transfer agents, company or issuer, stock exchange, bank depository participant and investors. All are electronically linked to the main depository for the settlement of trades and to perform a daily reconciliation of all accounts held with NSDL.

In order to provide quality service to the users of depository, NSDL launched a certification programme in depository operations in May 1999. This certification is conducted using NCFM infrastructure created by NSE and is called "NSDL - Depository Operations Module". The programme is aimed at certifying whether an individual has adequate knowledge of depository operations, to be able to service investors.NSDL commenced operations on November 8, 1996.

2. Central Depository Service (India) Limited (CDSL)

The Second agency in Dematerialization is CDSL - Central Depository Service (India) Limited. Main functions of CDSL agency are centralized database and accounting. Major participant in CDSL are LIC, GIC and BSE. This agency is set up with the object to keep in mind to accelerate growth of scripless trading, with major thrust of individual participation and creating competitive environment, responsible to the user’s interests and demands to enhance liquidity.

A Depository facilitates holding of securities in the electronic form and enables securities transactions to be processed by book entry by a Depository Participant (DP), who as an agent of the depository, offers depository services to investors.

According to SEBI guidelines, financial institutions, banks, custodians, stockbrokers, etc. are eligible to act as DPs. The investor who is known as beneficial owner (BO) has to open a demat account through any DP for dematerialisation of his holdings and transferring securities. The balances in the investors account recorded and maintained with CDSL can be obtained through the DP. The DP is required to provide the investor, at regular intervals, a statement of account which gives the details of the securities holdings and transactions. The depository system has effectively eliminated paper-based certificates which were prone to be fake, forged, counterfeit resulting in bad deliveries. CDSL offers an efficient and instantaneous transfer of securities

CDSL aims to retain the entire data of the investors in the central database of CDSL. It has opted for it with the following objectives:

- Within time information is available to issuers/registrar’s and share transfer agents.
- Companies can monitor critical holdings, e.g., holding of FIIs and FIs, investment companies, etc., by using up the parameters through their front-end terminals.
- There is no other database in the system to reconcile.
- No additional security or storage cost of data or critical database residing at the front-end terminals with the issuers/registrars.
- Recover only the annual maintenance charges.
CDSL signed a memorandum of understanding with NSDL for inter-depository connectivity. Presently, more than half the business of depositories is handled by this agency. Role of both these agencies has become very vital after SEBI’s declaration that there would be no deals in physical form and only dealing to happen in market through demat accounts.

Q 6.6 Does Axis Bank have a tie up with NSDL and CDSL for DP?
   a. Yes
   b. No

Q 6.7 In "Six Years: The Dematerialization of the Art Object" Lucy Lippard characterizes the period of 1966 to 1972 as one in which the art object was dematerialised through the new artistic practices of:
   a. Conceptual art
   b. Abstract expressionism
   c. Dada
   d. Minimalism

Q 6.8 In ______ and financial law, dematerialization refers to the substitution of paper-form securities by book-entry securities.
   a. Debt
   b. Bond (Finance)
   c. Financial Market
   d. Finance

Q 6.9 In ______, dematerialization refers to the absolute or relative reduction in the quantity of materials required to serve economic functions in society.
   a. Heterodox economics
   b. Keynesian economics
   c. Money
   d. Economics

Q 6.10 Therefore, dematerialized securities are often referred as intermediated securities, in particular by the ________.
   a. Hague Securities Convention
   b. Uniform Commercial Code
   c. Unidroit convention on substantive rules for intermediated securi
   d. Common law

6.12 Documents Required For Demat Account
To open a Demat account you have to provide documents which fulfill the requirements. In this, an investor have to sign a contract with Stock broker and provide following documents:-

1. PAN (Compulsory)
2. Bank statement (last 3 months)
3. Address Proof
4. Income Tax Return
5. Two colour photos
6. Bank crossed Cheque (If required)
7. An additional details

6.13 Disadvantages of dematerialization

- Trading in securities may become uncontrolled in case of dematerialized securities.
- It is incumbent upon the capital market regulator to keep a close watch on the trading in dematerialized securities and see to it that trading does not act as a detriment to investors.
- For dematerialized securities, the role of key market players such as stock-brokers needs to be supervised as they have the capability of manipulating the market.
- Multiple regulatory frameworks have to be conformed to, including the Depositories Act, Regulations and the various Bye-Laws of various depositories.
- Agreements are entered at various levels in the process of dematerialization. These may cause worries to the investor desirous of simplicity.
- There is no provision to close a demat account, which is having illiquid shares. The investor cannot close the account and he and his successors have to go on paying the charges to the participant, like annual folio charges etc.
- After liquidating the holdings, many Indian investors don’t close their DP account. They are unaware that DPs charge even on dormant accounts.

6.14 Initial public offer

An Initial Public Stock Offering (IPO) arises when a company issues common stock or shares to the public for the first time. They are often issued by smaller, younger companies seeking capital to expand, but can also be done by large privately owned companies looking to become publicly traded. In an IPO the issuer may obtain the assistance of an underwriting firm, which helps it determine what type of security to issue, best offering price and time to bring it to market.

6.15 Institutional structure

There are quite a few institutions that are directly and/or indirectly connected with dematerialised operations of securities. Understanding the interlinkages and functional responsibilities of these institutions will help us to have correct and holistic perspective about functioning of dematerialisation. The institutions connected with demat operations include; Depositories, Stock Exchanges (SEs), Clearing Corporations (CCs) / Clearing Houses (CHs), Depository Participants (DPs), and Registrars and Transfer Agents (RTAs). Both the depositories NSDL and CDSL are primarily promoted by NSE and BSE. Besides, there are many other institutional promoters in both the depositories. Most of the stock exchanges are connected with
the depositories to provide trading in dematerialisation segment. Eventually, all the exchanges will be connected to either of or both the depositories. The transaction cost for equity shares in India revealed substantial decrease in transaction costs and observed that the dematerialisation as one of the important factor for this trend. Functioning of clearing corporations / clearing houses materially changed after the entry of depositories; reduced manpower requirements and faster clearing operations. It also helped them to diversify into related businesses such as online stock lending. Depository participants are the new commercial intermediaries that sprang up. They interpose between investor and depository. It can be stated that they are the back-bone for the success of dematerialisation. RTAs facilitate dematerialisation and rematerialisation of shares.

6.16 market microstructure

Trading in dematerialised shares brought in many changes to the entire structure of the capital market functioning. With the introduction of demat, stock exchanges switched over (with a choice) from five day accounting period to T + 5 trading and settlement for demat stocks. Even for demat stocks dual settlement is in operation: fixed account period as well as rolling settlement. This partial change to T + 5 rolling settlement systems is a major shift in the market. Thus dematerialisation smoothly paved the way for rolling settlement and India joined other developed markets that are following T+ settlement system. In the physical segment there is a long gap between delivery and payment. Clearing corporations / Clearing houses are electronically directly connected to depositories that make settlements faster and easier and it results in lesser brokerage and custodial charges. Reduced transaction costs prompts investors to trade more frequently resulting in higher volumes.

6.17 Glossary

1. Dematerialization in short form is known as 'demat is the process by which an investor can get physical certificates converted into electronic form maintained in an account with the Depository Participant.

2. There are two types of securities exist: bearer and registered securities.

3. There are three parties involved in depisoty are Depository Participants, Investor and Depository

4. There are two depositories registered with SEBI, namely National Securities Depository Limited (NSDL), Central Depository Service (India) Limited (CDSL).

5. To open a Demat account, the important documents are PAN (Compulsory), Bank statement (last 3 months), Address Proof, Income Tax Return, Two colour photos, Bank crossed Cheque (If required) and customer related an additional details

6.18 Answers to Check your Progress

6.1 (b), 6.4 (b), 6.5 (b), 6.6 (a), 6.7 (a), 6.8 (d), 6.9 (d), 6.10 (c)

6.19 Test/Model Questions
1. Define dematerialization.
2. Discuss the various documents required for opening for demat account?
3. What is the process of dematerialization?
4. How dematted shares are traded and settled?
5. Explain the various agencies involved in dematerialization of securities?
6. Explain the parties involved in dematerialization of shares.
Chapter 5
Foreign institutional investment

Structure:
12.1 Objectives
12.2 Introduction of FII
12.3 Evolution of FII
12.4 Market design in India for FII
12.5 FIIs registered with SEBI fall under different categories
12.6 Salient features of FII
12.7 Registration process
12.8 Investment Conditions and Restrictions for FIIs
12.9 Prohibitions on Investments
12.10 Channels of Foreign Institutional Investments in India
12.11 Entities which can register as FII’s in India
12.12 Advantages of FII Investment
12.13 Disadvantages of FII Investment
12.14 Differences between FII & FDI (FII versus FDI)
12.15 Special incentives for FIIs in selected sectors of India
12.16 Summary
12.17 Answers to Check your Progress
12.18 Test/Model Questions
12.19 Suggested Readings

12.1 Objectives
After going through this chapter, you will be able to:

- Define the FII
- Understand the Channels of Foreign Institutional Investments in India
- Understand the Entities which can register as FII’s in India
- Explain the registration process of Foreign Institutional Investments
- Explain the various Prohibitions on Investments
### 12.2 Foreign Institutional Investors (FII’s)

Foreign investment refers to the investments made by the residents of a country in the financial assets and production process of another country. A foreign institutional investor (FII) is an investor or investment fund registered in a country outside of the one in which it is investing. Institutional investors most notably include hedge funds, insurance companies, pension funds and mutual funds. The term is used most commonly in India and refers to outside companies investing in the financial markets of India.

The foreign investment is necessary for all developing nation as well as developed nation but it may differ from country to country. The developing economies are in a most need of these foreign investments for boosting up the entire development of the nation in productivity of the labour, machinery etc. The foreign investment or foreign capital helps to build up the foreign exchange reserves needed to meet trade deficit or we can say that foreign investment provides a channel through which developing countries gain access to foreign capital which is needed most for the development of the nations in the area of industry, telecom, agriculture, IT etc. The foreign investment also effects on the recipient country like it effects on its factor productivity as well as effects on balance of payments. Foreign investment can come in two forms: foreign direct investment and foreign institutional investment. Foreign direct investment involves in direct production activities and in a long and medium term nature. As far as the FIIs concern it is the short term nature and short term investments. FIIs invest in financial markets such as money markets, stock markets and foreign exchange markets.

Q.: 12.1 Define Foreign Institutional Investors

_________________________________________________________________________
_________________________________________________________________________
_________________________________________________________________________

12.3 Evolution of Foreign Institutional Investors (FII’s)

Since 1990-91, the Government of India embarked on liberalization and economic reforms with a view of bringing about rapid and substantial economic growth and move towards globalization of the economy. As a part of the reforms process, the Government under its New Industrial Policy revamped its foreign investment policy recognizing the growing importance of foreign direct investment as an instrument of technology transfer, augmentation of foreign exchange reserves and globalization of the Indian economy. Simultaneously, the Government, for the first time, permitted portfolio investments from abroad by foreign institutional investors in the Indian capital market. The entry of FIIs seems to be a follow up of the recommendation of the Narsimhan Committee Report on Financial System. While recommending their entry, the Committee, however did not elaborate on the objectives of the suggested policy. The committee
only suggested that the capital market should be gradually opened up to foreign portfolio investments.

From September 14, 1992 with suitable restrictions, Foreign Institutional Investors were permitted to invest in all the securities traded on the primary and secondary markets, including shares, debentures and warrants issued by companies which were listed or were to be listed on the Stock Exchanges in India. While presenting the Budget for 1992-93, the then Finance Minister Dr. Manmohan Singh had announced a proposal to allow reputed foreign investors, such as Pension Funds etc., to invest in Indian capital market.

12.4 Market design in India for foreign institutional investors

Foreign Institutional Investors means an institution established or incorporated outside India which proposes to make investment in India in securities. A Working Group for Streamlining of the Procedures relating to Foreign Institutional Investors, constituted in April, 2003, inter alia, recommended streamlining of SEBI registration procedure, and suggested that dual approval process of SEBI and RBI be changed to a single approval process of SEBI. This recommendation was implemented in December 2003.

Currently, entities eligible to invest under the FII route are as follows:

- As FII: Overseas pension funds, mutual funds, investment trust, asset management company, nominee company, bank, institutional portfolio manager, university funds, endowments, foundations, charitable trusts, charitable societies, a trustee or power of attorney holder incorporated or established outside India proposing to make proprietary investments or with no single investor holding more than 10 per cent of the shares or units of the fund.
- As Sub-accounts: The sub account is generally the underlying fund on whose behalf the FII invests. The following entities are eligible to be registered as sub-accounts, viz. partnership firms, private company, public company, pension fund, investment trust, and individuals.

12.5 FIIs registered with SEBI fall under the following categories:

- Regular FIIs- those who are required to invest not less than 70 % of their investment in equity-related instruments and 30 % in non-equity instruments.
- 100 % debt-fund FIIs- those who are permitted to invest only in debt instruments.

The Government guidelines for FII of 1992 allowed, inter-alia, entities such as asset management companies, nominee companies and incorporated/institutional portfolio managers or their power of attorney holders (providing discretionary and non-discretionary portfolio management services) to be registered as Foreign Institutional Investors. While the guidelines did not have a specific provision regarding clients, in the application form the details of clients on whose behalf investments were being made were sought.
While granting registration to the FII, permission was also granted for making investments in the names of such clients. Asset management companies/portfolio managers are basically in the business of managing funds and investing them on behalf of their funds/clients. Hence, the intention of the guidelines was to allow these categories of investors to invest funds in India on behalf of their ‘clients’. These ‘clients’ later came to be known as sub-accounts. The broad strategy consisted of having a wide variety of clients, including individuals, intermediated through institutional investors, who would be registered as FIIs in India. FIIs are eligible to purchase shares and convertible debentures issued by Indian companies under the Portfolio Investment Scheme.

12.6 Salient Features of FIIs:

1. FIIs including pension funds, mutual funds, investment trust, asset management companies, Nominee Company, bank, incorporated/institutional portfolio manager or their power of attorney holder (providing discretionary and non-discretionary portfolio management services) would be welcomed to make investments under the new guidelines. Investment in all securities traded on the primary and secondary markets including the equity and other securities/instruments of companies which are listed/to be listed on the stock exchanges in India including the OTC exchange of India is permitted. The instrument includes shares, debentures, warrants, and scheme floated by domestic mutual funds. Government may even add further categories of securities from time to time.

2. FIIs would be required to obtain an initial registration with SEBI to enter the market. Nominee companies, affiliated and subsidiary companies of an FII will be treated as separate FIIs for registration and may seek separate registration with SEBI.

3. Since there are foreign exchange controls in force, FIIs shall also seek various permissions under FERA from the RBI, both SEBI and RBI registration will be under a single window approach.

4. FIIs seeking initial registration with SEBI shall be required to hold a registration from the securities commission or such other regulatory organization for the stock market in their country of domicile/incorporation.

5. SEBI’s initial registration would be valid for 5 years. RBI’s general permission under FERA to the FII will also hold well for five years, both will be renewable for similar five periods later on.

6. Under the FERA permission, FIIs will be able to buy, sell and realize capital gains on investments made through the initial corpus remitted to India, subscribe/renounce rights offering of shares invest on all recognized stock exchanges through a designated bank branch and appoint a domestic custodian for custody of the investment.

7. The general permission from the RBI will enable the FIIs to:
   - Open foreign currency account(s) in a designated bank (there can be more than one account in the same bank branch, in different currencies, if so required by the FII for its operational purpose).
   - Open a special non-resident rupee account to which all receipts from the capital inflows, sale proceeds of shares dividends and interest could be credited.
Transfer sums from the foreign currency accounts to the rupee accounts and vice-versa, at the market rates of exchange.

Make investment in securities in India out of the balances in the rupee accounts.

Transfer repatriable (after tax) proceeds from the rupee account to the foreign currency accounts.

Repatriate the capital, capital gains, dividends, income received by the way of interest etc; and any compensation received towards sale/renouncement of rights offering of shares subject to the designated branch of a bank/custodian being authorized to deduct withholding tax on capital gains and arranging to pay such tax and remitting the net proceeds at market rates of exchange.

Register FII’s holding without any further clearance under FERA.

8. There would be no restrictions on the volume of investment—minimum or maximum for the purpose of entry FIIIs in the primary/secondary markets and also on the lock in period described for the purpose of such investments made by FIIs, however, portfolio investment in primary and secondary markets will be subjected to ceiling of 24% of issued share capital for the total holding of all registered FIIs in any one company. Conversions, out of the fully and partly convertible debentures issued by the company will also be taken into account for the purpose. The holding of a single FII in any company would be subject to a ceiling of 5% of total issued share capital for which purpose, holding of an FII group will be counted as holdings of a single FII.

9. The maximum holding of 24% for all non-residential portfolio investments including those of the registered. FIIs will also include NRI corporate and non-corporate investments, but will not include; direct foreign investment (which are permitted up to 51% or 74% or even full in all priority sector) and investments by FIIs through the following alternatives offshore single/regional funds, global depository receipts and euro convertibles.

10. Disinvestment will be allowed only through stock exchanges in India including OTCEI. SEBI may permit sales other than through stock exchanges, provided the sale prices are not significantly different from the stock market quotations, where available.

11. All secondary market operations would be only through the recognized intermediaries on the Indian stock exchange including OTCEI. FIIs would not be expected to take delivery of purchased and give delivery of sold securities.

12. FIIs can appoint an custodian an agency approved by SEBI as a custodian of securities and for confirmation of transaction in securities, settlement of purchase and sale and for information reporting such a custodian shall establish separate accounts for detailing on a daily basis the investment capital utilization and securities held by each FII for which it is acting as custodian will report to the RBI and SEBI semi-annually, as part of their disclosure and reporting guidelines.

13. RBI may at any time request by an order, a registered FII to submit information regarding records of the utilization of the inward remittances of investment capital and the statement of its securities transactions. RBI and /or SEBI may also any time conduct a direct inspection of the records and accounting books of a registered FII.
14. FIIs investing under this scheme will benefit from a concessional tax regime of a flat tax rate of 20% on dividend and interest income and a tax rate of 10% on long-term (one or more year) capital gains.

12.7 Registration Process of FIIs

A FII is required to obtain a certificate by SEBI for dealing in securities. SEBI grants the certificate SEBI by taking into account the following criteria:

1. The applicant's track record, professional competence, financial soundness, experience, general reputation of fairness and integrity.
2. Whether the applicant is regulated by an appropriate foreign regulatory authority.
3. Whether the applicant has been granted permission under the provisions of the Foreign Exchange Regulation Act, 1973 (46 of 1973) by the Reserve Bank of India for making investments in India as a Foreign Institutional Investor.
4. Whether the applicant is a) an institution established or incorporated outside India as a pension fund, mutual fund, investment trust, insurance company or reinsurance company. (b) an International or Multilateral Organization or an agency thereof or a Foreign Governmental Agency or a Foreign Central Bank. (c) an asset management company, investment manager or advisor, nominee company, bank or institutional portfolio manager, established or incorporated outside India and proposing to make investments in India on behalf of broad based funds and its proprietary funds in if any or (d) university fund, endowments, foundations or charitable trusts or charitable societies.
5. Whether the grant of certificate to the applicant is in the interest of the development of the securities market.
6. Whether the applicant is a fit and proper person.

The SEBIs initial registration is valid for a period of three years from the date of its grant of renewal.

12.8 Investment Conditions and Restrictions for FIIs:

A Foreign Institutional Investor may invest only in the following:-

1. Securities in the primary and secondary markets including shares, debentures and warrants of companies, unlisted, listed or to be listed on a recognized stock exchange in India.
2. units of schemes floated by domestic mutual funds including Unit Trust of India, whether listed or not listed on a recognized stock exchange.
3. Dated Government securities.
4. Derivatives traded on a recognized stock exchange.
5. Commercial paper.
The total investments in equity and equity related instruments (including fully convertible debentures, convertible portion of partially convertible debentures and tradable warrants) made by a Foreign Institutional Investor in India, whether on his own account or on account of his sub-accounts, should not be less than seventy per cent of the aggregate of all the investments of the Foreign Institutional Investor in India, made on his own account and on account of his sub-accounts. However, this is not applicable to any investment of the foreign institutional investor either on its own account or on behalf of its sub-accounts in debt securities which are unlisted or listed or to be listed on any stock exchange if the prior approval of the SEBI has been obtained for such investments. Further, SEBI while granting approval for the investments may impose conditions as are necessary with respect to the maximum amount which can be invested in the debt securities by the foreign institutional investor on its own account or through its sub-accounts. A foreign corporate or individual is not eligible to invest through the hundred percent debt route. Even investments made by FIIs in security receipts issued by securitization companies or asset reconstruction companies under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 are not eligible for the investment limits mentioned above. No foreign institutional should invest in security receipts on behalf of its sub-account.

12.9 Prohibitions on Investments

Foreign Institutional Investors are not permitted to invest in equity issued by an Asset Reconstruction Company. They are also not allowed to invest in any company which is engaged or proposes to engage in the following activities:

- Business of chit fund
- Nidhi Company
- Agricultural or plantation activities
- Real estate business or construction of farm houses (real estate business does not include development of townships, construction of residential/commercial premises, roads or bridges).
- Trading in Transferable Development Rights (TDRs).

12. 10 Channels of Foreign Institutional Investments in India:

Portfolio investments in India include investments in American Depository Receipts (ADRs)/Global Depository Receipts (GDRs), Foreign Institutional Investments and investments in offshore funds. Before 1992, only Non-Resident Indians (NRIs) and Overseas Corporate Bodies were allowed to undertake portfolio investments in India. Thereafter, the Indian stock markets were opened up for direct participation by FIIs. They were allowed to invest in all the securities traded on the primary and the secondary market including the equity and other securities/instruments of companies listed/to be listed on stock exchanges in India.

12.11 Entities which can register as FII's in India:
Entities who propose to invest their proprietary funds or on behalf of “broad based” funds (fund having more than twenty investors with no single investor holding more than 10 per cent of the shares or units of the fund) or of foreign corporate and individuals and belong to any of categories given below can be registered for Foreign Institutional Investors (FII’s).

- Pension Funds
- Mutual Funds
- Investment Trust
- Insurance or reinsurance companies
- Endowment Funds
- University Funds
- Foundations or Charitable Trusts or Charitable Societies who propose to invest on their own behalf
- Asset Management Companies
- Nominee Companies
- Institutional Portfolio Managers
- Trustees
- Power of Attorney Holders
- Banks
- Foreign Government Agency
- Foreign Central Bank
- International or Multilateral Organization or an Agency thereof

Some of the above mentioned types are described below:

**Pension funds**: A pension fund is a pool of assets that form an independent legal entity that are bought with the contributions to a pension plan for the exclusive purpose of financing pension plan benefits. It manages pension and health benefits for employees, retirees, and their families. FII activity in India gathered momentum mainly after the entry of CalPERS (California Public Employees’ Retirement System), a large US-based pension fund in 2004.

**Mutual funds**: A mutual fund is a professionally managed type of collective investment scheme that pools money from many investors and invests it in stocks, bonds, short-term money market instruments, or other such securities. The mutual fund will have a fund manager that trades the pooled money on a regular basis. The net proceeds or losses are then distributed to the investors.

**Investment trust**: An Investment trust is a form of collective investment. Investment trusts are closed-end funds and are constituted as public limited companies. A collective investment scheme is a way of investing money with others to participate in a wider range of investments than feasible for most individual investors, and to share the costs and benefits of doing so.
**Investment banks:** An investment bank is a financial institution that raises capital, trades in securities and manages corporate mergers and acquisitions. Investment banks profit from companies and governments by raising money through issuing and selling securities in capital markets (both equity, debt) and insuring bonds (e.g. selling credit default swaps), as well as providing advice on transactions such as mergers and acquisitions.

**Hedge funds:** A hedge fund is an investment fund open to a limited range of investors that is permitted by regulators to undertake a wider range of investment and trading activities than other investment funds, and that, in general, pays a performance fee to its investment manager. Every hedge fund has its own investment strategy that determines the type of investments and the methods of investment it undertakes. Hedge funds, as a class, invest in a broad range of investments including shares, debt and commodities. Many hedge funds investments in India were facilitated by global investors borrowing at near zero interest rates in Japan and investing the proceeds in High interest markets like India.

**University Fund:** The purpose of investments of these funds is to establish an asset mix for each of the University funds according to the individual fund’s spending obligations, objectives, and liquidity requirements. It consists of the University’s endowed trust funds or other funds of a permanent or long-term nature. In addition, external funds may be invested including funds of affiliated organizations and funds where the University is a beneficiary.

**Endowment fund:** It is a transfer of money or property donated to an institution, usually with the stipulation that it be invested, and the principal remain intact in perpetuity or for a defined time period. This allows for the donation to have an impact over a longer period of time than if it were spent all at once.

**Insurance Funds:** An insurance company’s contract may offer a choice of unit-linked funds to invest in. All types of life assurance and insurers pension plans, both single premium and regular premium policies offer these funds. They facilitate access to wide range and types of assets for different types of investors.

**Asset Management Company:** An asset management company is an investment management firm that invests the pooled funds of retail investors in securities in line with the stated investment objectives. For a fee, the investment company provides more diversification, liquidity, and professional management consulting service than is normally available to individual investors. The diversification of portfolio is done by investing in such securities which are inversely correlated to each other. They collect money from investors by way of floating various mutual fund schemes.

**Nominee Company:** Company formed by a bank or other fiduciary organization to hold and administer securities or other assets as a custodian (registered owner) on behalf of an actual owner (beneficial owner) under a custodial agreement.

**Charitable Trusts or Charitable Societies:** A trust created for advancement of education, promotion of public health and comfort, relief of poverty, furtherance of religion, or any other purpose regarded as charitable in law. Benevolent and philanthropic purposes are not
necessarily charitable unless they are solely and exclusively for the benefit of public or a class or section of it. Charitable trusts (unlike private or non-charitable trust) can have perpetual existence and are not subject to laws against perpetuity. They are wholly or partially exempt from almost all taxes.

Foreign Institutional Investors are the primary source of portfolio investment in India. In September 1992, the government of India announced the opening of the country’s stock markets to direct participation by FIIs through guidelines for Foreign Institutional Investment. In November 1995, the SEBI (Foreign Institutional Investors) Regulations, 1995 had been notified, which were largely based on the earlier guideline. The regulations require Foreign Institutional Investors to register with SEBI and to obtain approval from the Reserve Bank of India under the Foreign Exchange Regulations Act, 1973 to enable them to buy and sell securities, to open foreign currency and rupee bank accounts and to remit and repatriate funds.

One category of institutional investors eligible for registration as Foreign Institutional Investors who propose to invest on their own behalf includes Pension Funds, Mutual Funds, Investment Trusts, Insurance Companies, Endowment Funds, University Funds, Foundations or Charitable Trusts or Charitable Societies. The other category of foreign institutional investors, who propose to invest their proprietary funds or on behalf of “broad based” funds which are registered with SEBI as sub-accounts of the FIIs include Asset Management Companies, Investment Advisors, Nominee Companies, Institutional Portfolio Managers, Trustees and Power of Attorney Holders.

It is important to note that apart from fulfilling some conditions under Regulations 6 of SEBI (Foreign Institutional Investors) Regulations, 1995, such as permission under the provision of the Foreign Exchange Regulation Act, 1973 (presently under Foreign Exchange Management Act, 2000) from the Reserve Bank of India and satisfaction of the “Fit and Proper” guidelines issued by SEBI, SEBI would also consider whether the grant of registration is in the interest of the development of the securities market (The Securities Exchange Board of India, Annual Report. 1999-2000).

Foreign Institutional Investors may invest in Indian through two routes: Equity Investment route and 100% Debt route. Under the equity investment route 100% investment could be in the equity related instruments or up to 30% could be invested in debt instruments i.e. 30 (Debt Instrument). Under the 100% Debt route, 100% investments have to be made in debt securities only.

In the case of equity route, the Foreign Institutional Investors can invest in the securities in the primary and secondary market, units floated by the Unit Trust of India and other domestic mutual funds and warrants. In the case of debt route, the Foreign Institutional Investors can
invest in debentures, bonds, dated government securities, treasury bills and other debt market instruments.

A Foreign Institutional Investors (investing on own behalf) or a sub account can hold up to 10% of paid-up Equity Capital of any Company. The total investments by Foreign Institutional Investors and Sub accounts in any Indian Company cannot exceed 40% of its total paid-up Capital. However, this is subject to

- Approval by the board of directors of the company to the enhanced limit up to 40%
- A Special resolution passed by the general body of the company approving the enhanced limit up to 40%

The 40% limit does not include investments made by the Foreign Institutional Investors outside the Portfolio Investment route, i.e. through the direct investment approval process. Investment made offshore through purchases of Global Depository Receipts and convertibles are also excluded.

The overall investments limit is monitored by Reserve Bank of India. When the overall Foreign Institutional Investors investment level reaches 38% in a company, Reserve Bank of India gives a caution notice. Subsequently, all purchases have to be done by prior approval of Reserve Bank of India. However, for Public Sector Banks (except HDFC Bank), the investment limit is 20% and the trigger point is 18%.

Foreign Institutional Investors can make 100% investments in debt securities subject to specific approval from SEBI as a separate category of Foreign Institutional Investors or sub-accounts. Foreign Institutional Investors investments in debt through the 100% debt route to subject to an overall cap under the category of external commercial borrowings. SEBI allocates individual ceilings to Foreign Institutional or sub-accounts within this overall limit on the basis of their track record or experience in debt markets. Foreign Institutional Investors investing through the 100% debt route may either invest proprietary funds or on behalf of broad based funds. There is no limit on investments in the debt securities of any particular issuer. Foreign Institutional Investors are permitted to invest in derivative contracts, which are traded on a recognized stock exchange.

Foreign Institutional Investors have to pay tax at the rate of 10% on long-term capital gains (capital gain on the sale of securities held for a period more than one year is termed as long-term capital gain), at 30% on short-term capital gains (capital gains on the sale of securities held for a period of less than one year is termed as short-term capital gain) and at the rate of 20% on interest income.

The amount invested by Foreign Institutional Investors is fully convertible. For this purpose Foreign Institutional Investors are enquired to seek permission from the Reserve Bank of India under the Foreign Exchange Regulations Act, 1973. This is procured by SEBI. The stock lending scheme was introduced by SEBI in 1996. The Foreign Institutional Investors, which are active participants in the Indian securities, have been allowed to lend stocks through an approved
intermediary. However, presently the Foreign Institutional Investors are not permitted to borrow securities, which could result into covered short sales, by the Foreign Institutional Investors.

While announcing the policy measures relating to the Government securities market in the credit policy announcement an April 29, 1998. The RBI allowed FIIs to invest in treasury bills within the overall approved debt ceiling. A previous amendment in 1997 had permitted FIIs to invest in proprietary funds and also to invest in dated government securities. The Finance Minister in his budget speech for 1998-99 announced that Foreign Institutional Investors investing through the 100 percent debt route would be permitted to invest in unlisted securities. Amendments to this effect have been approved and notified by the SEBI. The SEBI (Foreign Institutional Investors) Regulations, 1995 require FIIs to enter into secondary market transactions only through stockbrokers registered with SEBI. To facilitate the participation of FIIs in open offers, the FIIs have now been permitted to tender their securities directly in response to an open offer made in terms of SEBI (Substantial Acquisition of Shares and Takeover) Regulations, 1997.

As FIIs are potential participants in the derivatives markets; it was felt that the presence of FIIs and domestic institutions would be crucial to the success of the market. It was, therefore, decided to permit FIIs to buy and sell derivative contracts traded on a stock exchange. In terms of regulations 12 and 13 of the SEBI (Foreign Institutional Investors) Regulations, 1995, FIIs may invest on behalf of sub-accounts which are registered with SEBI. When considering an application for registration of sub-accounts, the Regulations required submission of detailed information for registration. Under this procedure, considerable time was sometimes taken in determining whether the applicant was “broad based” as required by the Regulations. To simplify the registration process for sub-accounts it has been decided that the determination of fulfillment of broad base criteria be done by the Foreign Institutional Investors itself and a declaration to this effect be submitted to SEBI. The Regulations have been amended to incorporate a simplified format for registration of sub-accounts under which registration is now granted within three days of receipt of application.

With a view to expand the Foreign Institutional Investors, it has been decided by the government to permit the following categories of investors and arrangements to invest through the FII Portfolio Investment route (The Ministry of Finance, The Government of India, Annual Report, 1999-00):

1. to permit foreign corporates and high net worth individuals to invest through SEBI registered FIIs, such investment will be subject to a sub-limit of 5% within the aggregate limit for FII portfolio investments of 40% in a single company; and
2. to permit SEBI registered domestic fund managers to manage foreign funds for investments in the Indian capital market through the portfolio investment route provided the funds are channeled through internationally recognized financial institutions and subject to the reporting requirements as applicable to FIIs.

12.12 Advantages of FII Investment
The advantages of having FII Investment can be broadly classified under the following categories:

1. **Enhanced flows of equity capital:** FIIs are well known for a greater appetite for equity than debt in their asset structure. For examples, pension funds in the United Kingdom and United states had 68 percent and 64 percent, respectively of their portfolios in equity in 1998. Thus, opening up the economy to FIIs is in line with the accepted preference for non-debt creating foreign inflows over foreign debt. Furthermore, because of this preference for equities over bonds, FIIs can help in compressing the yield-differential between equity and bonds and improve corporate capital structures. Further, given the existing saving investment gap of around 1.6 percent, FII inflows can also contribute in bridging the investment gap. So that sustained high GDP growth rate of around 8 percent targeted under the 10th five year plan can be materialize. Equity return has a significant and positive impact on the FII investment. But given the huge volume of investments, foreign investment could play a role of market makers and book their profits and enhanced equity capital in the host country.

2. **Improving capital markets:** FIIs as professional bodies of asset managers and financial analysts enhance competition and efficiency of financial markets. Equity market development aids economic development. By increasing the availability of riskier long term capital for projects, and increasing firms’ incentives to supply more information about themselves, the FIIs can help in the process of economic development. The increasing role of institutional investors has brought both quantitative and qualitative developments in the stock markets viz., expansion of securities business, increased depth and breadth of the market, and above all their dominant investment philosophy of emphasizing the fundamentals has rendered efficient pricing of the stocks. Foreign portfolio investments would help the stock markets directly through widening investors’ base and indirectly by compelling local authorities to improve the trading system. It is very important that FII flows should be viewed not in isolation but as a part of an integrated policy package for all capital receipts keeping in mind their role in the overall macroeconomic structure.

3. **Improved corporate governance:** Good corporate governance is essential to overcome the principal-agent problem between share-holders and management. Information asymmetries and incomplete contracts between share-holders and management are at the root of the agency costs. Dividend payment, for example, is discretionary. Bad corporate governance makes equity finance a costly option. With boards often captured by managers or passive, ensuring the rights of shareholders is a problem that needs to be addressed efficiently in any economy. Incentives for shareholders to monitor firms and enforce their legal rights are limited and individuals with small share-holdings often do not address the issue since others can free-ride on their endeavor. What is needed is large shareholders with leverage to complement their legal rights and overcome the free-rider problem, but shareholding beyond say 5 per cent can also lead to exploitation of minority shareholders. FIIs constitute professional bodies of asset managers and financial analysts, who, by contributing to better understanding of firms’ operations, improve corporate governance. Among the four models of corporate control – takeover or market control via
equity, leveraged control or market control via debt, direct control via equity, and direct control via debt or relationship banking – the third model, which is known as corporate governance movement, has institutional investors at its core. In this third model, board representation is supplemented by direct contacts by institutional investors.

4. **Managing uncertainty and controlling risks:** Institutional investors promote financial innovation and development of hedging instruments. Institutions, for example, because of their interest in hedging risks, are known to have contributed to the development of zero-coupon bonds and index futures. FIIs, as professional bodies of asset managers and financial analysts, not only enhance competition in financial markets, but also improve the alignment of asset prices to fundamentals. Institutions in general and FIIs in particular are known to have good information and low transaction costs. By aligning asset prices closer to fundamentals, they stabilize markets. Fundamentals are known to be sluggish in their movements. Thus, if prices are aligned to fundamentals, they should be as stable as the fundamentals themselves. Furthermore, a variety of FIIs with a variety of risk-return preferences also help in dampening volatility.

5. **Reduced cost of equity capital:** FII inflows augment the sources of funds in the Indian capital markets. In a common sense way, the impact of FIIs upon the cost of equity capital may be visualized by asking what stock prices would be if there were no FIIs operating in India. FII investment reduces the required rate of return for equity, enhances stock prices, and foster investments by Indian firms in the country. From the perspective of international investors, the rapidly growing emerging markets offer potentially higher rates of return and help in diversifying portfolio risk. FII flows increase the stock prices in the recipients markets, which in turn increases the Price-Earning (P/E) ratio of the concerned firms. Increase in P/E ratio tends to reduce the cost of capital and boosts the stock markets. The cost of equity capital is also cut down due to the sharing of risk by the foreign investors. Some investment projects with a negative Net Present Value (NPV) before the entry of foreign investors can turn into projects with positive NPV after their entry. As a result, there is boost to primary issues in such markets.

6. **Imparting stability to India’s Balance of Payments:** For promoting growth in a developing country such as India, there is need to augment domestic investments, over and beyond domestic saving, through capital flows. The excess of domestic investment over domestic savings result in a current account deficit and this deficit is financed by capital flows in the balance of payments. Prior to 1991, debt flows and official development assistance dominated these capital flows. This mechanism of funding and current account deficit is widely believed to have played a role in the emergence of balance of payments difficulties in 1981 and 1991. Portfolio flows in the equity markets, and FDI as opposed to debtcreating flows, are important as safer and more sustainable mechanisms for funding the current account deficit. Bandopadhyay (2005) has found that the portfolio capital helps many developing economies in mitigating their balance of payments deficit as well as maintaining liquidity in the financial markets. It is also observed that both return in the source country stock market and the inflation rate do not find any impact on the FII.
7. **Knowledge Flows**: The activities of international institutional investors help strengthen Indian finance. FIIs advocate modern ideas in market design, promote innovation development of sophisticated products such as financial derivatives, enhance competition in financial intermediation, and lead to spillovers of human capital by exposing Indian participants to modern financial techniques, and international best practices and systems.

8. **Improvements to market efficiency**: A significant presence of FIIs in India can improve market efficiency through two channels. First, when adverse macro-economic news, such as bad monsoons, unsettles many domestic investors, it may be easier for a globally diversified portfolio manager to be more dispassionate about India’s prospects and engage in stabilizing trades. Second, at a level of individual stocks and industries, FIIs may act as a channel through which knowledge and ideas about valuation of a firm or an industry can more rapidly propagate into India. For example, foreign investors were rapidly able to assess the potential of the firms like Infosys, which are primarily expert oriented, applying valuation principles, and the prevailed outside India for software services companies. In the Indian context, the FIIs are said to have seen instrumental in promoting market efficiency and transparency (Chopra, 1995). The argument, in favor of this conclusion, is that the advent of FIIs has benefited all investors by offering them a wider range of instruments with varying degrees of risk, return and liquidity. Hence, the policy measures have been targeted towards promoting more FII investment.

12.13 **Disadvantages of FII Investment**

There are also some disadvantages of FII Investment which are broadly classified under the following categories:

1. **Volatility and capital outflows**: There is also increasing possibility of abrupt and sudden outflows of capital if the inflows are of a short-term nature as in the case of portfolio inflows of FIIs. The recent experience of reversal of private capital flows observed in Global crisis of 2008, Asian crisis in 1997 and in Mexico during the later part of 1994 due to sudden change in FIIs’ investment sentiment provides a vivid illustration of such risks. Usually, FIIs take into account some specific risks in emerging markets such as (i) political instability and economic mismanagement, (ii) liquidity risk and (iii) currency movement. Currency movement can have a dramatic impact on equity returns of FIIs, a depreciation having an adverse effect. The withdrawal of FIIs from ASEAN countries led to large inflow of funds to FIIs to India for which equity market in India is buoyant at present. Thus, short-term flows including portfolio flows of FIIs to developing countries in particular are inherently unstable and increases volatility of the emerging equity markets. They are speculative and respond adversely to any instability either in the real economy or in financial variables.

2. **Price rigging**: Bear hammering by FIIs has been alleged in case of almost all companies in India tapping the GDR market. The cases of SBI and VSNL are most illuminating to show how the FIIs manipulate domestic market of a company before its GDR issues. The manipulation of FIIs, working in collusion operates in the following way. First, they sell enmasse and then when the price has been pulled down enough, pick up the some shares
cheaply in the GDR market. Though FIIs have the freedom of entry and exit, they alone have the access to both the domestic as well as the GDR market but the GDR market is not open to domestic investors. Hence FIIs gain a lot at the cost of domestic investors due to their manipulation which is possible owing to integration of Indian equity market with global market consequent upon liberalization.

3. **Herding and positive feedback trading:** There are concerns that foreign investors are chronically ill-informed about India, and this lack of sound information may generate herding (a larger number of FIIs buying or selling together). These kinds of behavior can exacerbate volatility, and push prices away from fair values.

4. **BOP vulnerability:** There are concerns that in an extreme event, there can be a massive flight of foreign capital out of India, triggering difficulties in the balance of payments front. India’s experience with FIIs so far, however, suggests that across episodes like the Pokhran blasts, or the 2001 stock market scandal, no capital flight has taken place. A billion or more of US dollars of portfolio capital has never left India within the period of one month. When juxtaposed with India’s enormous current account and capital flows, this suggests that there is little evidence of vulnerability so far.

5. **Possibility of taking over companies or backdoor control:** Besides price rigging, FIIs are trying to control indigenous companies through the GDR route where they are also active. GDRs acquire the voting rights once an ordinary share gets converted into equity within a specified limit. So, the GDR route which is considered as FDI plus portfolio investment is a roundabout way adopted by FIIs to gain control of indigenous companies. While FIIs are normally seen as pure portfolio investors can occasionally behave like FDI investors, and seek control of companies that they have a substantial shareholding in. Such outcome, however, may not be inconsistent with India’s quest for greater FDI. Furthermore, SEBI’s takeover code is in place and has functional fairly well, ensuring that all investors benefit equally in the event of a takeover.

6. **Money laundering:** The movement of hot money of FIIs due to integration of emerging markets of India and other countries with global market have helped the hawala traders and criminal elements an easy means to launder international money from illegal activities which in consequence have also an impact on equity market. Sometimes FIIs act as an agent for money laundering. It is also argued that the FII indulge in price rigging by collusive operation. Another ill effect of opening up of the capital market to FIIs has been the possibility of FIIs trying to gain control of indigenous companies. Finally, it is alleged that FIIs might indulge in money laundering transactions. Hence, some authors have argued that FIIs have no significant benefits for the economy at large.

7. **Management control:** FIIs act as agents on behalf of their principals – as financial investors maximizing returns. There are domestic laws that effectively prohibit institutional investors from taking management control. For example, US law prevents mutual funds from owning more than 5 per cent of a company’s stock. According to the International Monetary Fund’s Balance of Payments Manual 5, FDI is that category of international investment that reflects the objective of obtaining a lasting interest by a resident entity in one economy in an enterprise resident in another economy. The lasting interest implies the existence of a long-term relationship between the direct investor and
Institutional investors on the other hand are specialized financial intermediaries managing savings collectively on behalf of investors, especially small investors, towards specific objectives in terms of risk, returns, and maturity of claims. All take-overs are governed by SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997, and sub-accounts of FIIs are deemed to be “persons acting in concert” with other persons in the same category unless the contrary is established. In addition, reporting requirement has been imposed on FIIs and currently Participatory Notes cannot be issued to un-regulated entities abroad. Some of these issues have been relevant right from 1992, when FII investments were allowed in. The issues, which continue to be relevant even today, are: (i) benchmarking with the best practices in other developing countries that compete with India for similar investments; (ii) if management control is what is to be protected, is there a reason to put a restriction on the maximum amount of shares that can be held by a foreign investor rather than the maximum that can be held by all foreigners put together; and (iii) whether the limit of 24 per cent on FII investment will be over and above the 51 per cent limit on FDI. There are some other issues such as whether the existing ceiling on the ratio between equities and debentures in an FII portfolio of 70:30 should continue or not, but this is beyond the terms of reference of the Committee. It may be noted that all emerging peer marketshave some restrictions either in terms of quantitative limits across the board or in specified sectors, such as, telecom, media, banks, finance companies, retail trading medicine, and exploration of natural resources. Against this background, further across the board relaxation by India in all sectors except a few very specific sectors to be excluded, may considerably enhance the attractiveness of India as a destination for foreign portfolio flows. It is felt that with adequate institutional safeguards now in place the special procedure mechanism for raising FII investments beyond 24 per cent may be dispensed with. The restrictions on foreign ownership of companies in emerging markets have been summarized in Annex-III.

Q. 12.2 Participatory notes are like contract notes. These are issued by........
   a. Foreign Institutional Investors (FIIs)  
   b. Foreign Institutions
   c. Qualified Institutional Buyers
   d. All the Above

Q12.3 The foreign entities that want to invest in the Indian stock market but do not want to register themselves with the SEBI as Foreign Institutional Investors (FIIs) can invest in India through a mechanism called
   a. Participatory Notes 
   b. Foreign Deferred Notes
   c. IDR
   d. None of the above
12.4 FII are not allowed to issue Participatory Notes to
   a. Indian nationals
   b. Persons of Indian Origin (PIOs)
   c. Corporate bodies (which are majority owned or controlled by NRIs)
   d. All the Above

12.5 According to SEBI, 'A Foreign Institutional Investor or sub-account may issue, deal in or hold, offshore derivative instruments such as Participatory Notes, Equity Linked Notes or any other similar instruments, but are subject to
   a. Know Your Customer requirement
   b. Know Your Client requirement
   c. Know Your Company requirements
   d. Know your customer requirements

12.6 Foreign institutional investors (FIIs) can now invest up to................. Percent in stock exchanges in India
   a. 49
   b. 51
   c. 25
   d. 100

12.7 A Qualified Institutional Placement (QIP) is a private placement of equity shares to------
   a. Qualified institutional buyers (QIB)
   b. Foreign institutional buyers (FIB)
   c. Qualified institutional Investors (FII)
   d. All of the above

12.14 Differences between FII & FDI (FII versus FDI)

FDI and FIIs are two important sources of foreign financial flows into a country. FDI (Foreign Direct Investment) the acquisition abroad of physical assets such as plant and equipment, with operating control residing in the parent corporation. It is an investment made to acquire a lasting management interest (usually 10 percent of voting stock) in an enterprise operating in a country other than that of the investor, the investor’s purpose being an effective voice in the management of the enterprise. It includes equity capital, reinvestment of earnings, other long term capital, and short-term capital. Usually countries regulate such investments through their periodic policies. In India such regulation is usually done by the Finance Ministry at the Centre through the Foreign Investment Promotion Board).

12.15 Special incentives for FIIs in selected sectors of India

Power Sector

The power sector in India has undergone major transformation in terms of structure and form of regulation, thereby paving way to vast expansion opportunities-both to the domestic as well as foreign institutional investors. Some of the major initiative undertaken by the government to
meet the objective of “Power for all: 2012” including allowing private players, both domestic and foreign, to set up power generation facilities, transmission and distribution, and removing ceilings on investments by FDIs as well as FIIs. India has undoubtedly emerged as the fifth largest market in the world against eighth position in the last decade. The sector has an installed generation capacity of 123 GW, generates more than 600 billion kWh, and carries out transmission and distribution network of more than 6.3 million circuits kms. Keeping in view, the potential of the Indian power sector in the world power market, the Government of India has spelt out significant policy initiatives to make the investment climate more conducive towards attracting Foreign Investment in the power sector. 100 percent foreign equity participation is permitted under the automatic approval route in all segments of the industry like generation (through coal, gas, or hydro), transmission and retail distribution. In case of large generation projects, the Mega Power Policy also provides incentives like capital import duty concessions, and the waiver of local levies to ease the burden of transaction costs. In addition, all power projects enjoy the benefit of a tax holiday according to which, they are given deduction of 100 percent of profits of the generation, transmission or distribution company, for a period of 10 consecutive years out of 15 years from commencement of the company, or a process involving major renovation of the existing transmission lines, under the Income Tax Act. The policy initiatives are thus aimed at offering maximum benefits in respect of 100 percent foreign investment in all segments of the industry both in terms of fiscal benefits as well as tax holiday.

Telecommunication Sector

The telecom sector in India was opened to the private players in the early 80s (termed as phase I). Liberalization of any sector of an economy to competition is generally known to create furor and over expectations about its market potential and the Indian telecom sector was not expected to be an exception. In its inception phase itself, various operators plunged into the sector to rest the waters. As the II phase of consolidation was carried out in the 90s, the sector had few participants while most others succumbed to the cutthroat competition. The sector had remained asmonopoly for quite long with the government-run BSNL and MTNL together accounting for 98% of nationwide exchange lines. However, as other players start operations in fixed line services, with the phase III in progress, it is anticipated that this sector will witness a much tougher competition in the coming years.

Investments by the foreign investors in the telecom sector have been pegged at 49 percent, by the Government on India. This limit of 49% is inclusive of both FIIs and foreign direct investment (FDIs). It is well known fact that the telecom is a capitalintensive sector which necessitates huge long-term investments. It has been rightly recognized by the government working group on telecom sector, for the Tenth Five Year Plan that, in order to achieve the tele-density targets, funding requirement to the tune over Rs.46000 crores would be necessary through private sector investments.

As the domestic players may not be in a position to meet such a huge requirement themselves, substantial investments are expected from foreign investors to meet the shortfall. Taking into view, the prevalent financial condition in India, apart from the stateowned enterprise such as BSNL and MTNL it is next to impossible for otherparticipants of the market either to plan or to
actually make such huge outlays regularly over period of time. In addition, as the banks and financial institutions are becoming more risk averse by adopting more conservative and discreet appraisal procedures, it is believed that huge funds might not be easily available. Hence it is felt that those firms, which enjoy the comfort of free cash flows without too much of debt burden, would have an edge over competitors. As a result, most of the private players would be forced to rely heavily on overseas equity funding through strategic or venture capital investors. However, such a heavy reliance on external support would be subject to selective approval, notwithstanding the fact that India has remained a strong growth attraction in the world market. In such circumstances, a hike in the foreign investments ceiling from the current 49 percent to a composite cap of 74 percent (for both FDI and FII) in November 2005, has definitely proved beneficial in enhancing the investment climate of the Indian telecom sector towards attracting more FIIs.

Insurance Sector

The insurance sector in India was opened to private players – domestic as well as foreign, with the passage of the Insurance Regulatory and Development Authority (IRDA) Bill, in March 2000, thus lifting all entry barriers, with certain limits on direct as well as institutional foreign ownership. According to the current guidelines, there is a 26 percent equity cap for investments by FIIs inclusive of FDI limit, in an insurance company. Global insurers are allowed to set up and register a domestic company in order to carry out their business in India with a capital base of at least US$20 million, with the cap of 26 percent in such company. The foreign players were required to form a joint venture with an Indian partner who was in a position to invest the remaining capital in order to participate in the market. Ever since the enactment of the above IRDA rules, 8 global non-life insurance companies and 13 life insurance companies gained entry into the Indian Insurance market (Guy Carpenter Views- “The Liberalization of India’s Insurance Industry”.

The government of India announced its intention to make suitable amendments to IRDA law in order to increase the above cap to 49 percent in July 2004. However owing to intense political debate in domestic arena, action regarding the same has been delayed. Liberalization of the insurance sector is expected to bring about a greater awareness of the importance of insurance in India besides leading to restructuring and revival of the public sector insurance companies.

Banking Sector

Foreign banks are allowed to operate in India through only one of the three channels i.e. as a branch or a wholly owned subsidiary, or an ownership of up to 74 percent in a private Indian bank. Banks in India are to a large extent owned by the government and as a result foreign banks find it extremely difficult to gain entry owing to various regulations. As of September 2004, there were about 35 foreign banks with 217 branches in India. As a part of policy reforms, FDI, FII or portfolio investment and investments by non-resident Indians has been increased to 74 percent from the previous cap of 49 percent. However, a minimum of 26 percent of the paid up capital of the private sector banks is required to be held by resident Indian, as per the regulations.
On an average foreign investors have over one-third ownership in most of the state owned banks in India. Moreover, in the past two years, FII shareholding has more than doubled in most of the listed nationalized banks, with prime foreign shareholding especially in larger banks. Foreign investors account for more than one-third of the public shareholding in 12 out of the 16 listed public sector banks.

The foreign shareholding in the five major state-owned banks viz., State Bank of India, Canara Bank, Punjab National Bank, Bank of India, Bank of Baroda and Union Bank of India, which account for a 58% market share of nationalized banks in India, is more than 44% of the non-government holding. Roads and Highways, Ports and Harbours

It is well-known fact that a sound transport system is a pre-requisite for sustained overall growth as well as development. The transport system of an economy apart from serving as a vital infrastructural support for the growth process also plays a vital role towards promoting national integration, which is of prime importance, more so, in a large country like ours. It is also supports the cause of development of the backward regions and bringing them on par with the mainstream economy by exposing them to trade an investment. An efficient transport network becomes all the more necessary in a liberalized set-up towards enhancing productivity and competitive efficiency of the country in the world market. In the Indian transport system, FDI up to 100 percent is allowed under automatic route. In projects Pertaining to construction and maintenance of roads, ports and harbours, highways, vehicular bridges, toll roads and vehicular tunnels. The FII limit in these sectors is exclusive of the FDI limit up to the sectoral cap.

12.16 Summary

1. Foreign investment refers to the investments made by the residents of a country in the financial assets and production process of another country. A foreign institutional investor (FII) is an investor or investment fund registered in a country outside of the one in which it is investing.

2. A significant presence of FIIs in India can improve market efficiency through two channels. First, when adverse macro-economic news, such as bad monsoons, unsettles many domestic investors, it may be easier for a globally diversified portfolio manager to be more dispassionate about India’s prospects and engage in stabilizing trades. Second, at a level of individual stocks and industries, FIIs may act as a channel through which knowledge and ideas about valuation of a firm or an industry can more rapidly propagate into India.

3. The activities of international institutional investors help strengthen Indian finance.

4. Institutional investors promote financial innovation and development of hedging instruments.

12.17 Answers to Check your Progress

Ans.: 12.2 Foreign Institutional Investors

Ans.: 12.3 Participatory Notes
12.18 Test/Model Questions

1. What is foreign intuitional investment? How it is different from FDI.
2. How foreign intuitional investment can be registered in different categories?
3. Discuss the various features of foreign intuitional investment. Also describe the registration process in detail.
4. What are the various prohibitions on investment?
5. Describe the various foreign intuional investment in India.
6. Elaborate the special incentives for foreign intuional investment in selected sectors of India.
7. Discuss the various Channels of Foreign Institutional Investments in India
Lesson 6

SECURITIES CONTRACTS (REGULATION) ACT, 1956

[42 OF 1956] An Act to prevent undesirable transactions in securities by regulating the business of dealing therein, by providing for certain other matters connected therewith.

Be it enacted by Parliament in the Seventh Year of the Republic of India as follows:

➢ Structure

- Preliminary
- Recognised Stock Exchanges

- Listing of Securities
- Penalties and Procedure

- Miscellaneous
- Glossary
- Answers to Check your Progress
- Test/ Model Questions

➢ Objectives

After going through this chapter, you will be able to:

- Define the Securities Contracts (Regulation) Act,
- Understand the Listing of Securities.
- Identify the Penalties and Procedure regarding Securities Contracts Regulation Act.
1. Short title, extent and commencement:-

(1) This Act may be called the Securities Contracts (Regulation) Act, 1956.

(2) It extends to the whole of India.

(3) It shall come into force on such date (20th February, 1957, vide S.R.O.528, dated the 16th February, see Gazette of India, Extraordinary, 1957, part II, Sec, p.549.) as the Central Government may, by notification in the Official Gazette, appoint.

2. Definitions:-

In this Act, unless the context otherwise requires,-

(a) 'Contract' means a contract for or relating to the purchase or sale of securities;

(b) 'Government security' means a security created and issued, whether before or after the commencement of this Act, by the Central Government or a State Government for the purpose of raising a public loan and having one of the forms specified in clause (2) of section 2 of the Public Debt Act, 1944 (13 of 1944);

(c) 'member ' means a member of a recognised stock exchange;

(d) 'option in securities' means a contract for the purchase or sale of a right to buy or sell, or a right to buy and sell, securities in future, and includes a tezi, a manndi, a tezi manndi, a galli, a put, a call or a put and call in securities;

(e) 'prescribed' means prescribed by rules made under this Act;

(f) 'recognised stock exchange' means a stock exchange which is for the time being recognised by the Central Government under section 4;

(g) 'rules', with reference to the rules relating in general to the constitution and management of a stock exchange, includes, in the case of a stock exchange which is an incorporated association, its memorandum and articles of association;

(h) 'securities' include—

(i) shares, scripts stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate;

(ii) Government securities; and

(iii) rights or interests in securities;
(i) 'spot delivery contract' means a contract which provides for the actual delivery of securities and the payment of a price therefore either on the same day as the date of the contract or on the next day, the actual period taken for the despatch of the securities or the remittance of money therefore through the post being excluded from the computation of the period aforesaid if the parties to the contract do not reside in the same town or locality;

(j) 'stock exchange' means anybody of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities.

Check your Progress A:

Q1. In which year the Securities Contracts Regulation Act came into the force?
   a) 28th Nov 1952
   b) 26th Jan 1950
   c) 20th Sept 1956
   d) 20th Feb 1957

Q2. State whether it is true or false
   a) Contract means relating to the purchase or sale of securities.
   b) Recognised stock exchange' means a stock exchange which is for the time being recognised by the Central Government under section 8.
   c) 'prescribed' means prescribed by rules made under this Act.

Q3. What ‘spot delivery contract’?

RECOGNISED STOCK EXCHANGES

3. Application for recognition of stock exchanges:

(1) Any stock exchange, which is desirous of being recognised for the purposes of this Act, may make an application in the prescribed manner to the Central Government.

(2) Every application under sub-section (1) shall contain such particulars as may be prescribed, and shall be accompanied by a copy of the bye-laws of the stock exchange for the regulation and control of contracts and also a copy of the rules relating in general to the constitution of the stock exchange, and in particular, to—

   (a) The governing body of such stock exchange, its constitution and powers of management and the manner in which the business is to be transacted;

   (b) The powers and duties of the office bearers of the stock exchange;

   (c) The admission into the stock exchange of various classes of members, the qualifications for
memberships, and the exclusion, suspension, expulsion and re-admission of members there from or there into;

(d) The procedure for the registration of partnerships as members of the stock exchange in cases where the rules provide for such membership; and the nomination and appointment of authorised representatives and clerks.

4. Grant of recognition to stock exchanges:-

(1) If the Central Government is satisfied, after making such inquiry as may be necessary in this behalf and after obtaining such to further information, if any, as it may require,—

(a) that the rules and bye-laws of a stock exchange applying for registration are in conformity with such conditions as may be prescribed with a view to ensure fair dealing and to protect investors;

(b) that the stock exchange is willing to comply with any other conditions (including conditions as to the number of members) which the Central Government, after consultation with the governing body of the stock exchange and having regard to the area served by the stock exchange and its standing and the nature of the securities dealt with by its, may impose for the purpose of carrying out the objects of this Act; and

(c) that it would be in the interest of the trade and also in the public interest to grant recognition to the stock exchange;

it may grant recognition to the stock exchange subject to the conditions imposed upon it as aforesaid and in such form as may be prescribed.

(2) The conditions which the Central Government may prescribe under clause (a) of sub-section (1) for the grant of recognition to the stock exchanges may include, among other matters, conditions relating to,—

(i) the qualifications for membership of stock exchanges;

(ii) the manner in which contracts shall be entered into and enforced as between members;

(iii) the representation of the Central Government on each of the stock exchanges by such number of persons not exceeding three as the Central Government may nominate in this behalf; and

(iv) the maintenance of accounts of members and their audit by Chartered accountants wherever such audit is required by the Central Government.

(3) Every grant of recognition to a stock exchange under this section shall be published in the Gazette of India and also in the Official Gazette of the State in which the principal office of the stock exchange is situate, and such recognition shall have effect as from the date of its publication in the Gazette of India.

(4) No application for the grant of recognition shall be refused except after giving an opportunity to the stock exchange concerned to be heard in the matter; and the reasons for such refusal shall be communicated to the stock exchange in writing.

(5) No rules of a recognised stock exchange relating to any of the matters specified in sub-section (2) of section 3 shall be amended except with the approval of the Central Government.

5. Withdrawal of recognition:-

If the Central Government is of opinion that the recognition granted to a stock exchange under the
provisions of this Act should, in the interest of the trade or in the public interest, be withdrawn, the Central Government may serve on the governing body of the stock exchange a written notice that the Central Government is considering the withdrawal of the recognition for the reasons stated in the notice, and after giving an opportunity to the governing body to be heard in the matter, the Central Government may withdraw, by notification in the Official Gazette, the recognition granted to the stock exchange;

Provided that no such withdrawal shall affect the validity of any contract entered into or made before the date of the notification, and the Central Government may, after consultation with the stock exchange, make such provision as it deems fit in the notification of withdrawal or in any subsequent notification similarly published for the due performance of any contracts outstanding on that date.

6. Power of Central Government to call for periodical returns or direct inquiries to be made:-

(1) Every recognised stock exchange shall furnish to the Central Government such periodical returns relating to its affairs as may be prescribed.

(2) Every recognised stock exchange and every member thereof shall maintain and preserve for such periods not exceeding five years such books of account, and other documents as the Central Government, after consultation with the stock exchange concerned, may prescribe in the interest of the trade or in the public interest, and such books of account, and other documents shall be subject to inspection at all reasonable times by the Central Government.

(3) Without prejudice to the provisions contained in sub-section (1) and (2), the Central Government, if it is satisfied that it is in the interest of the trade or in the public interest so to do, may order in writing,—

(a) call upon a recognised stock exchange or any member thereof to furnish in writing such information or explanation relating to the affairs of the stock exchange or of the member in relation to the stock exchange as the Central Government may require; or

(b) appoint one or more persons to make an inquiry in the prescribed manner in relation to the affairs of the governing body of a stock exchange or the affairs of any of the members of the stock exchange in relation to the stock exchange and submit a report of the result if such inquiry to the Central Government within such time as may be specified in the order or, in the case of an inquiry in relation to the affairs of any of the members of a stock exchange, direct the governing body to make the inquiry and submit its report to the Central Government.

(4) Where an inquiry in relation to the affairs of a recognised stock exchange or the affairs of any of its members in relation to the stock exchange has been undertaken under sub-section (3),—

(a) every director, manager, secretary or other officer of such stock exchange;

(b) every member of such stock exchange;

(c) if the member of the stock exchange is a firm, every partner, manager, secretary or other officer of the firm; and

(d) every other person or body of persons who has had dealing in the course of business with any of the persons mentioned in clauses (a), (b) and (c), whether directly or indirectly;

shall be bound to produce before the authority making the inquiry all such books of account, and other documents in his custody or power relating to or having a bearing on the subject-matter of such inquiry and also to furnish the authorities within such time as may be specified with any such statement or information
relating thereto as may be required of him.

7. Annual reports to be furnished to Central Government by stock exchanges:-

Every recognised stock exchange shall furnish the Central Government with a copy of the annual report, and such annual report shall contain such particulars as may be prescribed.

8. Power of Central Government to direct rules to be made or to make rules:-

(1) Where, after consultation with the governing bodies of stock exchanges generally or with the governing body of any stock exchange in particular, the Central Government is of opinion that it is necessary or expedient so to do, it may, by order in writing together with a statement of the reasons therefore, direct recognised stock exchanges generally or any recognised stock exchange in particular, as the case may be, to make any rules or to amend any rules already made in respect of all or any of the matters specified in sub-section (2) of section 3 within a period of six months from the date of the order.

(2) If any recognised stock exchange fails or neglects to comply with any order made under sub-section (1) within the period specified therein, the Central Government may make the rules for, or amend the rules made by, the recognised stock exchange, either in the form proposed in the order or with such modifications thereof as may be agreed to between the stock exchange and the Central Government.

(3) Where in pursuance of this section any rules have been made or amended, the rules so made or amended shall be published in the Gazette of India and also in the Official Gazette or Gazettes of the State or States in which the principal office or offices of the recognised stock exchange or exchanges is or are situate, and on the publication thereof in the Gazette of India, the rules so made or amended shall, notwithstanding anything to the contrary contained in the Companies Act, 1956 (I of 1956), or in any other law for the time being in force, have effect, as if they had been made or amended by the recognised stock exchange or stock exchanges, as the case may be.

9. Power of recognised stock exchanges to make bye-laws:-

(1) Any recognised stock exchange may, subject to the previous approval of the Central Government, make bye-laws for the regulation and control of contracts.

(2) In particular, and without prejudice to the generality of the foregoing power, such bye-laws may provide for—

(a) the opening and closing of markets and the regulation of the hours of trade;

(b) a clearing house for the periodical settlement of contracts and differences there under, the delivery of and payment for securities, the passing on of delivery orders and the regulation and maintenance of such clearing house;

(c) the submission to the Central Government by the clearing house as soon as may be after each periodical settlement of all or any of the following particulars as the Central Government may, from time to time, require, namely;—

(i) the total number of each category of security carried over from one settlement period to another;

(ii) the total number of each category of security, contracts in respect of which have been squared up
during the course of each settlement period;

(iii) the total number of each category of security actually delivered at each clearing;

(d) the publication by the clearing house of all or any of the particulars submitted to the Central Government under clause (c) subject to the directions, if any, issued by the Central Government in this behalf;

(e) the regulation or prohibition of blank transfers;

(f) the number and classes of contracts in respect of which settlements shall be made or differences paid through the clearing house;

(g) the regulation, or prohibition of bundles or carry-over facilities;

(h) the fixing, altering or postponing of days for settlements;

(i) the determination and declaration of market rates, including the opening, closing, highest and lowest rates for securities;

(j) the terms, conditions and incidents of contracts, including the prescription of margin requirements, if any, and conditions relating thereto, and the forms of contracts in writing;

(k) the regulation of the entering into, making, performance, rescission and termination, of contracts, including contracts between members or between a member and his constituent or between a member and a person who is not a member, and the consequences of default or insolvency on the part of a seller or buyer or intermediary, the consequences of a breach or omission by a seller or buyer, and the responsibility of members who are not parties to such contracts;

(l) the regulation of traravani business including the placing of limitations thereon;

(m) the listing of securities on the stock exchange, the inclusion of any security for the purpose of dealings and the suspension or withdrawal of any such securities, and the suspension or prohibition of trading in any specified securities;

(n) the method and procedure for the settlement of claims or disputes, including settlement by arbitration;

(o) the levy and recovery of fees, fines and penalties;

(p) the regulation of the course of business between parties to contracts in any capacity;

(q) the fixing of a scale of brokerage and other chargers;

(r) the making, comparing, settling and closing of bargains;

(s) the emergencies in trade which may arise, whether as a result of pool or syndicated operations or cornering or otherwise, and the exercise of powers in such emergencies, including the power to fix maximum and minimum prices for securities;

(t) the regulation of dealings by members for their own account;

(u) the separation of the functions of the jobbers and brokers;
(v) the limitations on the volume of trade done by any individual member in exceptional circumstances;

(w) the obligation of members to supply such information or explanation and to produce such documents relating to the business as the governing body may require.

(3) The bye-laws made under this section may—

(a) specify the bye-laws the contravention of which shall make a contract entered into otherwise than in accordance with the bye-laws void under sub-section (1) of section 14;

(b) provide that the contravention of any of the bye-laws shall render the member concerned liable to one or more of the following punishments, namely:—

(i) fine;

(ii) expulsion from membership;

(iii) suspension from membership for a specified period;

(iv) any other penalty of a like nature not involving the payment of money.

(4) Any bye-laws made under this section shall be subject to such conditions in regard to previous publication as may be prescribed, and when approved by the Central Government, shall be published in the Gazette of India and also in the Official Gazette of the State in which the principal office of the recognised stock exchange is situate, and shall have effect as from the date of its publication in the Gazette of India;

Provided that if the Central Government is satisfied in any case that in the interest of the trade or in the public interest any bye-law should be made immediately, it may, by order in writing specifying the reasons therefore, dispense with the condition of previous publication.

10. Power of Central Government to make or amend bye-laws of recognised stock exchanges:

(1) The Central Government may, either on a request in writing received by it in this behalf from the governing body of a recognised stock exchange or on its own motion, if it is satisfied after consultation with the governing body of the stock exchange that it is necessary or expedient so to do and after recording its reasons for so doing, make bye-laws for all or any of the matters specified in section 9 or amend any bye-laws made by such stock exchange under that section.

(2) Where in pursuance of this section any bye-laws have been made or amended, the due-laws so made or amended shall be published in the Gazette of India and also in the Official Gazette of the State in which the principal office of the recognised stock exchange is situate, and on the publication thereof in the Gazette of India, the bye-laws so made or amended shall have effect as if they had been made or amended by the recognised stock exchange concerned.

(3) Notwithstanding anything contained in this section, where the governing body of a recognised stock exchange objects to any bye-laws made or amended under this section by the Central Government on its own motion, it may, within six months of the publication thereof in the Gazette of India under sub-section(2), apply to the Central Government for revision thereof, and the Central Government may, after giving an opportunity to the governing body of the stock exchange to be heard in the matter, revise the bye-laws so made or amended, and where any bye-laws so made or amended are revised as a result of any action taken under this sub-section, the bye-laws so revised shall be published and shall...
become effective as provided in sub-section(2).

(4) The making or the amendment or revision of any bye-laws under this section shall in all cases be subject to the condition of previous publication;

Provided that if the Central Government is satisfied in any case that in the interest of the trade or in the public interest any bye-laws should be made, amended or revised immediately, it may, by order in writing specifying the reasons therefore, dispense with the condition of previous publication.

11. Power of Central Government to supersede governing body of a recognised stock exchange :-

(1) Without prejudice to any other powers vested in the Central Government under this Act, where the Central Government is of opinion that the governing body of any recognised stock exchange should be superseded, then, notwithstanding anything contained in any other law for the time being in force, the Central Government may serve on the governing body a written notice that the Central Government is considering the supersession of the governing body for the reasons specified in the notice and after giving an opportunity to the governing body to be heard in the matter it may, by notification in the Official Gazette, declare the governing body of such stock exchange to be superseded, and may appoint any person or persons to exercise and perform all the powers and duties of the governing body, and, where more persons than one are appointed, may appoint one of such persons to be the chairman and another to be the vice-chairman thereof.

(2) On the publication of a notification in the Official Gazette under sub-section(1), the following consequences shall ensue, namely;—

(a) The members of the governing body which has been superseded shall, as from the date of the notification of supersession, cease to hold office as such members;

(b) The person or persons appointed under sub-section (1) may exercise and perform all the powers and duties of the governing body which has been superseded;

(c) All such property of the recognised stock exchange as the person or persons appointed under sub-section(1) may, by order in writing, specify in this behalf as being necessary for the purpose of enabling him or them to carry on the business of the stock exchange, shall vest in such person or persons.

(3) Notwithstanding anything to the contrary contained in any law or the rules or bye-laws of the recognised stock exchange the governing body of which is superseded under sub-section (1), the person or persons appointed under that sub-section shall hold office for such period as may be specified in the notification published under that sub-section, and the Central Government may from time to time, by like notification, vary such period.

(4) The Central Government may at any time before the determination of the period of office of any person or persons appointed under this section call upon the recognised stock exchange to re-constitute the governing body in accordance with its rules and on such re-constitution all the property of the stock exchange which has vested in, or was in the possession of, the person or persons appointed under sub-section (1) shall re-vest or vest, as the case may be, in the governing body so re-constituted;
Provided that until a governing body is so re-constituted, the person or persons appointed under sub-section (1) shall continue to exercise and perform their powers and duties.

12. Power to suspend business of recognised stock exchanges:-

If in the opinion of the Central Government an emergency has risen and for the purpose of meeting the emergency the Central Government considers it expedient so to do, it may, by notification in the Official Gazette, for reasons to be set out therein, direct a recognised stock exchange to suspend such of its business for such period not exceeding seven days and subject to such conditions as may be specified in the notification, and, if, in the opinion of the Central Government, the interest of the trade or the public interest requires that the period should be extended, may, by like notification extend the said period from time to time:

Provided that where the period of suspension is to be extended beyond the first period, no notification extending the period of suspension shall be issued unless the governing body of the recognised association has been given an opportunity of being heard in the matter.

Check your Progress B:

Q1. What are the conditions which the Central Government may prescribe under clause (a) of sub-section (1) for the grant of recognition to the stock exchanges?

Q2. What are the Power to suspend business of recognised stock exchanges:-

13. Contracts in notified areas illegal in certain circumstances:-

If the Central Government is satisfied, having regard to the nature or the volume of transactions in securities in any State or area, that is necessary so to do, it may, by notification in the Official Gazette, declare this section to apply to such State or area, and thereupon every contract in such State or area which is entered into after the date of the notification otherwise than between members of a recognised stock exchange in such State or area or through or with such member shall be illegal.
14. Contracts in notified areas to be void in certain circumstances:-

(1) Any contract entered into any State or area specified in the notification under section 13 which is in contravention of any of the bye-laws specified in that behalf under clause (a) of sub-section (3) of section 9 shall be void—

(i) as respects the rights of any member of the recognised stock exchange who has entered into such contract in contravention of any such bye-law, and also

(ii) as respects the rights of any other person who has knowingly participated in the transaction entailing such contravention.

(2) Nothing in sub-section (1) shall be construed to affect the right of any person other than a member of the stock exchange to enforce any such contract or to recover any sum under or in respect of such contract if such person had no knowledge that the transaction was in contravention of any of the bye-laws specified in clause (a) of sub-section (3) of section 9.

15. Members may not act as principals in certain circumstances:-

No member of a recognised stock exchange shall in respect of any securities enter into any contract as a principal with any person other than a member of a recognised stock exchange, unless he has secured the consent or authority of such person and discloses in the note, memorandum or agreement of sale or purchase that he is acting as a principal;

Provided that where the member has secured the consent or authority of such person otherwise than in writing he shall secure written confirmation by such persons of such consent or authority within three days from the date of the contract;

Provided further that no such written consent or authority of such person shall be necessary for closing out any outstanding contract entered into by such person in accordance with the bye-laws, if the member discloses in the note, memorandum or agreement of sale or purchase in respect of such closing that he is acting as a principal.

16. Power to prohibit contracts in certain cases:-

(1) If the Central Government is of opinion that it is necessary to prevent undesirable speculation in specified securities in any State or area, it may, by notification in the Official Gazette, declare that no person in the State or area specified in the notification shall, save with the permission of the Central Government, enter into any contract for the sale or purchase of any security specified in the notification except to the extent and in the manner, if any, specified therein.

(2) All contracts in contravention of the provisions of sub-section (1) entered into after the date of the notification issued there under shall be illegal.

Comment: It would follow that if pursuant to an agreement to do an illegal act a transaction, in part, takes place which would otherwise be valid if there was no such prior agreement, then notwithstanding the illegality of the contract the said completed transaction itself cannot be regarded as invalid. B.O.I. Finance Ltd. v. The Custodian and others AIR 1997 SUPREME COURT 1952

17. Licensing of dealers in securities in certain areas:-

(1) Subject to the provisions of sub-section (3) and to the other provisions contained in this Act, no person shall carry on or purport to carry on, whether on his own behalf of any other person, the business if dealing
securities in any State or area to which section 13 has not been declared to apply and to which the Central Government may, by notification in the Official Gazette, declare this section to apply, except under the authority of a licence granted by the Central Government in this behalf.

(2) No notification under sub-section (1) shall be issued with respect to any State or area unless the Central Government is satisfied, having regard to the manner in which securities are being dealt with in such State or area, that it is desirable or expedient in the interest of the trade or in the public interest that such dealings should be regulated by a system of licensing.

(3) The restrictions imposed by sub-section (1) in relation to dealing in securities shall not apply to the doing of anything by or on behalf of a member of any recognised stock exchange.

18. Exclusion of spot delivery contracts from sections 13, 14, 15 and 17:

(1) Nothing contained in sections 13, 14, 15 and 17 shall apply to spot delivery contracts.

(2) Notwithstanding anything contained in sub-section (1), if the Central Government is of opinion that in the interest of the trade or in the public interest it is expedient to regulate and control the business of delaying in spot delivery contracts also in any State or area (whether section 13 has been declared to apply to the State or area or not), it may, by notification in the Official Gazette, declare that the provisions of section 17 shall also apply to such State or area in respect of spot delivery contracts generally or in respect of spot delivery contracts for the sale or purchase of such securities as may be specified in the notification, and may also specify the manner in which, and the extent to which, the provisions of that section shall so apply.

19. Stock exchanges other than recognised stock exchanges prohibited:

(1) No person shall, except with the permission of the Central Government, organise or assist in organising or be a member of any stock exchange (other than a recognised stock exchange) for purpose of assisting in, entering into or performing any contracts in securities.

(2) This section shall come into force in any State or area on such date as the Central Government may, by notification in the Official Gazette, appoint.

20. Prohibition of options in securities:

(1) Notwithstanding anything contained in this Act or in any other law for the time being in force, all options in securities entered into after the commencement of this Act shall be illegal.

(2) Any option in securities which has been entered into before such commencement and which remains to be performed, whether wholly or in part, after such commencement, shall, to that extent, become void.

Check your Progress C:

Q1. What are the provisions of section 17 declared in Official Gazette?

........................................................................................................................................
........................................................................................................................................
........................................................................................................................................
Q2. Contracts in notified areas are illegal in which circumstances:

21. Conditions for listing:

Where securities are listed on the application of any person in any recognised stock exchange, such person shall comply with the conditions of the listing agreement with that stock exchange.

21 (A) Delisting of securities:

1. A recognised stock exchange may delist the securities, after recording the reasons therefore, from any recognised stock exchange on any of the ground or grounds as may be prescribed under this Act: Provided that the securities of a company shall not be delisted unless the company concerned has been given a reasonable opportunity of being heard.

2. A listed company or an aggrieved investor may file an appeal before the Securities Appellate Tribunal against the decision of the recognised stock exchange delisting the securities within fifteen days from the date of the decision of the recognised stock exchange delisting the securities and the provisions of sections 22B to 22E of this Act, shall apply, as far as may be, to such appeals: Provided that the Securities Appellate Tribunal may, if it is satisfied that the company was prevented by sufficient cause from filing the appeal within the said period, allow it to be filed within a further period not exceeding one month.

22. Right of appeal against refusal of stock exchanges to list securities of public companies:

Where a recognised stock exchange acting in pursuance of any power given to it by its bye-laws, refuses to list the securities of any public company or collective investment scheme, the company or scheme shall be entitled to be furnished with reasons for such refusal, and may,—

(a) within fifteen days from the date on which the reasons for such refusal are furnished to it, or

(b) where the stock exchange has omitted or failed to dispose of, within the time specified in sub-sec(1) of section 73 of the Companies Act, 1956 (1 of 1956) (hereafter in this section referred to as the “specified time”), the application for permission for the shares or debentures to be dealt with on the stock exchange, within fifteen days from the date of expiry of the specified time or within such further period, not exceeding one month, as the Central Government may, on sufficient cause being shown, allow, appeal to the Central Government against such refusal, omission or failure, as the case may be, and thereupon the Central Government may, after giving the stock exchange an opportunity of being heard,—
(i) vary or set aside the decision of the stock exchange, or

(ii) where the stock exchange has omitted or failed to dispose of the application within the specified
time, grant or refuse the permission, and where the Central Government sets aside the decision of the
recognised stock exchange or grants the permission, the stock exchange shall act in conformity with the
orders of the Central Government:

Provided that no appeal shall be preferred against refusal, omission or failure, as the case may be, under
this section on and after the commencement of the Securities Laws (Second Amendment) Act, 1999.

22A. Right of appeal to Securities Appellate Tribunal against refusal of stock exchange to list
securities of public companies.

(1) Where a recognised stock exchange, acting in pursuance of any power given to it by its bye-laws,
refuses to list the securities of any company, the company shall be entitled to be furnished with reasons for
such refusal, and may,—

(a) within fifteen days from the date on which the reasons for such refusal are furnished to it, or

(b) where the stock exchange has omitted or failed to dispose of, within the time specified in sub-
sec(1A) of section 73 of the Companies Act, 1956 (1 of 1956), (hereafter in this section
referred to as the “specified time”), the application for permission for the shares or debentures
to be dealt with on the stock exchange, within fifteen days from the date of expiry of the
specified time or within such further period, not exceeding one month, as the Securities
Appellate Tribunal may, on sufficient cause being shown, allow,

appeal to the Securities Appellate Tribunal having jurisdiction in the matter against such refusal, omission
or failure, as the case may be, and thereupon the Securities Appellate Tribunal may, after giving the stock
exchange, an opportunity of being heard,—

(i) vary or set aside the decision of the stock exchange; or

(ii) where the stock exchange has omitted or failed to dispose of the application within the specified
time, grant or refuse the permission, and where the Securities Appellate Tribunal sets aside
the decision of the recognised stock exchange or grants the permission, the stock exchange shall
act in conformity with the orders of the Securities Appellate Tribunal.

(2) Every appeal under sub-section (1) shall be in such form and be accompanied by such fee as may be
prescribed.

(3) The Securities Appellate Tribunal shall send a copy of every order made by it to the Board and parties
to the appeal.

(4) The appeal filed before the Securities Appellate Tribunal under sub-section (1) shall be dealt with by it
as expeditiously as possible and endeavour shall be made by it to dispose of the appeal finally within six
months from the date of receipt of the appeal.

22B. Procedure and powers of Securities Appellate Tribunal.

(1) The Securities Appellate Tribunal shall not be bound by the procedure laid down by the Code of Civil Procedure, 1908 (5 of 1908), but shall be guided by the principles of natural justice and, subject to the other provisions of this Act and of any rules, the Securities Appellate Tribunal shall have powers to regulate their own procedure including the places at which they shall have their sittings.

(2) The Securities Appellate Tribunal shall have, for the purpose of discharging their functions under this Act, the same powers as are vested in a civil court under the Code of Civil Procedure, 1908 (5 of 1908), while trying a suit, in respect of the following matters, namely:—

(a) summoning and enforcing the attendance of any person and examining him on oath;

(b) requiring the discovery and production of documents;

(c) receiving evidence on affidavits;

(d) issuing commissions for the examination of witnesses or documents;

(e) reviewing its decisions;

(f) dismissing an application for default or deciding it ex parte;

(g) setting aside any order of dismissal of any application for default or any order passed by it ex parte; and

(h) any other matter which may be prescribed.

(3) Every proceeding before the Securities Appellate Tribunal shall be deemed to be a judicial proceeding within the meaning of sections 193 and 228, and for the purposes of section 196 of the Indian Penal Code (45 of 1860) and the Securities Appellate Tribunal shall be deemed to be a civil court for all the purposes of section 195 and Chapter XXVI of the Code of Criminal Procedure, 1973 (2 of 1974).

22C. Right to legal representation.

The appellant may either appear in person or authorise one or more chartered accountants or company secretaries or cost accountants or legal practitioners or any of its officers to present his or its case before the Securities Appellate Tribunal. Explanation.— For the purposes of this section,—

(a) “chartered accountant” means a chartered accountant as defined in clause (b) of sub-section (1) of section 2 of the Chartered Accountants Act, 1949 (38 of 1949) and who has obtained a certificate of practice under sub-section (1) of section 6 of that Act;

(b) “company secretary” means a company secretary as defined in clause (c) of subsection (1) of section 2 of the Company Secretaries Act, 1980 (56 of 1980) and who has obtained a certificate of practice
under sub-section (1) of section 6 of that Act;

(c) “cost accountant” means a cost accountant as defined in clause (b) of sub-section (1) of section 2 of the Cost and Works Accountants Act, 1959 (23 of 1959) and who has obtained a certificate of practice under sub-section (1) of section 6 of that Act;

(d) “legal practitioner” means an advocate, vakeel or an attorney of any High Court, and includes a pleader in practice.

22D. Limitation.

The provisions of the Limitation Act, 1963 (36 of 1963) shall, as far as may be, apply to an appeal made to a Securities Appellate Tribunal.

22E. Civil court not to have jurisdiction.

No civil court shall have jurisdiction to entertain any suit or proceeding in respect of any matter which a Securities Appellate Tribunal is empowered by or under this Act to determine and no injunction shall be granted by any court or other authority in respect of any action taken or to be taken in pursuance of any power conferred by or under this Act.

22F. Appeal to Supreme Court.

[Any person aggrieved by any decision or order of the Securities Appellate Tribunal may file an appeal to the Supreme Court within sixty days from the date of communication of the decision or order of the Securities Appellate Tribunal to him on any question of law arising out of such order: Provided that the Supreme Court may, if it is satisfied that the appellant was prevented by sufficient cause from filing the appeal within the said period, allow it to be filed within a further period not exceeding sixty days.]

Check your Progress D:

Q1. What are the Conditions of Listing?
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Q2. What are the Provisions of Limitation Act?
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Q3. What do you mean by “Chartered Accountant”?
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23. Penalties:-

(1) Any person who—

(a) without reasonable excuse (the burden of proving which shall be on him) fails to comply with any requisition made under sub-section (4) of section 6; or

(b) enters into any contract in contravention of any of the provisions contained in section 13 or section 16; or

(c) contravenes the provisions contained in section 17, or section 19; or enters into any option in securities in contravention of the provisions contained in section 20; or

(d) enters into any option in securities in contravention of the provisions contained in section 20; or

(e) owns or keeps a place other than that of a recognised stock exchange which is used for the purpose of entering into or performing any contracts in contravention of any of the provisions of this Act and knowingly permits such place to be used for such purposes; or

(f) manages, controls, or assists in keeping any place other than that of a recognised stock exchange which is used for the purpose of entering into or performing any contracts in contravention of any of the provisions of this Act or at which contracts are recorded or adjusted or rights or liabilities arising out of contracts are adjusted, regulated or enforced in any manner whatsoever; or

(g) not being a member of a recognised stock exchange or his agent authorised as such under the rules or bye-laws of such stock exchange or being a dealer in securities licensed under section 17 wilfully represents to or induces any person to believe that contracts can be entered into or performed under this Act through him; or

(h) not being a member of a recognised stock exchange or his agent authorised as such under the rules or bye-laws of such stock exchange or not being a dealer in securities licensed under section 17, canvasses, advertises or touts in any manner either for himself or on behalf of any other persons for any business connected with contracts in contravention of any of the provisions of this Act; or

(i) joins, gathers or assists in gathering at any place other than the place of business specified in the bye-laws of a recognised stock exchange any person or persons for making bids or offers or for entering into or performing any contracts in contravention of any of the provisions of this Act; shall, on conviction, be punishable with imprisonment for a term which may extend to one year, or with fine, or with both.

(2) Any person who enters into any contract in contravention of the provisions contained in section 15 or who fails to comply with the orders of the cg under section 21 or section 22 shall, on conviction, be punishable with fine which may extend to one thousand rupees.

24. Offences by companies:-
(1) Where an offence has been committed by a company, every person who, at the time when the offence was committed, was in charge of, and was responsible to, the company for the conduct of the business of the company, as well as the company, shall be deemed to be guilty of the offence, and shall be liable to be proceeded against and punished accordingly;

Provided that nothing contained in this sub-section shall render any such person liable to any punishment provided in this Act, if he proves that the offence was committed without his knowledge or that he exercised all due diligence to prevent the commission of such offence.

(2) Notwithstanding anything contained in sub-section (1), where an offence under this Act has been committed by a company and is proved that the offence has been committed with the consent or connivance of, or is attributable to any gross negligence on the part of any director, manager, secretary or other officer of the company, such director, manager, secretary or other officer of the company, shall also be deemed to be guilty of that offence and shall be liable to be proceeded against and punished accordingly.

Explanation.— For the purpose of this section, :-

(a) 'company' means anybody corporate and includes a firm or other association of individuals, and

(b) 'director', in relation to a firm, means a partner in the firm.

25. Certain offences to be cognizable:-

Notwithstanding anything contained in the Code of Criminal Procedure, 1898 (5 of 1898), any offence punishable under sub-section (1) of section 23 shall be deemed to be cognizable offence within the meaning of that Code.

26. Jurisdiction to try offences under this Act:-

No court inferior to that of a presidency magistrate or a magistrate of the first class shall take cognizable of or try any offence punishable under this Act.

**Check your Progress E:**

Q1. What do you mean by Company ?

Q2. What do you mean by Director ?
➢ MISCELLANEOUS

27. Title to dividends:-

(1) It shall be lawful for the holder of any security whose name appears on the books of the company issuing the said security to receive and retain any dividend declared by the company in respect thereof for any year, notwithstanding that the said security has already been transferred by him for consideration, unless the transferee who claims the dividend from the transferor has lodged the security and all other documents relating to the transfer which may be required by the company with the company for being registered in his name within fifteen days of the date on which the dividend became due.

Explanation.— The period specified in this section shall be extended—

(i) in case of death of the transferee, by the actual period taken by his legal representative to establish his claim to the dividend;

(ii) in case of loss of transfer deed by theft or any other cause beyond the control of the transferee, by the actual period taken for the replacement thereof; and

(iii) in case of delay in the lodging of any security and other documents relating to the transfer due to causes connected with the post, by the actual period of the delay.

(2) Nothing contained in sub-section (1) shall affect—

(a) the right of a company to pay the dividend which has become due to any person whose name is for the time being registered in the books of the company as the holder of the security in respect of which the dividend has become due; or

(b) the right of the transferee of any security to enforce against the transferor or any other person his rights, if any, in relation to the transfer in any case, where the company has refused to register the transfer of the security in the name of the transferee.

28. Act not to apply in certain cases:-

The provisions of this Act shall not apply to the Government in Reserve Bank of India, any local authority or any corporation set up under a special law or any person who has effected any transaction with or through the agency of any such authority as is referred to in this section.

29. Protection of action taken in good faith:-

No suit, prosecution or other legal proceeding whatsoever shall lie in any court against the governing body or any member, office bearer or servant of any recognised stock exchange or against any person or persons appointed under sub-section (1) of section 11 for anything which is in good faith done or intended to be done in pursuance of this Act or of any rules or bye-laws made there under.

30. Power to make rules:-
(1) The Central Government may, by notification in the Official Gazette, make rules for the purpose of carrying into effect the objects of this Act.

(2) In particular, and without prejudice to the generality of the foregoing power, such rules may provide for,—

(a) the manner in which applications may be made, the particulars which they should contain and the levy of a fee in respect of such applications;

(b) the manner in which any inquiry for the purpose of recognizing any stock exchange may be made, the conditions which may be imposed for the grant of such recognition, including conditions as to the admission of members if the stock exchange concerned is to be the only recognised stock exchange in the area; and the form in which such recognition shall be granted;

(c) the particulars which should be contained in the periodical returns and annual reports to be furnished to the Central Government;

(d) the documents which should be maintained and preserved under section 6 and the periods for which they should be preserved;

(e) the manner in which any inquiry by the governing body of a stock exchange shall be made under section 6;

(f) the manner in which the bye-laws to be made or amended under this Act shall before being so made or amended be published for criticism;

(g) the manner in which applications may be made by dealers in securities for licenses under section 17, the fee payable in respect thereof and the period of such licences, the condition subject to which licences may be granted, including condition relating to the forms which may be used in making contracts, or documents to be maintained by licensed dealers and the furnishing of periodical information to such authority as may be specified and the revocation of licences for breach of conditions;

(h) the requirement which shall be compiled with by public companies for the purpose of getting their securities listed on any stock exchange; and

(i) any other matter which is to be or may be prescribed.

(3) Every rule made under this Act shall be laid, as soon as may be after it is made, before each House of Parliament, while it is in session, for a total period of thirty days which may be comprised in one session or in two or more successive sessions, and if, before the expiry of the session immediately following the session or the successive sessions aforesaid, both Houses agree in making any modification in the rule or both Houses agree that the rule should not be made, the rule shall thereafter have effect only in such modified form or be of no effect, as the case may be; so, however, that any such modification or annulment shall be without prejudice to the validity of anything previously done under that rule.

31. Power of Securities and Exchange Board of India to make regulations :-

(1) Without prejudice to the provisions contained in section 30 of the Securities and Exchange Board of India Act, 1992 (15 of 1992), the Securities and Exchange Board of India may, by notification in the Official Gazette, make regulations consistent with the provisions of this Act and the rules made there under to carry out the purposes of this Act.
(2) In particular and without prejudice to the generality of the foregoing power, such regulations may provide for the manner in which at least fifty-one per cent of equity share capital of a recognised stock exchange is held within twelve months from the date of publication of the order under sub-section (7) of section 4B by the public other than the shareholders having trading rights under sub-section (8) of that section.

(3) Every regulation made under this Act shall be laid, as soon as may be after it is made, before each House of Parliament, while it is in session for a total period of thirty days which may be comprised in one session or in two or more successive sessions, and if, before the expiry of the session immediately following the session or the successive sessions aforesaid, both Houses agree in making any modification in the regulation or both Houses agree that the regulation should not be made, the regulation shall thereafter have effect only in such modified form or be of no effect, as the case may be; so, however, that any such modification or annulment shall be without prejudice to the validity of anything previously done under that regulation.

➢ Glossary

(a) Contract :- relating to the purchase or sale of securities

(b) Government security :- a security created and issued, whether before or after the commencement of this Act, by the Central Government or a State Government for the purpose of raising a public loan and having one of the forms specified in clause (2) of section 2 of the Public Debt Act, 1944 (13 of 1944)

(c) Member :- a member of a recognised stock exchange

(d) Option in securities :- a contract for the purchase or sale of a right to buy or sell, or a right to buy and sell, securities in future, and includes a tezi, a manndi, a tezi manndi, a galli, a put, a call or a put and call in securities

(e) Recognised stock exchange :- a stock exchange which is for the time being recognised by the Central Government under section (4)

(f) Spot delivery contract :- a contract which provides for the actual delivery of securities and the payment of a price therefore either on the same day as the date of the contract or on the next day, the actual period taken for the despatch of the securities or the remittance of money therefore through the post being excluded from the computation of the period aforesaid if the parties to the contract do not reside in the same town or locality

(g) Stock exchange :- anybody of individuals, whether incorporated or not, constituted for the purpose of listing, regulating or controlling the business of buying, selling or dealing in securities.

(h) Company:- means anybody corporate and includes a firm or other association of individuals, and

(i) Chartered accountant:- a chartered accountant as defined in clause (b) of sub-section(1) of section 2 of the Chartered Accountants Act, 1949 (38 of 1949) and who has obtained a certificate of practice under sub-section (1) of section 6 of that Act

(j) Company Secretary :- a company secretary as defined in clause (c) of subsection (1) of section 2 of the Company Secretaries Act, 1980 (56 of 1980) and who has obtained a certificate of practice under sub-section (1) of section 6 of that Act
(k) Cost Accountant: a cost accountant as defined in clause (b) of sub-section (1) of section 2 of the Cost and Works Accountants Act, 1959 (23 of 1959) and who has obtained a certificate of practice under sub-section (1) of section 6 of that Act

(l) Legal Practitioner: an advocate or an attorney of any High Court, and includes a pleader in practice.

➢ Answers to Check your Progress

Check Your Progress A:
1. d
2. a) true   b) false   c) true
3. Base your answer on the interdependence in section 1.4

Check Your Progress B:
1. Base your answer on the interdependence in (point 4. Grant of recognised to stock exchanges sub point (2))
2. Base your answer on the interdependence in (point 12. Powers to Suspend business of recognised stock exchange)

Check Your Progress C:
1. Base your answer on the interdependence in (point 18. Exclusion of spot delivery contracts from sec 13,14,15 and 17)
2. Base your answer on the interdependence in (point 13 Contracts in notified areas illegal in certain circumstances)

Check Your Progress D:
1. Base your answer on the interdependence in (point 21. Conditions of Listing)
2. Base your answer on the interdependence in (point 22 D. Limitation Act)
3. Base your answer on the interdependence in (point 22 C. Right to legal Representation)

Check Your Progress E:
1. Base your answer on the interdependence in (point 24. Offences by companies)
2. Base your answer on the interdependence in (point 24. Offences by companies)

➢ Test/ Model Questions
1. What are the applications regarding recognition of stock exchanges?
2. Explain the powers of central government?
3. What are the powers to suspend business of recognised stock exchanges?
4. What are the powers of recognised stock exchanges to make bye-laws?
5. What do you mean by delisting of securities?
6. What are the penalties and procedures of securities?
7. What are the powers to make rules?
8. What are the powers of SEBI to make regulations?
1.1 Objectives

After going through this chapter, you will be able to:

- Define the OTCEI
- Understand the history and advantages of OTCEI
- Realize the procedure for listing in OTCEI
- Explain the body regulates an Indian securities markets
Explain the trading mechanism for OTCEI
Discuss the buy/sell scrip on OTCEI
Understand the trading process on OTCEI
Identify the growth of OTCEI

13.2 OTCEI

OTCEI has played an important milestone in the annals of Indian financial system. OTC Exchange Of India (OTCEI) is also known as Over-the-Counter Exchange of India based in Mumbai, Maharashtra. It is the first exchange for small companies and first screen based nationwide stock exchange in India. It was set up to access high-technology enterprising promoters in raising finance for new product development in a cost effective manner and to provide transparent and efficient trading system to the investors. OTCEI is promoted by the Unit Trust of India, the Industrial Credit and Investment Corporation of India, the Industrial Development Bank of India, the Industrial Finance Corporation of India and others and is a recognised stock exchange under the SCR Act.

The over-the-counter exchange of India (OTCEI) is an electronic stock exchange based in India that is comprised of small- and medium-sized firms looking to gain access to the capital markets. Over The Counter Exchange of India (OTCEI) can be defined as a stock exchange without a proper trading floor. All stock exchange have a specific place for trading their securities through counters. But the OTCEI is connected through a computer network and the transactions are taking place through computer operations. Thus, the development in information technology has given scope for starting this type of stock exchange. OTCEI is recognized under the Securities Contract (Regulation) Act and so all the stocks listed in this exchange enjoy the same benefits as other listed securities enjoy.

The OTCEI is a company incorporated under the Companies Act 1956. The first electronic OTC stock exchange in India was established in 1990 to provide investors and companies with an additional way to trade and issue securities. This was the first exchange in India to introduce market makers, which are firms that hold shares in companies and facilitate the trading of securities by buying and selling from other participants with an aim to provide small and medium companies an access to the capital market for raising finance in a cost effective manner. It was also provide investors with a convenient transparent and efficient avenue for capital market investment, as it is fully computerised, transparent, single window exchange which commenced trading in 1992. This exchange is established on the lines of NASDAQ (National Association of Securities Dealers Automated Quotations) the OTC exchange in USA. It has been promoted by UTI, ICICI, IDBI, IFCI, LIC, GIC, SBI Capital markets and Can Bank Financial Services. Over the counter market may be defined as a place where buyers seek sellers and vice-versa and then attempt to arrange terms and conditions for purchase/sale acceptable to both the parties. It is a negotiated market place that exists anywhere as opposed to the auction market place, represented by the activity on securities exchanges. Thus, in the OTC exchange, trading takes place when a buyer or seller walks up to an OTCEI counter, taps on the computer screen, finds quotes and effects a purchase or sale depending on whether the prices meet their targets. There is no particular market place in the geographical sense. The objectives of OTCEI are to provide quicker liquidity to securities at a fixed and fair price, liquidity for less traded securities
or that of small companies, a simplified process of buying and selling and easy and cheaper means of making public sale of new issues. However, the need of OTCEI is as below:

- Hybrid Trading System
- Sponsorship of Companies
- Cost Effective
- Ideal for Start-up Companies
- Enhanced Visibility and Recognition
- Assist in Forging Partnership
- Specialist exchange for technology and growth companies

13.3 Definition
An electronic stock exchange based in India that is comprised of small- and medium-sized firms looking to gain access to the capital markets. Like electronic exchanges in the U.S. such as the Nasdaq, there is no central place of exchange and all trading is done through electronic networks.

13.4 Objectives of OTCEI
1. The aim at creating a fully decentralized and transport market. Over the counter exchange means trading across the counter in scrip.
2. The counter refers to the location of the member or dealer of the OTCEI where the deal or trade takes place. Every counter is treated as trading floor for OTCEI where the investor buy or sell.
3. To provide quicker liquidity to investors.
4. To make available the securities at fixed and fair prices to small investors.
5. To provide liquidity to a less traded security or that of small company.
6. To simplify the process of buying and selling.
7. To create the public interest in risky but viable ventures.
8. To make available the easy and cheaper means of making public sale of new issues.

13.5 Features of OTCEI
The features of OTCEI are discussed below:

1. **Ringless and Screen-based Trading:** The OTCEI is the first stock exchange to introduce automated, screen-based trading in place of conventional trading ring found in other stock exchanges. The network of online computers providers all relevant information to the market participants on their computer screens. This allows them the luxury of executing their deals in the comfort of their own offices.
2. **Sponsorship:** All the companies seeking listing on OTCEI have to approach one of the members of OTCEI for acting as a sponsor to the issue. The sponsor makes a thorough appraisal of the project, as by entering into the sponsorship agreement, the sponsor is committed to making market in that scrip (giving a buy sell quote) for a minimum period of 18 months. Sponsorship ensures quality of the companies and enhance liquidity for the scrip’s listed on OTCEI.
3. **Transparency of Transactions:** The investor can view the quotations on the computer screen at the dealer’s office before placing the order. The OTCEI system ensures that traders are done at the best prevailing quotation in the market. The confirmation
slip/trading document generated by the computers gives the exact price at which the deals has been done and the brokerage charged.

4. **Liquidity through Market Making:** - The Sponsor-member is required to give two-way quotes (buy and sell) for the scrip for 18 months from commencement of trading. Besides the compulsory market maker, there is an additional market maker giving two way quotes for the scrip. The idea is to create an environment of competition among market makers to produce efficient pricing and narrow spreads between buy and sell quotations.

5. **Listing of Small and Medium-sized Companies:** - Many small and medium-sized companies were not able to enter capital market due to the listing requirements of Securities Contracts (Regulation) Act, 1956 regarding the minimum issued equity of Rs 10 crores in case of the Mumbai stock Exchange and Rs 3 crores in case of other stock exchanges. The OTCEI provides an opportunity to these companies to enter the capital market as companies with issued capital of Rs. 30 lacks onwards can raise finance from the capital market through OTCEI.

6. **Technology:** - OTCEI uses computers and telecommunications to bring members/dealers together electronically, enabling them to trade with one another over the computer rather than on a trading floor in a single location.

7. **Nation-wide Listing:** - OTCEI network is spread all over India through members, dealers and representative office counters. The company and its securities get nation-wide exposure and investors all over India can start trading in that scrip.

8. **Brought-out Deals:** - Through the concept of a bought-out deal, OTCEI allows companies to place its equity with the sponsor-member at a mutually agreed price. This ensures swifter availability of funds to companies for timely completion of projects and a listed status at a later date.

### 13.6 History of OTCEI

OTCEI (Over the Counter Exchange of India) was incorporated in 1990 as a Section 25 company under the Companies Act 1956 and is recognized as a stock exchange under Section 4 of the Securities Contracts Regulation Act, 1956. The Exchange was set up to aid enterprising promoters in raising finance for new projects in a cost effective manner and to provide investors with a transparent & efficient mode of trading. Modelled along the lines of the NASDAQ market of USA, OTCEI introduced many novel concepts to the Indian capital markets such as screen-based nationwide trading, sponsorship of companies, market making and scripless trading. As a measure of success of these efforts, the Exchange today has 115 listings and has assisted in providing capital for enterprises that have gone on to build successful brands for themselves like VIP Advanta, Sonora Tiles & Brilliant mineral water, etc.

Over The Counter Exchange of India (OTCEI) was incorporated in October 1990 under Section 25 of the Companies Act, 1956 with the objective of setting up a national, ringless, screen-based, automated stock exchange. It is recognized as a stock exchange under Section 4 of the Securities Contracts (Regulations) Act, 1956. It was set up to provide investors with a convenient, efficient and transparent platform for dealing in shares and stocks; and to help enterprising promoters set up new projects or expand their activities, by providing them an opportunity to raise capital from the capital market in a cost-effective manner. Trading in securities takes place through
OTCEI’s network of members and dealers spanning the length and breadth of India. OTCEI was promoted by a consortium of financial institution including:
- Unit Trust of India.
- Industrial Credit and Investment Corporation of India.
- Industrial Development Bank of India.
- Industrial Finance Corporation of India.
- Life Insurance Corporation of India.
- General Insurance Corporation and its subsidiaries.
- SBI Capital Markets Limited.
- Canbank Financial Services Ltd.

**Advantages of OTC Market**

1. It provides a trading platform to smaller and less liquid companies as they are not eligible for listing on a regular exchange.
2. It is a cost effective method for corporates as there is a lower cost of new issues and lower expenses of servicing the investors.
3. Family concerns and closely held companies can go public through OTC.
4. Dealers can operate both in new issues and secondary market at their option.
5. It gives greater freedom of choice to investors to choose stocks by dealers for market making in both primary and secondary markets.
6. It is a transparent system of trading with no problem of bad or short deliveries.
7. Information flows are free and more direct from market makers to customers since there is close contact between them.

**13.7 Promoters of OTCEI**
The promoters of OTCEI are given below:
- ICICI Bank Limited
- Administrator of Specified Undertaking of Unit Trust of India
- IDBI Bank Limited
- SBI Capital Markets Limited
- IFCI Limited
- Life Insurance Corporation of India
- Canbank Financial Services Limited
- General Insurance Corporation of India
- The New India Assurance Company Limited
- The Oriental Insurance Company Limited
- United India Insurance Company Limited
- National Insurance Company Limited

**13.8 Benefits of getting OTCEI listing for companies**
The OTCEI offers facilities to the companies having an issued equity capital of more than Rs.30 lakhs. The benefits of listing at the OTCEI are
1. Small and medium closely-held companies can go public
2. The OTCEI encourages entrepreneurship
3. Companies can get the money before the issue in cases of Bought-out-deals.
4. It is more cost-effective to come with an issue of OTCEI.
5. Small companies can get listing benefits
6. Easy issue marketing by using the nation-wide OTCEI dealer network.
7. Nation-wide trading by listing at just one exchange

Benefits of Trading OTCEI for Investors
1. The OTCEI trading counters are easily accessible by any investors.
2. The OTCEI provides greater confidence to investors because of complete transparency in deals.
3. At the OTCEI, the transactions are fast and are completed quickly.
4. The OTCEI ensures security, liquidity by offering two-way quotes.
5. The OTCEI is an investor friendly exchange with Single Window Clearance for all investor requests.

13.9 Trading Process on OTCEI
One can trade in securities by going to any counter of the OTCEI. All the counters are linked with the central computer at the OTCEI headquarter. This office is in Mumbai. There can be three types of trading on the OTCEI

(1) Initial Allotment (2) Buying in Secondary Market (3) Selling in Secondary Market

1. Initial Allotment: - When an investor is allotted shares through the medium of OTCEI, he is given a receipt which is called Counter Receipt - CR. This receipt is just like the share certificate. Selling and buying can be done through the medium of this receipt.

2. Buying in the Secondary Market: - For the purpose of buying shares listed on the OTCEI. A person has to get himself registered (if he is not already registered). After this, he informs the counter operator about the number of the shares to be purchased. The counter operator displays the rates on the screen. After getting himself satisfied with the rate, the investor hands over the cheque to the operator. On the encashment of the cheque, the CR is handed over to the investor. This procedure normally takes about a week.

3. Selling in the Secondary Market: - Any investor who has purchased shares from the OTCEI can sell his shares at any counter of the OTCEI. After getting himself satisfied with the rate displayed on the screen, the investor hands over the Counter Receipt and the Transfer Deed to the Operator. The operator prepares the Sales Confirmation Slip (SCS) and a copy of it is handed over to the seller. The operator sends the CR, TD and SCS to the Registrar for confirmation. After confirming every detail the Registrar sends them back to the counter operator. In the end the operator issues a cheque to the seller and receives back the SCS from the seller.

OTC has a unique feature of trading compared to other traditional exchanges. That is, certificates of listed securities and initiated debentures are not traded at OTC. The original certificate will be safely with the custodian. But, a counter receipt is generated out at the counter which substitutes the share certificate and is used for all transactions. In
the case of permitted securities, the system is similar to a traditional stock exchange. The difference is that the delivery and payment procedure will be completed within 14 days. Compared to the traditional Exchanges, OTC Exchange network has the following advantages.

1. OTCEI has widely dispersed trading mechanism across the country which provides greater liquidity and lesser risk of intermediary charges.
2. Greater transparency and accuracy of prices is obtained due to the screen-based scripless trading.
3. Since the exact price of the transaction is shown on the computer screen, the investor gets to know the exact price at which s/he is trading.
4. Faster settlement and transfer process compared to other exchanges.

In the case of an OTC issue (new issue), the allotment procedure is completed in a month and trading commences after a month of the issue closure, whereas it takes a longer period for the same with respect to other exchanges. Thus, with the superior trading mechanism coupled with information transparency investors are gradually becoming aware of the manifold advantages of the OTCEI.

**Buy/Sell scrip on OTCEI**

1. The investor approaches any of the brokers (Members/ Dealers) and views the screen displaying the best current quotes/ prices offered.
2. The investor can put in an order to match either the best quote or the best order rate.
3. Alternatively the order may be entered for a different rate than currently available, whereby the order is executed against a corresponding order received within the same settlement period.
4. The investor can also enter into speculative trades by buying first and later squaring up the trade at a higher price (buying forward) or selling first and squaring up later at lower price (short selling).

**Benefits of OTCEI**

1. **For Companies**
   - It will provide a method of funds raising through capital market instruments which are priced fairly.
   - In OTCEI the companies will be able to negotiate the issue price the sponsor who will make the issue.
   - It will also help to save unnecessary issue expenses on raising funds from capital market.

2. **For Investor**
   - Investment in stock will become easier. Its wide network will bring the stock exchange to every street corner.
   - It will provide greater confidence and fidelity of trade.
   - Investor can look up the price displayed at the OTC counter.
   - It will enable transaction complete quickly.
   - It also provide liquidity to investors.
   - It will quote regularly to provide sufficient opportunities for investors to exist.
• Investors may get greater sense of security.

3. For Financial Environment
• It will help spread the stock exchange operations geographically and integrated.
• Capital investment into a national forum.
• It will encourage closely held companies across the country to boost entrepreneurship.

13.10 Trading Mechanism of OTCEI
An investor can buy and sell any listed scrip at any OTC Exchange counter. The investor can also make an application for services like transfer of shares, splitting and consolidation of shares, nomination and revocation of nomination, registering power of attorney etc. The parties involved in trading on OTC are investor, Counter, Settler Registered Custodian, Company and Bank. The trading documents mainly involved in OTC Exchange transactions are:
   a. Temporary Counter Receipt (TCR)
   b. Permanent Counter Receipt (PCR)
   c. Sales Confirmation Slip (SCS)
   d. Transfer Deed (TD)
   e. Service Application Form (SAF)
   f. Application Acknowledgement Slip (AAS)
   g. Deal Form (DF)

13.11 Listing of OTCEI
Listing requirements

A company should have a minimum paid-up capital of Rs. 30 lakhs and the minimum offer to the public should be 25% of the issued capital or Rs. 20 lakhs worth of shares in face value, whichever is higher. Guidelines on Disclosure and Investor Protection will be applicable to all OTCEI issues. Every company that intends to get listed has to be sponsored by a merchant banker (member/sponsor) of the exchange. The sponsor of the issue must arrange for market makers to give Buy and Sell quotes in the securities for an initial period of 18 months.

Relaxation In Listing Norms as Compared to Other Stock Exchanges

These are Companies that do not fulfill the following conditions are also eligible for listing on OTCEI
• 3 year dividend paying record in the last 5 years
• Appraisal and funding by financial institutions, will be allowed to raise funds by listing on OTCEI, provided they are sponsored by a Member/Sponsor of OTCEI
• Appoint at least 2 market makers for continuous liquidity to their shares
• Bought out deals undertaken earlier and all future bought out deals - which may not fulfill the 3 year dividend record/Financial Institution appraisal and funding criteria

Qualifying Norms
Along with the above norms, all Public Limited Companies fulfilling the following criteria are eligible to get themselves listed on the OTCEI:

1. Company Valuation
Net Tangible Assets (or) Rs. 1 crore (or)
Market capitalisation (or) Rs. 5 crore (or)
Net Income (in latest fiscal year or 2 of last 3 fiscal year). Rs. 0.25 acres

2. Shareholding

Minimum Total float (shares) 11,00,000
Minimum Public Float (shares) 5,00,000
Minimum Value of Public float Rs. 2.50 crore
Minimum Offer to the Public 25% of total paid-up capital
Minimum No. of Shareholders 1000

3. Market Making

No.of Market Makers Minimum 2
Duration of Market Making 18 months
Obligation Mandatory
Market Making Inventory (at the time of public issues) Graded

4. Company Fact File

Operating History (or) 1 year (or)
Minimum Market CapitalisationRs. 5 crores
Corporate Governance Yes
Compliance Standards No Defaults

5. It is also desirable for the company to have a website

Additional Requirements for Finance Companies
For finance companies these additional conditions will also apply:

Registration with RBI as NBFC Compulsory
Investment Grade Rating in case of FD or Debenture Issues
Continuous Profitability Past 3 years

Market Making Inventory
Principal and Additional Market Maker 10% minimum together
Debt-Equity Ratio As per RBI guidelines

Continuous Listing Requirements for All
The trading in the equity shares of the company will commence 3 days after the company is listed. Post listing, the company is required to provide a Bank Guarantee of 1% of the issue amount in favour of OTCEI, for complying with continuous requirements.
Bank Guarantee to be valid for a period of 3 years and to be provided prior to refund of security deposit. Once listed, the company would have to continuously fulfill the following criteria after a period of 18 months.

1. **Company Valuation**
   - Net Tangible Assets, or Rs. 0.75 crore, or
   - Market Capitalisation, or Rs. 3.75 crore, or
   - Net Income (in last fiscal year or 2 of last 3 fiscal year) Rs. 0.15 crore

2. **Shareholding**
   - Minimum Total Float (shares) 825,000
   - Minimum Public Float (shares) 3,75,000
   - Market Value of Public Float Rs. 1.90 crore
   - Minimum Public Offer to the Public 25% of total paid-up capital
   - Minimum No of Shareholders 1000

3. **Company Fact File**
   - Operating History Not Applicable, or
   - Minimum Market Capitalisation Rs. 3.75 crore
   - Corporate Governance Yes
   - Compliance Standards No Defaults

**Procedure for Listing**

The procedure adopted for the listing of shares at OTCEI is as follows:

- OTCEI appoints a member as a sponsor for the company's issue. The sponsor appraises the project or company on various aspects, such as technical, managerial, commercial, economical and financial. After appraisal, the sponsor certifies the OTCEI.
- The Sponsor appoints market makers
- The sponsor determines the price of shares to be offered to the public, members and dealers of OTCEI.
- The sponsor after compliance with all SEBI guidelines gets all statutory consent.
- The sponsor registers the issue with OTCEI for approval and makes the listing application to the OTCEI as per rules and regulations.
- The sponsor submits the notice of issue/offer.
- After getting the approval, the allotment is made.
- Once the allotment is over, the equity is listed and trading commences

**Application for Listing**

After the completion of entire process of allotment and refund, the company or the sponsor makes the application for the listing of scrips at OTCEI. The following documents are to be attached with the application for listing:

- Listing Agreement;
- Certificate from the auditor that the allotment letters, counter receipts and advice-cum-refund orders have been mailed;
- A certificate from the auditor that the allotment has been made as per the basis approved by the OTCEI;
- Company's confirmation that all cheques for brokerage and underwriting commission have directly been posted to members and dealers;
• A copy of the newspaper announcement giving the basis of allotment as approved by OTCEI.
• A cheque/demand draft for the listing fee.

**Listing Fee**
The fee structure for listing is as follows:

- **Initial Listing Fees**: Rs 7500

**Annual Listing Fees**

**Paid-up capital : Amount of Annual Fees**

<table>
<thead>
<tr>
<th>Upto</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rs. 3 crore</td>
<td>Rs 7500</td>
</tr>
<tr>
<td>Rs. 3 crore - Rs. 10 crore</td>
<td>Rs 15000</td>
</tr>
<tr>
<td>Rs. 10 crore - Rs. 20 crore</td>
<td>Rs 25000</td>
</tr>
<tr>
<td>Rs. 20 crore - Rs. 50 crore</td>
<td>Rs 40000</td>
</tr>
<tr>
<td>Rs. 50 crore - Rs. 100 crore</td>
<td>Rs 85000</td>
</tr>
</tbody>
</table>

**Above Rs. 100 crore**: Rs 1000 for every Rs 10 crore or part thereof of the capital

**Obligations on the Companies**
A company seeking listing on OTCEI has to satisfy the following additional conditions:

1. At least 4 centers each in Northern, Western, Southern and Eastern regions should be opened for collection of application forms.
2. Securities are to be issued in a market lot of 100.
3. A company listed on OTCEI can issue partly paid-up securities only with the special permission of OTCEI.
4. The securities to be issued by the company should be in conformity with the provisions of SC(R) Act, SEBI Act, rules, regulations, etc.
5. The audited accounts for the last 5 years or for a shorter period for which they are available in case of a new company, are to be submitted with OTCEI.
6. In case of change in the management recently, OTCEI has to be satisfied regarding the requisite expertise of the current management.
7. If the company is not interested in the trading of certain portion of its share capital, then the company has to declare it to the OTCEI.
8. The company has to undertake to process applications for transfer of shares lodged with it or its nominee or agents within 18 days from the date of lodgement including holidays.
9. The company has to authorise OTCEI or any of its nominees or agents to transfer shares called 'small deal'.
10. Listing on OTCEI is permitted only if the company has obtained necessary statutory approvals under MRTP, FERA, etc.
11. Publicity to an issue of security to the public has to be subject to approval by OTCEI.

**13.12 Players in OTCEI**
Members/dealers, registrars and custodians, clear bank settler and the entire set of regulatory and monitoring mechanism etc. facilitates the smooth
functioning of OTCEI. Market players in the OTC market are as follows:

I. **Investor:** - Investors are the most important players in the market who buy and sell the shares. Actually all other activities are carried for investors' operations and all other players work for smooth, efficient and fault-free investors' operations. An investor can buy or sell shares through 'INVESTOTC Card' through OTCEI. Investors may be an individual, company, firm, FIIs, Fls, FMs or commercial banks.

II. **Issuer Companies:** - Issuer company means the company whose securities are bought and sold on OTCEI. The securities of the companies are as follows:

- **Listed Securities:**
  Listed securities are those which are allowed to be traded at any counter of OTCEI and cannot be traded on any other stock exchange.

- **Permitted Securities:**
  Permitted securities are the securities which are listed on other exchanges but are allowed to be traded as permitted securities on the counters of OTCEI.

- **Equity Shares of Unlisted Companies:**
  The shares of those companies which are not listed on any exchange can now be traded on OTCEI.

- **Initiated Debentures:**
  Any entity holding a minimum of 1 lakh debentures of a particular company can offer them for trading on OTCEI by appointing a member or a dealer as a compulsory market maker in these debentures. These are called as initiated debentures.

III. **Members:** - The functions of members and dealers are almost the same. But the status of members is superior to dealers as members can be sponsors while dealers cannot. The main functions of members at OTCEI are as under:

1. Appraisal and evaluation of proposal
2. Valuation of shares for companies appraised
3. Participation in bought out deals
4. Offer of shares to public
5. Stock broking activities
6. Market making
7. Investor Services

**Dealers**

Norms for Dealers

**Individuals**

**Age:** Minimum 21 years and not more than 60 years.
Net Worth Requirements: Minimum Rs. 15 lakhs excluding the value of membership/dealership/deposits with OTCEI/Other stock exchanges.
Minimum Educational Qualification: Graduate.
Experience: Minimum 2 years’ experience in Capital Markets/Stock broking/Portfolio Management/Investment Consultancy.
Citizenship: Indian Citizenship

Corporate Entity

Net Worth Requirements: Rs. 20 lakhs excluding the value of membership/dealership/deposits with OTCEI/Other Stock Exchanges.
Capital: The minimum paid-up capital should be Rs. 10 lakhs plus free reserves (excluding revaluation reserves, capital reserves and specified reserves cost of dealership and networth of other exchanges) less accumulated losses, if any.
Minimum Educational Qualifications: At least 2 whole time directors of the corporate should be graduate.
Experience: Minimum of 2 whole time Directors should possess a minimum of 2 years experience in either capital market/stockbroking/portfolio management/investment consultancy.
Citizenship: The company should be incorporated under Companies Act, 1956.

Sponsors: - The sponsors are the members who buy wholesale and sell in the market through a network of licensed dealers. Sponsorship of scrips is the process through which the companies and their projects are screened before listing of scrips at OTCEI, so that the investors get better scrips. A sponsor performs the following functions:
To appraise the company and its projects for ensuring the company's projects are technologically and financially viable.
To participate in bought-out deals.
To sponsor companies for listing and to lead manage those issues.
To appoint market makes for all issues sponsored.

Eligibility Norms
Eligibility: Only SEBI recognised merchant bankers (Corporate entities only) are eligible to become sponsors.
Networth Requirements: Rs. 1 crore comprising of the minimum paid-up capital plus free reserves (excluding revaluation reserves, capital reserves, specified reserves & cost of sponsorship) less accumulated losses, if any. Minimum funds committed for OTC operations should be Its. 1 crore.
Minimum Educational Qualifications: Minimum 2 whole time directors should be graduate.
Citizenship: Company should be incorporated under Companies Act, 1956.
Experience: Minimum of 2 Directors should possess a minimum of 2 years experience in either of capital market/stock broking/portfolio management/investment consultancy.

Selection Procedure for Sponsors
Prospective sponsors to submit the application in prescribed form.
The selection will be at the sole discretion of the Board of OTCEI.

Registrars and Custodians
Registrar and custodians are also the part and parcel of OTCEI. They carry out the following functions:

- To transfer shares not exceeding 0.5 per cent of equity portfolio.
- To maintain a register of members.
- To keep in custody share certificates of the company.
- To update the list of members.
- To register power of attorney, transmission and transposition of shares.
- To maintain a record of signatures and to check them at the time of receiving counter receipts (CR) and transfer deed (TD) for transferring securities.
- To register nominations, etc.

Central Clearing Bank

All inter-counter deals and settlements are done through a central bank which is known as central clearing bank.

Seller:

The following functions are performed by settler:

- Record keeping of documents generated by counters.
- Checking of applications for splitting of sharers.
- Keeping a record of signatures of all investors at the counters.
- Monitoring the movement of documents.
- Verification of signatures on counter receipts.
- Checking genuineness of counter receipts.
- Sending confirmations to the counters regarding receipts of counter receipts.
- Exchange of counter receipts for shares before sending them to registrar.

Monitoring Agencies:

OTCEI has a committee which monitors the activities of sponsors, members and the overall trading at OTCEI. Ministry of Finance and Government of India also keep eye on the working of OTCEI. SEBI monitors the activities at OTCEI and frames rules and regulations for the smooth and proper working of the exchange.

13.13 Growth Equity Market (GEM)

The Growth Equity Market (GEM) is the OTC Exchange of India's new market for start-up enterprises. The 'GEM' enables businesses to seek proper valuation and see their shares more widely traded without formally listing their shares on a stock exchange through the traditional listing mechanism. The 'GEM' provides a new and significant opportunity to a dynamic company for further growth as well as valuation of their equity.

Features of GEM

With the introduction of the 'GEM', the market for trading in securities that are not listed, the OTCEI would:

- provide an exit route/opportunity for investments of venture capital and private equity funds
- promote organised trading in unlisted securities by bringing scattered investors onto a trading platform introducing greater level of transparency in utilised securities market;
- broad-base the existing informal market in order to make it more liquid;
- provide benchmark rates for security prices;
• act as a preparatory ground prior to an IPO issue;
• provide companies the protection of institutional investment, and at the same time the visibility and the benefits of exchange trading; encourage companies to adopt transparency and corporate governance in their dealings

Intermediaries
There are three key entities in the 'GEM' of the OTCEI:

1. Companies: - The 'GEM' is suitable for trading among a broad range of companies, from young businesses to management buy-outs and family concerns. Be it a company that is operating in an emerging technology sector or a traditional manufacturing or service industry, the 'GEM' could be market for such companies.

2. Introducers: - A company wanting to trade on the 'GEM' would need to appoint advisors to assist in the admission procedure and compliance with ongoing requirements. The advisors are called 'introducers' and are either OTCE1's sponsor/member or a SEBI registered Category 1 Merchant Banker. The introducer communicates between the company and the market to ensure that investors are able to reach fully informed investment decisions. (iii)

3. Qualified Participants: - qualified participant is the investor on the 'GEM'. It has been determined that a QP should have a net worth of at least Rs. 2.5 crore. The QP can buy/sell securities and participate in book- building of a company's security. Corporates including scheduled banks, venture capital funds, private equity funds or mutual funds, CM, development financial institutions, state level institutions created by an Act of Parliament/legislation and high networth individuals can become qualified participants.

Trading Mechanism
Listed securities and Permitted securities have different trading mechanisms at OTCEI. Therefore it is divided in the following two parts.

For Listed Securities Trading in listed securities starts three days after the listing. Trading commences with the compulsory market maker, additional market maker and voluntary market maker offering quotes for the minimum depth which depends on the issue price of the security. The market makers have to give quotes for at least 10 market lots in case. The issue price is Rs. 50 and 5 market lots in other cases. Share certificates of listed securities are not traded on OTCE1. An investor has to first convert share certificates into counter receipts before trading which are tradeable documents. Following steps are followed in trading process at OTCE1:

• Counter receipt is issued in lieu of share certificate.
• A counter receipt is also issued every time when a scrip is purchased at OTCE1 counter.
• The counter fills up seller's details and obtains his signature.
• Triple copies of counter receipts, one each for buyer, custodian and counter are prepared.
• An Application Acknowledgment Slip (AAS) in triplicate is also generated for the transfer of security in the name of investor. In addition to this, the investor gives a duly stamped and attested transfer deed to the counter.
- All transfer deeds with relevant counter receipts and AAS are sent to the custodian at the end of each day.
- Registrar affects the transfer and issues actual certificate in lieu of counter receipts.
- The counters send those transfer deeds to the registrar for the necessary action.
- An investor interested in selling securities, submits the counter receipts at the counter. After verification of the particulars on the CR and settlement of price, a sale confirmation slip is issued to the investor and the deal is put through. If the shares are already transferred in the seller's name, then he has to submit a transfer deed before he gets sale confirmation slip (SCS) and a cheque.

For Permitted Securities
The trading of permitted securities was initiated in 1994-95. The securities which are listed on other stock exchanges can now be permitted to be traded under this category. OTCEI issued guidelines for listing of finance, investment, leasing and hire purchase companies on April 7, 1995 after obtaining SEBI's approval in this regard. The trading mechanism is as follows:

Trading document is the share certificate with a valid transfer deed. The counters give two-way quotes voluntarily. They are free to modify or withdraw their quotes before the deal is struck. Selling and purchasing investors are issued with purchase confirmation slips (PCS) and sale confirmation slips (SCS) respectively by the counters. The counters have to ensure that the share certificates are accompanied by valid transfer deeds. All delivering brokers have to affix their rubber stamp on the reverse of the transfer deed.

13.14 Settlement System
The OTCEI has five days trading cycle at present. Forward trading is not permitted on OTCEI. OTCEI does not permit short selling in listed securities. Whereas short selling and squaring up in permitted securities is to be completed within the trading cycle. All deals in listed securities get completed after the counter receipts, sale confirmation slips and application acknowledgment slips are confirmed, matched and issued. The settlement process is based on a rolling T+3 settlement system. SEBI has allowed shifting of settlement system on the recommendation of Dave Committee from the T+3 system to T+1 system where the pay-in takes place on the next day and pay-out on second day.

Methods of Offering New Issues
Companies can offer new issues OTCEI in any of the following ways:

1. Primary Issues:- The issuing company may offer its shares directly to the public. The sponsor performs the functions of issue management and as a single underwriter. He may also go for sub-underwriting with a syndicate of members/dealers.

2. Secondary Issues: - The issuer company offloads the shares to the sponsor and receives the cash from him. The sponsor holds these shares till the conditions are favourable for public Issue. The sponsor acts as a manager to the issue at the time of public issue. The sponsor may appoint additional sponsors. He may offload these shares to the public either directly or through members/dealers. Thus, this method provides the capital to the company at an early stage and can take up speedy commencement of the project.
3. **Book-building:** - The Company can also issue the shares through book-building process at OTCEI.

4. **Bought Out Deals:** - Dave Committee suggested that Bought Out Deals should be allowed as a facility of offer for sale, listing and trading only on OTCEI. This facility should be available to those who do not fulfil the criteria of three year dividend, financial institutional appraisal and funding. This suggestion was approved and accepted. The detailed scheme for offloading shares acquired under SOD was chalked out. These companies when listed on OTCEI were remain to be listed only at OTCEI for minimum of 3 years

13.15 Slow Growth of OTCEI

Despite technical superiority of OTCEI in terms of computerization. Speed, transparency and integrated functioning, the growth of OTCEI operations has been found to be highly unsatisfactory. Following are some of the factors that have contributed for the slow growth of business on OTCEI

Crash of BOD market: the primary reason for the slow growth of the business of the OTCEI was the crash of the Bought-out. Deal (BoD) market. Large amounts of money stuck in bought-outs contributed to the liquidity problem on the exchange. Many OTCEI sponsors are responsible for making a fast buck by listing bought-outs six to nine months after the deal at very high premium and then failing to support the scrip.

Lack of commitment: - Only a few sponsors are willing to commit time, staff and funds for OTCEI operations. Most members and dealers operate only as brokers and only a limited number takes up the market-making function. Further, there was a lack of support from the founder institutions too. SEBI's insistence for de-linking OTCEI business to companies with no fund-based activities also contributed to the shrinkage in the OTCEI operations.

Poor settlement system: - The T+3 trading cycle that was in operation earlier limits broking operations as it takes a minimum of three days for the client's cheque to get encashed. Whereas the payment has to be made on the third day after the trade takes place. Institutional clients take even seven to eight days to make payment. Market operators have to commit funds for the intervening period. However with the introduction of T+5 trading cycle this problem has been taken care of to a great extent.

Other causes
- Lack of depth which makes the market susceptible to large swings on small deals
- Inadequate funds for market-making
- Existence of only spot market and lack of short selling and forward trading has kept many operators away from OTCEI
- Existence of only spot market and lack of short selling and forward trading has kept many operators away from OTCEI
- Inefficient software
• Delay in transfer of shares by registrars
• Lack of aggressiveness on the part of OTCEI board
• Limited representation of members and dealers on the policy making committees of OTCEI
• Limited awareness about the merits of operations on OTCEI due to inadequate marketing of the exchange.

13.16 REVAMPING OTCEI

A number of measures have been initiated in order to revamp the functioning of the trading and settlement mechanisms at the OTCEI. Following are some of these measures:

Membership in the National Stock Exchange (NSE) through a wholly owned subsidiary wherein all those existing brokers who have cleared their dues with OTCEI will be permitted to act as sub-brokers with the subsidiary to trade on the NSE order book. Total revamp of its market-making mechanism aimed at providing greater liquidity and an easy exit for investors at all stages whereby market-makers need to have a minimum net worth of Rs. 1 crore.

Introduction of the concept of an inventory bandwidth, whereby a market-maker does not get a stock dumped on him during adverse market conditions. Accordingly, when once a market-maker's net inventory reaches 5 percent of the net offer to the public for the scrip, the 'bid' side gets disabled and when it falls to 3 percent, it gets reactivated automatically.

SEBI allowing the OTCEI to have a 'free hand' in increasing the number of companies under the permitted securities and debentures category.

RBI with effect from November, 1997 permitting many market players to undertake transactions in government securities through the members of the OTCEI which resulted in an increasing number of brokers opting to trade through the OTCEI. The OTCEI trading screens provide for online calculation of yield on government securities and display the accrued interest portion of the security price. The trading software allows brokers to negotiate deals directly on the trading screen. The introduction of this segment on OTCE-I increases both the volume of business as well as the spread of OTCEI activities.

13.17 CHANGING ROLE OF OTCEI

By insisting on uniform settlement, OTCEI has realized that brokers will avoid OTCEI transactions in the absence of business. Speculation is very important to drive the share prices. An important ingredient of any stock market is the facility for investors to speculate and also possess the ability to close out and shift position from one exchange to another so as to take advantage of price differential at different exchanges. If this facility is absent, price discovery and price formation will be hampered leading to low investor interest in capital markets. In view of the emerging trends in the capital market, a major need has been felt to improve the working of OTCEI. The Over-the-counter Exchange of India is currently being revived with help from the National Stock Exchange (NSE).
MAJOR CHANGES IN OTCEI FUNCTIONING

OTCEI has named itself as "The Contemporary and Competitive Exchange" in its brochures thereby emphasizing its new role in the following spheres:

- Weekly Settlement
- Revamping the Trading System
- Technology

Weekly Settlement

OTCEI had introduced weekly settlement for the listed segment. This is an Arbitrage Opportunity involving Saturday-Friday trading. This introduces a weekly settlement cycle instead of the current rolling settlement on a T+5 basis (transaction day and five days thereafter). Brokers on the exchange have long argued that the rolling settlement does not provide any leeway for speculation and thereafter, the exchange lacks much needed liquidity. The trading time in operation is Monday-Friday 10-4 p.m., Saturday. 1st day of trading 10-1 p.m. All weekly settlements under new system are successfully completed without default/crisis.

Revamping the Trading System

OTCEI has decided to revamp its trading activity by switching over to share certificate to attract investor interest. Counter Receipt, as a trading document, would cease to be a valid trading document. In its place, the physical shares will be allotted to the logical holders. This move by OTCEI to shift from CR to share certificate OT dematerialization is a fresh initiative to improve initiative to improve liquidity and bring about price discovery and price formation. Similarly, a change from the earlier system of Counter Receipts (CR) (tradable document on the exchange) commenced from March 1, 1999, when all the counter-receipts ceased to be valid trading documents. OTCEI has informed all the listed companies to move from CR to share certificates mode or dematerialization. Companies that choose to dematerialize will give the option to their shareholders to retain their share certificates.

Technology

OTCEI has introduced the latest trading platform Hardware — Fully Fault Tolerant Stratus Machine. The latest trading software adopted is the OASIS. The OTCEI plans to update and change its trading software. For this purpose, it will adopt a modified version of the NSE's trading software, for which negotiations have already started with the software vendor. Facilities support is to be provided by experts like TCS, HCL, Comment, CMS and CMC. Other measures include trading through VSATs, Modems and Lease Line. Y2K compliance has been achieved and continuous upgradation of software is taking place.

Obligations on the Companies

Companies that seek listing at OTCEI have to satisfy the following obligations:

Collection centers: Arrange at least four centers for collection of application forms in respect of issue of securities—one each from the Northern, Western, Southern and Eastern regions of the
country. Depending on the nature and size of the issue of a company, OTCEI can increase the required number of centers.

**Security issue:** The rate of premium on the public issues on OTCEI is to be entirely determined by market forces where securities are issued at premium. A Company is not allowed to issue securities at par if the securities are eligible to be issued at a premium under the guidelines issued by SEBI. Securities are to be issued in a market lot of I 00 and any variation requires the prior special permission of OTCEI. A company listed on OTCEI can issue partly paid-up securities only with the special permission from OTCEI.

**Trading:** Trading on both the fully paid and partly paid securities has to commence simultaneously. A company already listed on OTCEI can issue debentures, preference shares, bonds, etc provided a minimum of Rs.20 lakhs of issued securities of that particular class is admitted for trading.

Relevant provisions The securities to be issued by the company should be in conformity with the provisions of SCRA, SEW Act, rules, regulations and guidelines on disclosure and investor protection, and government guidelines prescribed for OTCEI operations. The issue should be in conformity with the memorandum and articles of the company.

**OTCEI MoU WITH NASSCOM**

To provide for exchange of ideas and concepts for developing a vibrant and active market for hi-tech companies in India, NASSCOM and the OTC Exchange of India have decided to enter into a memorandum of understanding. According to the MOU, NASSCOM will nominate a representative on the Screening Committee for listing IT companies on OTCEI; develop models and methodology for rating promoters and projects of software companies planning to raise capital through the OTCEI route. The NASSCOM will arrange and conduct investor education programmes to generate awareness on investment opportunities and risks associated with software companies and provide for research and analysis of the software industry/OTCEI listed software companies for market information and business development. The OTCEI has also put in place mechanisms to handhold new IT entrepreneurs through the entire stock exchange listing and market creation process. The NASSCOM along with OTCEI will from time to time plan and organize seminars and conferences on topics related to the role and scope of capital market in the software industry. The NASSCOM will assist start-up companies listed on the OTCEI by registering them for NASSCOM membership and providing them with software industry updates. Getting recognition for companies in the international markets through its ongoing process. It will also hold training programs for the entrepreneurs on process/quality controls.

**Conclusion**

Some of the advantages claimed by the OTCEI include nationwide trading, ring less trading, transparent and computerised trading, greater liquidity, trading in derivatives, etc. In addition, it also offers benchmarks for various scrips that are traded on the exchange. With the national network of
operations, the presence of OTCEI is expected to add dynamism to the functioning of the capital market in India. The players in the over-the-counter market are the investor, the issuer, the members and dealers, registrars and custodians; central clearing bank and monitoring agenda. OTCEI is required to obtain registration with the SEBI and is expected to follow the guidelines issued by it from time to time. The guidelines prescribe obligations on the players in the OTC market. Separate mechanism has been prescribed for listed and permitted securities for the purpose of trading at the OTCEI. The growth of OTCEI in India has not been on the expected lines. In fact, the growth is tardy owing to many factors such as crash of bought-out deal market, lack of commitment on the part of sponsors, poor settlement system, etc. The OTCEI has entered into a MoU with the NASDAQ of the U.S.

13.22 Summary

1. OTCEI (Over The Counter Exchange of India) was incorporated in 1990 as a Section 25 company under the Companies Act 1956 and is recognized as a stock exchange under Section 4 of the Securities Contracts Regulation Act, 1956. The Exchange was set up to aid enterprising promoters in raising finance for new projects in a cost effective manner and to provide investors with a transparent & efficient mode of trading.
2. The network of online computers providers all relevant information to the market participants on their computer screens. This allows them the luxury of executing their deals in the comfort of their own offices.
3. OTCEI (Over The Counter Exchange of India) is also known as Over-the-Counter Exchange of India based in Mumbai, Maharashtra. It is the first exchange for small companies. It is the first screen based nationwide stock exchange in India. It was set up to access high-technology enterprising promoters in raising finance for new product development in a cost effective manner and to provide transparent and efficient trading system to the investors.
4. An electronic stock exchange based in India that is comprised of small- and medium-sized firms looking to gain access to the capital markets.
5. OTCEI is promoted by the Unit Trust of India, the Industrial Credit and Investment Corporation of India, the Industrial Development Bank of India, the Industrial Finance Corporation of India and others and is a recognised stock exchange under the SCR Act.
6. Members/dealers, registrars and custodians, clear bank settler and the entire set of regulatory and monitoring mechanism etc. facilitates the smooth functioning of OTCEI.

13.20 Test/Model Questions

1. What is OTCEI? Explain the various objectives of OTCEI.
2. Elaborate the History of OTCEI in detail.
3. What the various advantages of OTCEI for a company and an investor?
4. Apprehend the growth of OTCEI in India.
5. How investor can Buy and Sell a scrip on OTCEI?
6. Describe the qualifying norms and procedure for listing requirements for OTCEI?
7. What is the trading mechanism of OTCEI?
8. Explain the various players in OTCEI?
13.21 Suggested reading

1. Dr S Guruswamy “Financial Markets And Institutions”
2. Dr Alok Goyal, Mridula Goyal “Financial Market Operations”