UNIT 7 BROKING AND TRADING IN EQUITY

Objectives

The objectives of this unit are to:

- highlight regulations related to broking and trading in equity in India;
- indicate role of self-regulation vis-a-vis legislative regulation of securities market; and
- discuss the trading practices in equity market.

Structure

7.1 INTRODUCTION

Stock brokers play an important role in securities market transactions. They act as an intermediary between buyers and sellers of securities, who would otherwise need to spend lot of time and cost in their search of buyers and sellers. Liquidity is improved with the presence of active stock brokers, who through their network, either in open outcry hall or in computer trading systems are constantly in touch with other brokers. Some brokers also create market by giving two way buy-sell quotes. The process of buy-sell discovery, which is one of the most important features of the stock market is achieved with the help of stock brokers. Without stock broking community, it would be impossible to run the stock market transactions, which now runs into billions.

Yet another problem of direct dealing is credit risk associated with counter parties of transactions. Broker to a large extent takes out such risk of trading by becoming a member of clearing house/corporation and restrict their dealings only with the members of clearing house/corporation. Clearing house/corporation generally assures performance of trade even though a member of clearing house fails to perform the contract. Since brokers deal with crores of Rupees, there is a need to regulate them. Regulations covers registration of brokers, capital adequacy, inspection of records and punishment in case of any violation of regulations. In this unit, we will cover the regulation relating to stock brokers and trading of equity. Stock market transactions and stock brokers are governed by Securities Contract (Regulation) Act, 1956 and stock brokers are in addition governed by SEBI Regulations and self-regulations. Initially, we will cover these regulations before discussing the market practices relating to stock market operations.

7.2 SECURITY CONTRACT (REGULATION) ACT, 1956

Securities Contract (Regulation) Act 1956 and the rules made there under, namely in Securities Contract (Regulation) Rules, 1957 are the main laws governing securities market trading.

The preamble to the Securities Contract (Regulation) Act states that it is 'an act to prevent undesirable transactions in securities by regulating the business of dealing therein, by prohibiting options and by providing certain other matters connected therewith". This Act provides for the direct and indirect control of virtually all aspects of securities trading and the running of the stock exchanges. The Act makes every transaction in securities in any notified State or area illegal and punishable by fine and/or imprisonment if it is not entered into between or with members of a recognized stock exchange in the state or area. It also makes every such securities contracts void.

The Act thus prohibits the existence of other than recognised stock exchanges and provides the mechanism of recognizing stock exchanges. Application to the Central Government for recognition must include a copy of the rules relating in general to the constitution of the stock exchange and in particular to, among other things, the admission into the stock exchange of various classes of members, the exclusion, suspension, expulsion and readmission of members, and the procedure for registration of partnership as members. In determining whether to grant recognition, the Central Government may make whatever inquiry is necessary and impost in the rules and bye-laws of the stock exchanges whatever conditions are required to ensure "fair dealing" and to "protect investors". These conditions concern, *inter alia*, the qualifications for members, the manner in which contracts are to be entered into and enforced, the representation of not more than three Central Government nominees on the board of the stock exchange, and the maintenance of books and record by members and their audit by chartered accountants. The Central Government has the power to impose further conditions, other than in the rules, such as limiting the number of members. Finally, the Central Government has the power to unilaterally withdraw recognition.

After it recognizes a stock exchange, the Central Government exerts regulatory control over it. Periodic reports are furnished to the Central Government. Certain books and records are maintained for a period of five years. The Central Government can make an inquiry itself, or through an appointed third party, into the affairs of a stock exchange or any of its members. All officers, directors, members and others who have had dealings in the matter under inquiry are required to produce requested documents, statements, or information.

The Central Government retains control over the stock exchange's bye-laws and its rule amendments. A stock exchange, subject to previous Central Government approval, has the authority to make bye-laws for the regulation and control of contracts and the regulation of trading. Similarly, no rule amendments have effect until they are approved by the Central Government. The Central Government, furthermore, has the power to direct stock exchange to amend its rules; and if it fails to do so, the Government may directly amend such rules. The Securities Contract (Regulation) Act grants the Central Government power to supersede governing body of a recognised exchange. The suspension of business may be complete or subject to conditions. Suspensions may not last more than seven days initially but may be extended from time to time. The Central Government may supersede the governing body of any exchange by declaration and then appoint any person or group of persons to exercise and perform all the power and duties of the governing body.

Other powers granted to the Central Government include the ability to stop further trading in specified securities for the purpose of preventing undesirable speculation, and the power to compel a public company " in the interest of the trade or in the public interest" to list its securities on any of the recognized exchanges.

Activity 1

i) What is a recognised stock exchange?

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ii) Name any three important reasons to have stock exchanges.

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iii) State some of the recent changes in SCRA relating to derivatives contracts.

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7.3 REGULATION ON BROKERS AND SUB-BROKERS BY SEBI

In 1992, SEBI has prescribed regulations that govern broker and sub-brokers. This section explains some of the important regulations relating to brokers and sub-brokers.

Registration of Stock Brokers

It is important for a member of stock exchange to register with SEBI before acting as a broker and buy or sell securities on behalf of investors. An application by a stock-broker for grant of a certificate shall be made through the stock exchange where the member is admitted. SEBI will take into account for considering the grant of a certificate all matters relating to buying, selling, or dealing in securities and in particular the following, namely, whether the stock broker

a) is eligible to be admitted as a member of a stock exchange;

b) has the necessary infrastructure like adequate office space, equipments and man power to effectively discharge his activities;

c) has any past experience in the business of buying, selling or dealing in securities;

d) is subjected to disciplinary proceedings under the rules, regulations and bye-laws of a stock exchange with respect to his business as a stock-broker involving either himself or any of his partners, directors or employees;

e) is a fit and proper person.

Registration of Sub-Broker

An application by a sub- broker for the grant of a certificate shall be made in *Form B* accompanied by a recommendation letter from a stock-broker of a recognized stock exchange with whom he is to be affiliated along with two references including one from his banker. The application form shall be submitted to the stock exchange, of which the stock- broker with whom he is to be affiliated is a member. The stock exchange on receipt of an application shall verify the information contained therein and shall also certify that the applicant is eligible for registration as per criteria specified in the regulation.

The eligibility criteria for registration as a sub-broker is as follows, namely:

i) in the case of an individual;

  a) the applicant is not less than 21 years of age;

  b) the applicant has not been convicted of any offence involving fraud or dishonesty;

  c) the applicant has atleast passed 12th standard equivalent examination from an institution recognised by the Government;

  d) the applicant is a fit and proper person
  Provided that the Board may relax the educational qualifications on merits having regard to the applicant's experience.

ii) In the case of partnership firm or a body corporate the partners or directors, as the case may be, shall comply with the requirements contained in clauses (a) to (c) of sub- regulation (i).

General Obligations and Responsibilities of Brokers

1) Every stock-broker shall keep and maintain the following books of accounts, records and documents namely;

  a) Register of transactions (Sauda Book);

  b) Clients ledger;

  c) General ledger;

  d) Journals;

  e) Cash book;

  f) Bank pass book;

  g) Documents register should include particulars of shares and securities received and delivered;

  h) Members' contract books showing details of all contracts entered into by him with other members of the same exchange or counterfoils or duplicates of memos of confirmation issued to such other member;

  i) Counterfoils or duplicates of contract notes issued to clients;

  j) Written consent of clients in respect of contracts entered into as principals;

  k) Margin deposit book;

  l) Registers of accounts of sub- brokers;

  m) an agreement with a sub-broker specifying the scope of authority and responsibilities of the Stock Broker and such sub-broker.

2) Every stock broker shall intimate to the Board the place where the books of accounts, records and documents are maintained.

3) Every stock broker shall, after the close of each accounting period furnish to the Board if so required as soon as possible but not later than six months from the close of the said period a copy of the audited balance sheet and profit and loss account, as at the end of the said accounting period.

4) Every stock broker shall preserve the books of account and other records maintained for a minimum period of five years.

7.4 SELF REGULATION

In addition to legislative regulation, self-regulation is equally important. Indeed in developed securities markets like U.K. self-regulation plays an important role. There exist a number of self-regulatory organisations (SROs) which really complement legislative regulation.

The spirit of self-regulation had been prevalent in the Indian securities market as well. If one looks at the powers given to recognized stock exchanges in India to make and enforce bye-law under the Securities Contracts (Regulation) Act, 1956, one tends to conclude that Indian stock exchange have been envisaged as self-regulatory organisations. Just to elaborate the point let us look at section 9 of the Securities Contracts (Regulation) Act, 1956, which states as follows:

Any recognized stock exchange may, subject to the previous approval of the Central Government (till 1991) and Securities and Exchange Board of India (since 1992) make bye-laws for the regulation and control of contracts.

1) In particular, 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 difference thereunder, the delivery of the payment for securities, the passing on of delivery orders and the regulation and maintenance of such a clearing house;
   c) The submission to the Central Government (till 1991) and Securities and Exchange Board of India (since 1992) 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 (till 1991) and Securities and Exchange Board of India (since 1992) 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 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 (till 1991) and Securities and Exchange Board of India (since 1992) under the clause © subject to the directions, if any, issued by the Central Government (till 1991). Securities and Exchange Board of India since (1992) 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 difference paid through the clearing house;
   g) The regulation, or prohibition of badlas 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, recession 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 by a seller or buyer, and the responsibility of members who are not parties to such contracts;

l) The regulation of **taravani** 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 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 charges;

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 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.

2) 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) Explusion from membership,

      iii) Suspension from membership for a specified period,

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

3) Any bye-laws made under this section shall be subject to such conditions in regard to previous publications as may be prescribed, and, when approved by the Central Government (till 1991) and Securities and Exchange Board of India (since 1992) 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 situated and shall have effect as from the date of its publication in the Gazette of India:

Provided that if the Central Government (till 1991) and Securities and Exchange Board of India (since 1992) is satisfied in any case that in the interest of the trade or in the public interest any bye-laws should be made immediately, it may, by ordering in writing, specifying the reasons thereof, dispense with the condition of previous publication.

The foregone discussion clearly shows that Indian stock exchanges have been envisaged as self-regulatory bodies. Of late, merchant banks and mutual funds have also been envisaged as SROs. Unfortunately, the record of Indian stock exchanges as SROs has been dismal. Despite various malpractices prevalent in stock exchanges, hardly any disciplinary action had been initiated against any member of the stock exchange. Recent inspection by SEBI of some of the stock exchanges have clearly brought out that their bye-laws relating to margins, etc. have been observed more in breach. Nevertheless it can't be denied that self-regulation is a necessary complement to legislative regulation of securities market in any country.

7.5 TRADING IN EQUITY

Trading System

Trading system differs from exchange to exchange. In the next few pages, the trading system followed by the National stock Exchange is described. Students desire to know more about the trading system of other exchanges in India as well as outside India can visit respective web sites of stock exchanges.

NSE operates on the 'National Exchange for Automated Trading' (NEAT) system, a fully automated screen based trading system, which adopts the principle of an order driven market. NSE consciously opted in favour of an order driven system as opposed to a quote driven system. This has helped reduce jobbing spreads not only on NSE but in other exchanges as well, thus reducing transaction costs. Till the advent of NSE, an investor wanting to transact in a security not traded on the nearest exchange had to route orders through a series of correspondent brokers to the appropriate exchange. This resulted in a great deal of uncertainty and high transaction costs. NSE has made it possible for an investor to access the same market and order book, irrespective of location, at the same price and at the same cost.

Market Types

The NEAT system has four types of market. They are:

i) **Normal:** All orders which are of regular lot size or multiples thereof are traded in the Normal Market. For shares which are traded in the compulsory dematerialised mode the market lot of these shares is one. Normal market consists of various book types wherein orders are segregated as Regular lot orders, Special Term orders, Negotiated Traded orders and Stop Loss orders depending on their order attributes.

ii) **Odd Lot Market:** All orders whose order size is less than the regular lot size are traded in the odd-lot market. An order is called an odd lot order if the order size is less than regular lot size. These orders do not have any special terms attributes attached to them. In an odd-lot market, both the price and quantity of both the orders (buy and sell) should exactly match for the trade to take place. Currently the odd lot market facility is used for the Limited Physical Market as per the SEBI directives.

iii) **Spot Market:** Spot orders are similar to the normal market orders except that spot orders have different settlement periods vis-à-vis normal market. These orders do not have any special terms attributes attached to them. Currently the Spot Market is being used for the Automated Lending and Borrowing Mechanism (ALBM) session.

iv) **Auction Market:** In the Auction Market, auctions are initiated by the Exchange on behalf of trading members for settlement related reasons. There are 3 participants in this market.

- ***Initiator:*** The party who initiates the auction process is called an initiator.
- ***Competitor:*** The party who enters orders on the same side as of the initiator is called a Competitor.
- ***Solicitor:*** The party who enters orders on the opposite side as of the initiator is called a Solicitor.

Order Books

The NSE trading system provides complete flexibility to members in the kinds of orders that can be placed by them. Orders are first numbered and time-stamped on receipt and then immediately processed for potential match. Every order has a distinctive order number and a unique time stamp on it. If a match is not found, then the orders are stored in different 'books'. Orders are stored in price-time priority in various books in the following sequence:

- Best Price
- Within Price, by time priority.

Price priority means that if two orders are entered into the system, the order having the best price gets the higher priority. Time priority means if two orders having the same price are entered, the order that is entered first gets the higher priority.
The Capital Market segment has following types of books:

Regular Lot Book

The Regular Lot Book contains all regular lot orders that have none of the following attributes attached to them.

- All or None (AON)
- Minimum Fill (MF)
- Stop Loss (SL)

Special Terms Book

The Special Terms book contains all orders that have either of the following terms attached:

- All or None (AON)
- Minimum Fill (MF)

Note : Currently, special term orders i.e AON and MF are not available on the system as per the SEBI directives.

Negotiated Trade Book

The Negotiated Trade book contains all negotiated order entries captured by the system before they have been matched against their counterparty trade entries. These entries are matched with identical counterparty entries only. It is to be noted that these entries contain a counterparty code in addition to other order details.

Stop-Loss Book

Stop Loss orders are stored in this book till the trigger price specified in the order is reached or surpassed. When the trigger price is reached or surpassed, the order is released in the Regular lot book.

The stop loss condition is met under the following circumstances:

Sell Order: A sell order in the Stop Loss book gets triggered when the last traded price in the normal market reaches or falls below the trigger price of the order.

Buy Order: A buy order in the Stop Loss book gets triggered when the last traded price in the normal market reaches or exceeds the trigger price of the order.

Odd Lot Book

The Odd lot book contains all odd lot orders (orders with quantity less than marketable lot) in the system. The system attempts to match an active odd lot order against passive orders in the book. Currently, pursuant to a SEBI directive the Odd Lot Market is being used for orders which has a quantity less than or equal to 500 (Qty more than the market lot) for trading. This is referred as the Limited Physical Market (LPM).

Spot Book

The Spot lot book contains all spot orders (orders having only the settlement period different) in the system. The system attempts to match an active spot lot order against the passive orders in the book. Currently the Spot Market book type is being used for conducting the Automated Lending & Borrowing Mechanism (ALBM) session.

Auction Book

This book contains orders that are entered for all auctions. The matching process for auction orders in this book is initiated only at the end of the solicitor period.

Order Matching Rules

The best buy order is matched with the best sell order. An order may match partially with another order resulting in multiple trades. For order matching, the best buy order is the one with the highest price and the best sell order is the one with the lowest price. This is because the system views all buy orders available from the point of view of a seller and all sell orders from the point of view of the buyers in the market. So, of all buy orders available in the market at any point of time, a seller would obviously like to sell at the highest possible buy price that is offered. Hence, the best buy order is the order with the highest price and the best sell order is the order with the lowest price.

Members can proactively enter orders in the system which will be displayed in the system till the full quantity is matched by one or more of counter-orders and result into trade(s) or is cancelled by the member. Alternatively, members may be reactive and put in orders that match with existing orders in the system. Orders lying unmatched in the system are 'passive' orders and orders that come in, to match the existing orders are called 'active' orders. Orders are always matched at the passive order price. This ensures that the earlier orders get priority over the orders that come in later.

Order Conditions

A Trading Member can enter various types of orders depending upon his/her requirements. These conditions are broadly classified into three categories: time related conditions, price-related conditions and quantity related conditions.

Time Conditions

- **DAY:** A Day order, as the name suggests, is an order which is valid for the day on which it is entered. If the order is not matched during the day, the order gets cancelled automatically at the end of the trading day.

- **GTC:** A Good Till Cancelled (GTC) order is an order that remains in the system until it is cancelled by the Trading Member. It will therefore be able to span trading days if it does not get matched. The maximum number of days a GTC order can remain in the system is notified by the Exchange from time to time.
- **GTD:** A Good Till Days/Date (GTD) order allows the Trading Member to specify the days/date up to which the order should stay in the system. At the end of this period the order will get flushed from the system. Each day/date counted is a calendar day and inclusive of holidays. The days/date counted are inclusive of the day/date on which the order is placed. The maximum number of days a GTD order can remain in the system is notified by the Exchange from time to time.
- **IOC:** An Immediate or Cancel (IOC) order allows a Trading Member to buy or sell a security as soon as the order is released into the market, failing which the order will be removed from the market. Partial match is possible for the order, and the unmatched portion of the order is cancelled immediately.

Price Conditions

- **Limit Price/Order:** An order which allows the price to be specified while entering the order into the system.
- **Market Price/Order:** An order to buy or sell securities at the best price obtainable at the time of entering the order.
- **Stop Loss (SL) Price/Order:** The one which allows the Trading Member to place an order which gets activated only when the market price of the relevant security reaches or crosses a threshold price. Until then the order does not enter the market.

Sell Order

A sell order in the Stop Loss book gets triggered when the last traded price in the normal market reaches or falls below the trigger price of the order.

Buy Order

A buy order in the Stop Loss book gets triggered when the last traded price in the normal market reaches or exceeds the trigger price of the order.
e.g. If for stop loss buy order, the trigger is 93.00, the limit price is 95.00 and the market (last traded) price is 90.00, then this order is released into the system once the market price reaches or exceeds 93.00. This order is added to the regular lot book with time of triggering as the time stamp, as a limit order of 95.00

Quantity Conditions

Disclosed Quantity (DQ): An order with a DQ condition allows the Trading Member to disclose only a part of the order quantity to the market. For example, an order of 1000 with a disclosed quantity condition of 200 will mean that 200, is displayed to the market at a time. After this is traded, another 200, is automatically released and so on till the full order is executed. The Exchange may set a minimum disclosed quantity criteria from time to time.

- **MF:** Minimum Fill (MF) orders allow the Trading Member to specify the minimum quantity by which an order should be filled. For example, an order of 1000 units with minimum fill 200 will require that each trade be for at least 200 units. In other words there will be a maximum of 5 trades of 200 each or a single trade of 1000. The Exchange may lay down norms of MF from time to time.

- **AON:** All or None orders allow a Trading Member to impose the condition that only the full order should be matched against. This may be by way of multiple trades. If the full order is not matched it will stay in the books till matched or cancelled.

Note : Currently, AON and MF orders are not available on the system as per SEBI directives.

7.6 SUMMARY

Stock brokers play a critical role in securities market transactions. They provide liquidity by being constantly in touch with other members on behalf of buyers and sellers of the securities. Their active involvement increases the volume of transactions and hence provides high level of liquidity. Such liquidity leads to better price discovery process. Since stock brokers deals with large value, regulations are in force. Regulations covers admission of membership of stock exchanges and capital adequacy norms. Stock exchanges and stock brokers have created trading system, which are much easier for investors to perform buying and selling. It meets the requirement of several types of investors including those who want to take short-term positions. Stock market and stock brokers use large amount of technology to create such advanced system. Stock market operations have become much easier today with the help of advanced trading system through which an investor can buy and sell securities through internet and also due to paperless trading. It was a pain to buy and sell securities in physical mode but today almost all transactions are done through depository mode.

7.7 SELF ASSESSMENT QEUSTIONS

1) Effective regulation is an essential condition for orderly growth of securities market. Discuss.
2) Write a brief note SCRA relating to members of stock exchanges.
3) Between self-regulation and legislative regulation, which is more relevant for India and why?
4) How Securities and Exchange Board of India regulate brokers and sub-brokers?
5) Who can be a member of a Stock Exchange in India?
6) Explain different method of placing orders with a stock broker?
7) How trading in stock market changed over the years?

7.8 FURTHER READINGS

Casey, John L., *Ethics in the Financial Market Place*, New York: Scudder, Stevens & Clark, 1990.

Hammer, Richard M., Gilbert Simonetti Jr., and Charles T Crawford, eds. *Investment Regulation around the world*, Somerset, N.J.: Ronald Press, 1983.

Ramaiya, A, *Guide to the Companies Act*, Agra Wadwa & Co., (refer latest edition and Volumes relating to SEBI Regulations).

Web Sites

U.S. Security Exchange Commission: www.sec.gov

Financial Service Authority, UK: www.fsa.gov.uk

SEBI, India: www.sebi.com