CAPITAL MARKET - SECONDARY

After going through the chapter student shall be able to understand:

- Introduction to Secondary Market
- Development of the stock market in India
- Stock market Organization in India
- Demutualization of Stock Exchanges
- Share Trading in Secondary Market
- Stock Market and Its Operations
- Risk Management in Secondary Market
  1. Trading Rules and Regulations
  2. Circuit Breakers
  3. Trading and Settlement
  4. National Securities Clearing Corporation Limited
  5. Market Making System
  6. Securities Lending and Borrowing
  7. Straight Through Processing
  8. Margin Trading
  9. Indian Debt Market
1. INTRODUCTION TO SECONDARY MARKET

Secondary market is a market where shares initially issued are traded. Trading of securities takes place when securities are purchased or sold. This market is also known as stock market. In India, secondary market consists of recognized stock exchanges operating under rules, regulations and guidelines approved by the government. The stock exchanges are organized market where securities issued by the Companies, Central and State Government, and public bodies are traded. As per section 2(j) of the Securities Contract Regulation Act, 1956, “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.

Therefore, in nutshell, securities issued by a company for the first time are offered to the public in the primary market. Once the IPO is done and the stock is listed, they are traded in the secondary market. The main difference between the two is that in the primary market, an investor gets securities directly from the company through IPOs, while in the secondary market, one purchase securities from other investors willing to sell the same.

Equity shares, bonds, preference shares, debentures, etc. are some of the key products available in a secondary market.

Functions of Secondary Market

(i) Economic Indicator – Every major change in the economy either due to government policy or any major international event has a bearing on the secondary/stock market. So, if the stock market is doing well, it is an indicator that economy is more or less in a stable position.

(ii) Valuation of Securities – Secondary market helps in the valuation of securities through its demand and supply. The securities of those companies which are growth oriented and doing well will surely have higher demand in comparison to securities of companies which are not doing well. Consequently, the share prices of growth oriented companies will be high.

(iii) Transaction in securities is safe in the secondary market – Transactions executed in the secondary market are safe because all the trading taking place in an electronic system which is highly secure.

(iv) Contributes to economic growth – It contributes to economic growth through allocation of funds to the most efficient sector through the process of disinvestment to reinvestment. This leads to capital formation and economic growth.

(v) Motivating people to invest in equity shares – Efficient secondary market motivate people to invest in the securities market. The reason is that the people would be less apprehensive about the riskiness of the stock market.
(vi) It ensures safety and measure of fair dealing to protect investor’s interest.

(vii) It induces companies to improve their performance since market price of shares showing at the stock exchanges is the indicator that reflects a company’s performance and is easily available to the investors.

2. DEVELOPMENT OF THE STOCK MARKET IN INDIA

The stock market originated in India at the end of the eighteenth century when lots of new negotiable instruments were introduced. However, the real beginning was made in the middle of nineteenth century when Companies Act, 1860 was enacted where the concept of limited liability was introduced.

The Bombay Stock Exchange was formed in 1875. This was followed by formation of exchanges in Ahmedabad in 1894, Calcutta (Kolkata) in 1908, and Madras (now Chennai) in 1937. Calcutta Stock Exchange (CSE) was the largest stock exchange in India till 1960’s. In 1961, there were 1203 listed companies. Of these, 576 were listed on the CSE and 297 on the BSE. However, the latter part 1960’s saw significant decline in the share of CSE. But, the share of BSE gained during that period.

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Source: SEBI Annual Report, Various issues

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Till 1990’s, the Indian Stock Market was suffering from many drawbacks which are enumerated as below:

- Uncertainty of execution prices.
- Uncertain delivery and settlement periods.
- Lack of transparency.
- High transaction costs.
- Absence of risk management.
- Systematic failure of market due to market failure.
- Partiality of brokers to certain client only.

**Market Reforms after 1991**

After the initiation of reforms in 1991, the secondary market has adopted the following system:

- Regional stock exchanges
- The National Stock Exchanges (BSE and NSE)
- The Over the Counter Exchange of India (OTCEI)
- The Interconnected Stock Exchange of India (ISE)

The NSE was set up in 1994. It was the first stock exchange in India to bring new technology, new trading practices, new institutions and new products. The OTCEI was established in 1992 providing small and medium sized enterprises the means to generate capital. Metropolitan Stock Exchange of India Ltd. (MSEI), formerly known as MCX Stock Exchange Ltd. (MCX-SX), is recognized by country’s securities market regulator - Securities and Exchange Board of India (SEBI). It offers an electronic platform for trading in Capital Market, Futures & Options, Currency Derivatives, Interest Rate Futures (IRF) and Debt Market segments. MSEI’s current shareholders include Indian public sector banks, private sector banks, investors and domestic financial institutions.

3. **STOCK MARKET ORGANIZATION IN INDIA**

The organization of stock exchanges has been depicted in the following figure:
The stock market organization (highlighting the capital market intermediaries) in India as shown in the above diagram is discussed as below:

(i) **Stock Broking** – Brokers are members of stock exchange. They enter into share trading transactions either on their own account or on behalf of their clients. They have to get registration from SEBI before starting their operations and have to comply with the prescribed code of conduct. Till recently, most of the brokers work as proprietary or partnership concerns. However, now many top broking firms are company form of organizations. Recent examples are:

- Sharekhan Limited
- India Bulls
- Angel Broking Limited
- India Infoline Limited
- Reliance Money
- Kotak Securities Limited
- ICICI Direct
- Motilal Oswal Securities
- HDFC Securities
Bajaj Capital

Brokers are important intermediaries in the stock market as they bring buyers and sellers together. However, the brokerage on transactions varies from broker to broker. The maximum allowable brokerage is 2.5% of the contract price.

Further, every stock broker should appoint a compliance officer to monitor the compliance of SEBI Act and its various rules, regulations and guidelines and also for redressal of investor grievances. The compliance officer should immediately report any non-compliance observed by him to the SEBI.

SEBI is also empowered to appoint one or more persons as inspectors to inspect the books of accounts, other records and documents of the stockbroker. Also, a stock broker shall only deal with any person as a sub-broker only if he has obtained a certificate of registration from the SEBI. Further, a stock broker or a sub-broker who has contravened any provisions of SEBI Act, rules and regulations are liable for penal actions.

(ii) Custodial Services – The custodians play a critical role in the secondary market. SEBI Custodian of Securities Regulation, 1996 was framed for the proper conduct of their business. According to SEBI regulations, custodial services in relation to securities of a client or gold/gold related instrument held by a mutual fund or title deeds of real estate assets held by a real estate mutual fund mean safekeeping of such securities or gold/gold related instruments or title deeds of real estate assets and providing related services.

The related services provided by them are as follows:

- Maintaining accounts of the securities of a client.
- Collecting the benefits/rights accruing to the client in respect of securities.
- Keeping the client informed of the actions taken by issuer of securities.
- Maintaining and reconciling records of the services as referred above.

SEBI can also ask for information from the custodian in regard to his activities. Such information has to be given within a reasonable period as laid down by SEBI. Further, SEBI is also empowered to conduct inspection/investigation including audit of books of account, records etc. of custodians to ensure that they are being properly maintained. SEBI’s task is also to ascertain that compliance of provisions of SEBI Act and its regulations have been duly complied with. Moreover, his job is also to investigate into complaints received from the investors or clients.

(iii) Depository System – A major reform of the Indian stock markets has been the introduction of the depository system and scripless trading mechanism. The Depository Act was passed in 1996 to provide further fillip to the process.

The issuers should enter into an agreement with the depository to enable the investor to dematerialize the securities.
Before the depository system came into being, the market suffered from various drawbacks including thefts and forgeries of share certificates. Moreover, dealing in the physical mode had its own limitations which inhibited the growth of the capital market in India. These shortcomings were acutely felt more so after the liberalization of the economy. To address all such issues the Central Government enacted the Depositories Act, 1996, with retrospective effect from September 20, 1995.

Is it compulsory for every investor to hold securities in the demat form or can he also hold shares in the physical form? The Depositories Act provides that every person subscribing to securities offered by an issuer has the option to receive the security certificates or hold securities with a depository. However, investors need to note that while securities can be held by way of certificates, dealing in the market is permitted only if the securities are in the demat mode.

When an investor holds securities in the physical form, the certificates bear serial numbers, the distinctive numbers, etc. However, when the securities are held in demat mode, they are akin to money lying in the bank account. Therefore, there is no question of certificate numbers or distinctive numbers, though the quantity will remain the same.

As in the case of certificates, holders of securities in demat mode (called beneficial owners) can create a pledge or hypothecation in respect of the securities held by them. In such cases, it is necessary for the beneficial owner to inform the depository of the pledge or hypothecation created by him. The depository concerned has to make a noting in its records to that effect.

Can the investor, who has opted for holding the securities in demat form, ask for certificates on opting out of the depository. A beneficial owner has a right to opt out of the depository at any time he or she may desire. In fact, the depository has to note the request in its records and also convey the same to the company. The company is obliged to issue the certificates in respect of the securities within 30 days of the receipt of the intimation from the depository.

What can an investor do if a depository or any participant or an issuer fails to redress his grievances? A complaint should be lodged with Sebi giving the necessary particulars in the prescribed form. Sebi would write to the concerned party asking it to redress the grievances of the investors within a specified time. In exceptional circumstances Sebi may grant further time for redressing the grievances. However, if the depository or the participant indulges in dilatory tactics or neglects to redress the grievances, Sebi has power to proceed against such defaulting party and impose penalty. In fact, Sebi has come down heavily on various market intermediaries as also the defaulting companies which ignore the investors and fail to redress their grievances. The heavy penalties that Sebi can impose and in many cases it has done so have come as an eye opener for various market players. *(Source: Financial Express)*

**Secondary Market Structure**

**SEBI Registered Market Intermediaries**

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## Market Intermediaries

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Source: SEBI handbook of statistics

4. **DEMUTUALIZATION OF STOCK EXCHANGES**

Demutualization is the process by which any member owned organization can become a shareholder owned company. Such a company can either be listed on a stock exchange or be established as a closely held company. In simple words, a demutualized stock exchange is basically a company form of organization in which the company goes public and owners will be given equity shares.

Earlier (i.e. prior to 1991), all stock exchanges in India are broker owned and broker controlled. In other words, it is the brokers who collectively owned, controlled and managed these exchanges. However, the ownership and managership of these stock exchanges led to a conflict of interest where the interest of these brokers was given prominence than the investors. These led to price rigging, frequent payment...
crises on stock exchanges and misuse of official position by office bearers. Therefore, demutualization of stock exchange was resorted to instill confidence in the minds of the investors.

So, through the demutualization process, a stock exchange becomes a profit making company and a tax paying entity. Demutualization separates the ownership and control of stock exchange from the trading rights of members. This reduces the conflict of interest and also the chances of brokers using the trading mechanism for personal gains.

In November 2002, SEBI approved the uniform model of corporatization and demutualization of stock exchanges, recommended by the Kania Committee. Further, Securities Contract Regulation Act was amended on October 12, 2004, through an ordinance, making it compulsory for the exchanges to convert into corporate entities and delink their broker members from the management. The ordinance restricts brokers’ representation in the governing body of stock exchanges to 25%. It also reduces their shareholding from 100% to 49%. Moreover, 51% of the stake of the stock exchange should be held by the public. This segregation was initiated to safeguard the interest of shareholders, bring greater transparency and efficiency of stock exchanges.

**Advantages of Demutualization**

(i) Enable stock exchanges to have more access to funds for investment in technology.

(ii) Facilitate merger and acquisition of other exchanges.

(iii) Facilitate alliances with other stock exchanges.

(iv) Benefit to members of the stock exchange as their asset becomes liquid.

(v) Members get share of the profits made by exchanges through dividends.

(vi) Makes operations of the stock exchanges transparent.

(vii) Transparency brings better governance.

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**5. SHARE TRADING IN SECONDARY MARKET**

Secondary Market or Stock Exchange Market refers to a market where securities are traded after being initially offered to the public in the primary market and/or listed on the Stock Exchange. Majority of the trading is done in the secondary market. Secondary market comprises of equity markets and the debt markets. For the general investor, the secondary market provides an efficient platform for trading of his securities. For the management of the company, secondary equity markets serve as a monitoring and control conduit—by facilitating value-enhancing control activities, enabling implementation of incentive-based management contracts, and aggregating information (via price discovery) that guides management decisions.

*Share Trading by a Retail Investor*

One can either choose to trade online or via a stockbroker or investment firm or an agent. One needs to take following steps to conduct trade in secondary market in India:
(i) **Open a Bank Account**: The first step towards investing in Indian stock market is to open a bank account. A bank account is required to hold the funds which would be investing in secondary market.

(ii) **Open a Demat Account**: Just as a bank account is required to hold the funds, a Demat Account is required to hold and trade the securities i.e. Shares, debentures and mutual funds electronically.

(iii) **Open a trading account**: After opening a Demat account, a trading account is required to trade in securities market. A trading/brokerage account allows you to purchase stocks, bonds, mutual funds, and other units by paying the broker to do the trading on your behalf. A retail investor would not be able to do trading without a trading account. Now, many banks have started providing all these services in a single unified account. The trading platform of a stock exchange is accessible only to trading members. The brokers would give buy/sell orders either on their own account or for their clients.

(iv) **Trading Mechanism**: Trading at Stock exchange takes place through an open electronic limit order book, in which order matching is done by the trading computer. The market orders placed by investors are automatically matched with the best limit orders. As a result, buyers and sellers remain anonymous. The advantage of an order driven market is that it brings more transparency, by displaying all buy and sell orders in the trading system. However, in the absence of market makers, there is no guarantee that orders will be executed.

Investors buy/sell securities on stock exchange platform by placing buy/sell orders through their stock brokers with whom they are registered as client. On successful execution of order (buy/sell), securities will be bought/sold on behalf for the client. This activity is known as buying/selling of securities on the stock exchange platform on specific days which is known as trading day. This activity is referred to as trading and is carried out by stock exchanges for a specific period called trading hours. After the trading activity is completed, the process of delivering securities by the seller and payment of funds by the buyer is called securities pay-in/funds pay-in respectively. This activity also has to be conducted within a stipulated time period. After the pay-in process is completed successfully, the buyer will get shares and the seller will get money. The above mentioned activities of, pay-in and, payout are collectively referred to as settlement process. Each settlement is identified by a unique number called settlement id/Settlement number.

(v) **Payment to Broker for purchase of shares/securities**: The payment for the shares purchased is required to be done prior to the pay-in date for the relevant settlement or as otherwise provided in the Rules and Regulations of the Exchange.

(vi) **Delivery of shares to the broker for sale**: The delivery of shares has to be done prior to the pay-in date for the relevant settlement or as otherwise provided in the Rules and Regulations of the Exchange and agreed with the broker/sub broker in writing.

(vii) **Receipt of money for a sale transaction and receipt of shares for a buy transaction**: Brokers were required to make payment or give delivery within two working days of the pay-out day. However, as settlement cycle has been reduced from T+3 rolling settlement to T+2, the pay out of funds and securities to the clients by the broker will be within 24 hours of the payout.
The stock exchanges are meant to facilitate mobilization of resources by companies. Their effective regulation is required for protecting the interests of investors and safeguarding their developmental role.

The Securities Contracts (Regulation) Act 1956 along with the Securities Contracts (Regulation) Rules 1957 has been the main laws to regulate the securities market in India. As per the Securities Contracts Regulations Act, 1956, a stock exchange is defined as "an association, organization or body of individuals whether incorporated or not, established for the purpose of assisting, regulating and controlling business in buying, selling and dealing in securities". A look at the powers given to stock exchanges in India to make and enforce bylaws under the Act and the rules reveals that Indian Stock Exchanges have been envisaged as self-regulatory organizations.

6.1 Growth of Stock Exchanges

The history of Stock Exchanges in India goes back to the eighteenth century, when securities of the East India Company were transacted. There were 50-60 brokers led by the legendary Premchand Roychand. They formed the backbone of share floatation by East India Company and a few commercial banks. Corporate shares made their entry in the 1830s and assumed significance with the enactment of the Companies Act in the 1850s. The Bombay Stock Exchange, the oldest stock exchange in India was established in 1875 under the name, “Share and Stockbrokers Association”.

The stock exchanges are tightly regulated as self-regulatory organizations (SROs) under the Act. In addition to ordinary regulatory powers over the stock exchanges, the Central Government and/or SEBI may nominate up to three members to the board of each stock exchange [Section 4(2)(iii) of the SC(R) Act, 1956 and Section 10 of SC(R) Rules, 1957]. The government and/or the agency have the authority to make, approve and amend the byelaws of the stock exchanges [Section 4(1)(a) & 8 of the SC(R) Act, 1956]. In return, the stock exchanges have been granted a strong disciplinary authority (as well as obligations) over their member stockbrokers.

6.2 Leading Stock Exchanges in India:

The two leading stock exchanges in India are Bombay Stock Exchange (BSE) and National Stock Exchange (NSE). A brief about them is as under:

(a) Bombay Stock Exchange Limited: It is the oldest stock exchange in Asia and was established as "The Native Share & Stock Brokers Association" in 1875. It is the first stock exchange in the country to obtain permanent recognition in 1956 from the Government of India under the Securities Contracts (Regulation) Act, 1956. The Exchange's pivotal and pre-eminent role in the development of the Indian capital market is widely recognized and its index, SENSEX, is tracked worldwide. Initially, an Association of Persons (AOP), the Exchange is now a demutualised and corporatized entity incorporated under the provisions of the Companies Act, 1956, pursuant to the BSE (Corporatisation
and Demutualisation) Scheme, 2005 notified by the Securities and Exchange Board of India (SEBI). The systems and processes of the Exchange are designed to safeguard market integrity and enhance transparency in operations.

The Exchange provides an efficient and transparent market for trading in equity, debt instruments and derivatives. The BSE's On Line Trading System (BOLT) is a proprietary system of the Exchange and is BS 7799-2-2002 certified. The surveillance and clearing & settlement functions of the Exchange are ISO 9001:2000 certified.

(b) National Stock Exchange: Report of the High Powered Study Group on Establishment of New Stock Exchanges recommended promotion of a National Stock Exchange by financial institutions (FIs) to provide access to investors from all across the country on an equal footing. It was incorporated in November 1992 as a tax-paying company unlike other stock exchanges in the country.


It uses satellite communication technology to energize participation from around 320 cities spread all over the country. NSE can handle up to 6 million trades per day in Capital Market segment.

NSE is one of the largest interactive Very Small Aperture Terminal (VSAT) based stock exchanges in the world. It supports more than 3000 VSATs. The NSE- network is the largest private wide area network in the country and the first extended C- Band VSAT network in the world. Currently more than 9000 users are trading on the real time-online NSE application. There are over 15 large computer systems which include non-stop fault-tolerant computers and high end UNIX servers, operational under one roof to support the NSE applications. This coupled with the nationwide VSAT network makes NSE the country's largest Information Technology user.

6.3 Stock Exchanges Abroad

With the increasing globalization and liberalization, the prices of securities on Indian stock exchanges are influenced by stock exchanges abroad. Under this heading we have tried to give a brief introduction of the major stock exchanges abroad.

(a) New York Stock Exchange (NYSE): The New York Stock Exchange was established more than 200 years ago in 1792. NYSE is the world’s foremost securities marketplace.

Each day on the NYSE trading floor an auction takes place. Open bid and offers are managed on the Trading Floor by Exchange members acting on behalf of institutions and individual investors. Buy and sell orders for each listed security meet directly on the trading floor in assigned locations. Prices are determined through supply and demand. Stocks buy and sell orders funnel through a single location, ensuring that the investor, no matter how big or small, is exposed to a wide range of buyers and sellers.
(b) **Nasdaq:** Nasdaq is known for its growth, liquidity, depth of market and the world’s most powerful, forward-looking technologies. All these make Nasdaq choice of the leading companies worldwide. Since its inception in 1971, Nasdaq has steadily outpaced the other major markets to become the fastest-growing stock market in the U.S. Nasdaq is a screen-based market, operating in an efficient, highly competitive electronic trading environment.

As the market for Nasdaq’s largest and most actively traded securities, the Nasdaq National Market lists more than 4,000 securities. To be listed on the National Market, a company must satisfy stringent financial, capitalization, and corporate governance standards. Nasdaq National Market companies include some of the largest, best known companies in the world.

In contrast to traditional floor-based stock markets, Nasdaq has no single specialist through which transactions pass. Nasdaq’s market structure allows multiple market participants to trade stock through a sophisticated computer network linking buyers and sellers from around the world. Together, these participants help ensure transparency and liquidity for a company’s stock while maintaining an orderly market and functioning under tight regulatory controls.

(c) **London Stock Exchange:** Its history goes back to 1760 when 150 brokers kicked out of the Royal Exchange for rowdiness formed a club at Jonathan’s Coffee House to buy and sell shares. In 1773, members voted to change the name to Stock Exchange and 2000 shareholders voted it to become a public limited company and thus London Stock Exchange was formed. Dealing in shares is conducted via an off-market trading facility operated by Cazenove and Co.

London Stock Exchange provides a range of services for companies and investors:

(i) **Company Services** - It provides a number of markets which allow companies large and small to raise capital, and a range of services to increase the profile of the companies.

(ii) **Trading Services** - It gives market users access to a well-developed trading environment with a proven record of stability and flexibility.

(iii) **Information Services** - It provides high quality real-time price information to market users worldwide, as well as historical and reference data.

Supporting these activities, the exchange regulates the markets to give protection to investors and companies and to maintain its reputation for high standards and integrity. In addition, in partnership with others, it helps to track the performance of the markets through various indices.

**6.4 Characteristics of Stock Exchanges in India**

Traditionally, a stock exchange has been an association of individual members called member brokers (or simply members or brokers), formed for the express purpose of regulating and facilitating the buying and selling of securities by the public and institutions at large. A stock exchange in India operates with due recognition from the Government under the Securities & Contracts (Regulations) Act, 1956. Corporate membership of stock exchanges has also been introduced lately. As you know, there are at present 20 stock exchanges in India.
A stock exchange is typically governed by a board, consisting of directors. Some Members of the Board are nominated by the Government. Government nominees include representatives of the Ministry of Finance, as well as some public representatives, who are expected to safeguard the interest of investors in the functioning of the exchanges. The board is headed by a President, who is an elected member, usually nominated by the government, from among the elected members. The Executive Director, who is appointed by the stock exchange with government approval, is the operational chief of the stock exchange. His duty is to ensure that the day-to-day operations of the stock exchange are carried out in accordance with the rules and regulations governing its functioning. Securities and Exchanges Board of India (SEBI) has been set up in Mumbai by the Government to oversee the orderly development of stock exchanges in the country. All companies wishing to raise capital from the public are required to list their securities on at least one stock exchange. Thus, all ordinary shares, preference shares and debentures of publicly held companies are listed in one or more stock exchanges. Stock exchanges also facilitate trading in the securities of the public sector companies as well as government securities.

6.5 Functions of Stock Exchanges

The Stock Exchange is a market place where investors buy and sell securities. Functions of the stock exchanges can be summarized as follows:

(a) Liquidity and Marketability of Securities: The basic function of the stock market is the creation of a continuous market for securities, enabling them to be liquidated, where investors can convert their securities into cash at any time at the prevailing market price. It also provides investors the opportunity to change their portfolio as and when they want to change, i.e. they can at any time sell one security and purchase another, thus giving them marketability.

(b) Fair Price Determination: This market is almost a perfectly competitive market as there are large number of buyers and sellers. Due to nearly perfect information, active bidding take place from both sides. This ensures the fair price to be determined by demand and supply forces.

(c) Source for Long term Funds: Corporates, Government and public bodies raise funds from the equity market. These securities are negotiable and transferable. They are traded and change hands from one investor to the other without affecting the long-term availability of funds to the issuing companies.

(d) Helps in Capital Formation: There is nexus between the savings and the investments of the community. The savings of the community are mobilized and channeled by stock exchanges for investment into those sectors and units which are favoured by the community at large, on the basis of such criteria as good return, appreciation of capital, and so on. It is the preference of investors for individual units as well as industry groups, which is reflected in the share price that decides the mode of investment. Stock exchanges render this service by arranging for the preliminary distribution of new
issues of capital, offered through prospectus, as also offers for sale of existing securities, in an orderly and systematic manner. They themselves administer the same, by ensuring that the various requisites of listing (such as offering at least the prescribed minimum percentage of capital to the public, keeping the subscription list open for a minimum number of days, making provision for receiving applications at least at the prescribed centres, allotting the shares against applications on a fair and unconditional basis) are duly complied with.

Members of stock exchanges also assist in the flotation of new issues by acting (i) as brokers, in which capacity they, inter alia, try to procure subscription from investors spread all over the country, and (ii) as underwriters. Stock exchanges also provide a forum for trading in rights shares of companies already listed, thereby enabling a new class of investors to take up a part of the rights in the place of existing shareholders who renounce their rights for monetary considerations.

(e) Reflects the General State of Economy: The performance of the stock markets reflects the boom and depression in the economy. It indicates the general state of the economy to all those concerned, who can take suitable steps in time. The Government takes suitable monetary and fiscal steps depending upon the state of the economy.

6.6 Basics of Stock Market Indices

6.6.1 Stock Market Index: It is representative of the entire stock market. Movements of the index represent the average returns obtained by investors in the stock market. A base year is set along with a basket of base shares. The change in the market price of these shares is calculated on a daily basis. The shares included in the index are those shares which are traded regularly in high volume. In case the trading in any share stops or comes down then it gets excluded and another company’s shares replaces it.

Each stock exchange has a flagship index like in India, Sensex of BSE and Nifty of NSE and outside India is Dow Jones, FTSE etc.

6.6.2 Concept behind Fluctuations of Index: Stocks are valued by discounting future earnings of a company; therefore, stock indices reflect expectation about future performance of the companies listed in the stock market or performance of the industrial sector. When the index goes up, the market thinks that the future returns will be higher than they are at present and vice versa.

Stock prices are sensitive to Company specific news and Country specific news (which includes budget, elections, government policies, wars and so on)

6.6.3 Computation of Index: Following steps are involved in calculation of index on a particular date:

- Calculate market capitalization of each individual company comprising the index.
Calculate the total market capitalization by adding the individual market capitalization of all companies in the index.

Computing index of next day requires the index value and the total market capitalization of the previous day and is computed as follows:

\[
\text{Index Value} = \frac{\text{Total market capitalisation for current day}}{\text{Total capitalisation of the previous day}} \times \text{Index on Previous Day}
\]

It should also be noted that Indices may also be calculated using the price weighted method. Here, the share price of the constituent companies forms the weight. However, almost all equity indices world-wide are calculated using the market capitalization weighted method.

7. RISK MANAGEMENT IN SECONDARY MARKET

The stock exchanges have developed a comprehensive risk management mechanism to promote a safe and efficient capital market. These include:

- Laying down trading rules and regulations for broker members.
- Setting up market surveillance systems to curb excess volatility.
- Creating trade/settlement guarantee fund to ensure timely settlements even if a member defaults to deliver securities or pay cash.
- Setting up a clearing corporation to guarantee financial settlement of all trades and thereby reduce credit risk in the settlement system.

The Risk Management structure of Secondary Market (or stock exchanges) has been discussed in detail in the following paragraphs to enable students to have a good grasp over the nuances of secondary market.

I. Trading Rules and Regulations

Strict rules and regulations have been framed to prevent unfair trading practices and insider trading. Stock exchanges impose different types of margins on brokers for individual stocks, depending upon the exposures taken by these brokers in these stocks, both on ownership basis and on behalf of clients. These margins are collected to prevent brokers from taking market positions in excess of their buying capacity. They are also used to settle any amount due to the stock exchange, clearing corporation and traders, in case the broker faces any shortage of amount.

Further, there is a real time monitoring of the intra-day trading limits and gross exposure limits by the stock exchanges. There is an automatic deactivation of trading terminals in case of breach of exposure limits. Also, SEBI stipulated that stock brokers and sub-brokers of one exchange cannot
deal with the brokers and sub-brokers of the same exchange either for proprietary trading or for trading on behalf of their clients. However, they can deal with the brokers and sub-brokers of another exchange for proprietary trading only.

Moreover, to ensure fair trading practices, the SEBI has devised insider trading regulations by prohibiting insider trading and making it a criminal offence. To ensure transparency in the takeover process, SEBI takeover regulations have been made.

II. Circuit Breakers to curb excess volatility

Circuit Breaker is a temporary halt or suspension of trading in any particular stock or index for certain period of time. The move is basically resorted to curb excess volatility in the stock market.

There are two methods by which circuit breakers are practiced:

1. Suspension of trade in a security or index for a certain period.

2. Suspension of trade in a security or index for the entire trading day.

In case of first option, trading activities are suspended for few hours to enable the market to settle down. This also allows market participants to make an informed decision by having a relook at the market. If the market is very volatile and it seems that it is going out of control, then the trading may be halted for the entire day.

Advantages of Circuit Breakers

(i) During the suspension period, circuit breakers allow participants to reassess the situation by gathering new information.

(ii) It helps in controlling panic among the investors.

(iii) It also helps exchange clearing houses to monitor their members.

(iv) It also helps investors to take a rational approach towards the security during the time the trading is suspended.

Disadvantages of Circuit Breakers

(i) Firstly, circuit breakers prevents true discovery of price for the period during which it is imposed.

(ii) Secondly, sometimes circuit breakers prove to be unfair to retail investors because well informed investors such as foreign institutional investors usually makes a move before the circuit breaker can be invoked leading to chaos and confusion among retail investors.

The extent of duration of the market halt and pre-open session is as given below:
Circuit Breaker

<table>
<thead>
<tr>
<th>Trigger limit</th>
<th>Trigger Time</th>
<th>Market halt duration</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>Before 1 p.m.</td>
<td>1 Hour</td>
</tr>
<tr>
<td></td>
<td>At or after 1 p.m. up to 2.30 p.m.</td>
<td>30 minute</td>
</tr>
<tr>
<td></td>
<td>At or after 2.30 p.m.</td>
<td>No halt</td>
</tr>
<tr>
<td>15%</td>
<td>Before 1 p.m.</td>
<td>2 hours</td>
</tr>
<tr>
<td></td>
<td>At or after 1 p.m. up to 2.30 p.m.</td>
<td>1 hour</td>
</tr>
<tr>
<td></td>
<td>On or after 2 p.m.</td>
<td>Remainder of the day</td>
</tr>
<tr>
<td>20%</td>
<td>Any time during market hours</td>
<td>Remainder of the day</td>
</tr>
</tbody>
</table>

III. Trading and Settlement

Rolling settlement is basically settlement of transaction in stock market in a certain number of days after the trade is agreed.

Rolling settlement can be explained with the help of following table:

<table>
<thead>
<tr>
<th>Activity</th>
<th>Description of Activities</th>
<th>Day</th>
<th>Timings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trading</td>
<td>Trading by investors</td>
<td>T day</td>
<td></td>
</tr>
<tr>
<td>Clearing</td>
<td>National Securities Clearing Corporation Ltd. (NSCCL) confirms the trade from stock exchange. Then, NSCCL process and download obligation files to brokers.</td>
<td>T + 1</td>
<td>By 1.30 P.M.</td>
</tr>
<tr>
<td>Settlement</td>
<td>Pay-in of securities and funds to NSCCL. NSCCL gives pay out of securities and funds.</td>
<td>T + 2</td>
<td>By 10.30 A.M. By 1.30 P.M.</td>
</tr>
</tbody>
</table>

The above chart has been explained in the next paragraph:

Trading Day (T Day)

T stands for trading. Trading can be done during the entire day i.e. from 9.00 A.M. to 3.30 P.M. Trading can be done on any working day (except Saturday and Sunday and other holidays as intimated by the stock exchange from time to time). During the trading process, one investor buys
the shares and other investor purchases the shares. After the execution of trading, the buyer receives the shares and the seller receives money for the shares he parted.

Clearing Activities (T+1 day)

Clearing is a process of determination of obligations, after which obligations are discharged by settlement. On the T+1 day i.e. one day after the trading day, first of all, the National Securities Clearing Corporation Ltd. (NSCCL) confirms the trade executed during the day from the Stock Exchange which helps it to determine the obligation of each member (broker) in terms of funds and securities. After that, the netting of obligations is done. This entire process of determining the obligation is done by the custodians/clearing corporation which works under the NSCCL. Once the netting of obligation is done, all the files are processed and downloaded so that each broker knows what he has to pay-in and receive.

Netting explained

Suppose, an investor buys 100 shares @ Rs. 2000 each on Monday and sell those shares @ 2500 each on the same day. His net obligation in terms of funds and securities will be calculated on Tuesday. In terms of securities, his net obligation is nil as he has sold all the shares he bought. So, he will neither receive nor give any security. On the other hand, his net monetary obligations will be calculated taking into account his buying and selling amount. In this case, the net amount he is receiving is Rs. 50000 (100 shares x Rs. 2500 – 100 shares x Rs. 2000). This pay-in and pay-out of funds are calculated on T+2 day i.e. on Wednesday.

Settlement Activities (T+2 Day)

On the second working day i.e. T+2 day, all the brokers has to pay-in the required funds and securities to the NSCCL by 10.30 A.M. giving the required instructions to the respective clearing banks and members on the same day. Moreover, by 1.30 on the same day, brokers get the required funds through the NSCCL. This is called pay-out of funds.

Pay-in and pay-out of funds explained

Pay-in of funds take place when NSCCL gives the required funds to the clearing corporation by giving instructions to the clearing bank which credits the account of clearing corporation and debit the accounts of clearing bank. This is called pay-in of funds. After that, the NSCCL gives electronic instructions to the clearing banks to credit accounts of clearing members and debit accounts of the clearing corporation. This is called pay-out of funds and this completes the settlement cycle.

Pay-in and pay-out of securities explained

Pay-in of securities means that shares that the shareholder wants to sell are picked up from their Demat account and transferred to the broker's account. All these shares are then delivered to the clearing corporation. In pay-out of securities, the shares that the investor wants to buy are received from the clearing corporation and then transferred to the broker's account. After that, the shares are transferred from the broker's account to the buyer's demat account.
IV. National Securities Clearing Corporation Limited

In April 1995, the NSE set up the National Securities Clearing Corporation Limited (NSCCL), its wholly owned subsidiary, to undertake clearing and settlement at the exchange. It started operations from April 1996. The NSCCL undertakes the counter party risk of each member and guarantees settlement. Settlement guarantee is a guarantee provided by the clearing corporation for the settlement of all trading of products in the stock exchange. The organizations linked with Clearing Corporation in the clearing and settlement process are discussed as below:

(a) Custodians/Clearing Members: NSCCL takes trading information from the exchange and pass the trade details to custodians/clearing members. Custodians confirm the obligations of the parties by netting.

(b) Clearing Banks: They act as a link between clearing corporation and clearing member. Every clearing member is required to maintain a clearing account with one of the clearing banks. A clearing bank has to enter into an agreement with the NSCCL and clearing member and open clearing account with the depository.

(c) Depositories: They hold securities in dematerialized form for the investors in their beneficiary account. Every clearing member is required to maintain a clearing pool account with the depositories.

The clearing banks, on receiving electronic instructions from the NSCCL, debit accounts of clearing banks and credit accounts of the clearing corporation. This is termed as pay-in of funds and securities. The NSCCL, after providing for shortages of funds and securities, sends electronic instructions to the depositories and clearing banks to credit accounts of clearing members and debit accounts of the clearing corporation. Thus, the settlement cycle is completed once the pay out of funds and securities is done.

V. Market Making System

The job of the market maker is to provide liquidity to the stock market by providing a two way quote i.e. a buy and a sell quote. How do the market makers do this? And what is the purpose. Consider a situation, when you want to purchase shares and there is no one there to sell his share. What will happen? Such a person has to wait until he finds a person who can sell his shares at a price quoted by him. The market maker resolves this problem. He sells shares at the quoted price. This way, the person gets the shares he wants to sell. Conversely, if a person wants to sell his shares, market maker may come at his rescue and purchase shares at the price quoted by him. So, he gets the shares he was so willing to purchase. Hence, market maker has devised a system in which anyone can buy and sell shares anytime.

Market makers are basically large brokerage houses. But, how do they make money? And, there is a chance that they may suffer loss. For e.g. if they buy shares at a particular price and are not able to sell them later at a higher price because of fall in market price of shares, they will incur loss. To offset this loss, they purchase shares at a particular price (ask price) say Rs. 100 and sell them at
a slightly higher price say Rs. 100.10 (bid price). This profit margin of 0.10 seems to be very nominal. But, when trading of millions of shares takes place in a day, the market maker at the end of the day managed to pocket a significant amount.

The obligations and responsibilities of Market Makers (as per BSE website)

The Market Maker shall fulfill the following conditions to provide depth and continuity on this exchange:

a. The Market Maker shall be required to provide a 2-way quote for 75% of the time in a day. The same shall be monitored by the stock exchange. Further, the Market Maker shall inform the exchange in advance for each and every black out period when the quotes are not being offered by the Market Maker.

b. The minimum depth of the quote shall be Rs.1,00,000/- . However, the investors with holdings of value less than Rs 1,00,000 shall be allowed to offer their holding to the Market Maker in that scrip provided that he sells his entire holding in that scrip in one lot along with a declaration to the effect to the selling broker.

c. Execution of the order at the quoted price and quantity must be guaranteed by the Market Maker, for the quotes given by him.

d. There would not be more than five Market Makers for a scrip. These would be selected on the basis of objective criteria to be evolved by the Exchange which would include capital adequacy, networth, infrastructure, minimum volume of business etc.

e. The Market Maker may compete with other Market Makers for better quotes to the investors;

f. Once registered as a Market Maker, he has to start providing quotes from the day of the listing / the day when designated as the Market Maker for the respective scrip and shall be subject to the guidelines laid down for market making by the exchange. Once registered as a Market Maker, he has to act in that capacity for a period as mutually decided between the Merchant Banker and the market maker.

g. Further, the Market Maker shall be allowed to deregister by giving one month notice to the exchange.

VI. Securities Lending and Borrowing (SLB)

Securities lending means lending of stocks, derivatives and other securities to investor or firm. Securities lending requires the borrower to pledge, whether cash, security or a letter of credit to the lender. When a security is lent, the title and the ownership are also transferred to the borrower.

Why securities lending and borrowing is important? The Securities lending and borrowing has its importance in short selling. Basically, short selling is a facility in which a person (short seller) can sell shares which he does not own or possess. What is the advantage of doing that? The short seller borrows security to immediately sell them. He generally does that when he has a firm belief
that security prices will come down in the near future. So, he borrows security hoping to profit by selling the security and buying it back at a lower price. The borrower of securities pays the lender interest on the value of the securities borrowed.

The borrower of securities are usually brokers, speculators, market makers, custodian banks, clearing banks, clearing corporation, and finance companies. The lenders are mutual funds, insurance companies, custodian banks, finance companies, brokers and high net worth individuals.

Further, the lender still remains the owner of stock after SLB and gets all beneficial rights such as dividend, rights or bonus shares in respect of the stock lent. The borrower, however, has the legal title of the borrowed securities and is eligible to trade and sell securities in any manner he thinks fit. Moreover, there is roll over facility also i.e. the lender and borrower can extend the period of their borrowing and lending respectively.

Merits of Stock Lending and Borrowing

(i) Provides facility to the borrowers who are anticipating fall in the market price of securities to sell securities which they don’t own.

(ii) Provides an incentive to institutional investors such as banks, mutual funds, financial institutions and insurance companies to earn income by lending their idle stock in the market and earn interest income from borrowers.

(iii) Increase liquidity of the stock as more and more people can sell or purchase stock inspite of shortage of money.

(iv) Providing stability to stock market movements.

(v) Helps to avoid delivery failures as it is routed through the clearing house and facilitates timely delivery.

(vi) And, lastly, manipulation of stock prices is difficult.

VII. Straight Through Processing (STP)

The concept of Straight Through Processing is designed to complete the transaction without human intervention. Straight through processing (STP) is an initiative that financial companies use to optimize the speed at which they process transactions. This is performed by allowing information that has been electronically entered to be transferred from one party to another in the settlement process without manually re-entering the same pieces of information repeatedly over the entire sequence of events.

The primary purpose of STP is to streamline the processing of transactions across multiple points. By allowing information to pass along electronically, this eliminates the need for a hands-on reentry of data that has already been completed at the source. Additionally, information could be sent to more than one party simultaneously if it is appropriate for the transaction type.

So, the purpose of STP is to eliminate costly delays during transaction processing period. Since
manual assistance is not needed, there is no delay between one party receiving information and the other being able to proceed further.

In normal processing, information must be handled by the multiple persons involved. This requires taking the time to accept and review the information, rekeying data as required, and then sending it forward to the next part of the transaction process. STP eliminates the human factor, allowing an automated process to complete any steps needed for a transaction to proceed. By eliminating these delays, the transactions can be more cost-effective as they require less time to manage. This is particularly attractive to investors looking for lower fee options.

The benefit of STP can be explained with the help of an example. In a manual trade, the broker issues a contract note which is then passed on to the custodian or a depository participant. There are multiple data entries during the different stages of a manual trade which makes the process prone to errors, delays and manipulation. However, in STP, contract note is issued in electronic form and the trade is settled in computer leaving almost no scope for manipulation. Further, in comparison to manual trade, STP is quicker, risk free and eliminates any failure in trade. (Source: Investopedia)

**VIII. Margin Trading**

Margin Trading is a facility given to the investors in which they can invest in shares by part financing from the bank. In other words, investors can provide some amount of money from their pocket to invest in shares, and rest of the amount will be financed by the banks. Margin trading permits investors to buy shares by providing 40% of the total value as margin, while borrowing 60% from the banks.

For example, an investor wants to buy 20000 shares worth Rs. 2,00,000 (price of one share is Rs. 10). But, he can invest only Rs. 80000 from his own pocket. However, under margin trading, he can buy as many as 20000 shares worth Rs. 200000 from his broker by paying Rs. 80000 as margin and by borrowing the balance Rs. 120000 from a bank through his broker. The broker pledges 20000 shares with the bank. The bank has collateral of Rs. 200000 backing the loan of Rs. 120000.

Now, suppose, the market price of share moves upwards from Rs. 10 to Rs. 15. So, with the help of the facility of margin trading, the shareholder can sell his entire shareholding of 20000 shares and pocket a gain of Rs. 100000 (20000 shares x Rs. 15 – 20000 shares x Rs. 10). Conversely, if he hadn’t availed the facility of margin trading, he would have been able to sell only 8000 shares and pocketed a gain of Rs. 40000 only. The reason is that he would have purchased only 8000 shares because of paucity of funds.

On the other hand, if the market price of shares fall below Rs. 10, the bank will give a margin call under which the investors will have to furnish additional funds/securities for the broker to pass on to the bank.

Margin trading gives a unique opportunity to the bank to lend short term funds at a high rate of interest. However, banks have to evolve a suitable risk management mechanism to safeguard the loans given by them against collateral of securities. In the same way, it provides a facility to the investors to borrow money from the bank and invest it in the stock market.
8. INDIAN DEBT MARKET

Debt market refers to the financial market where investors buy and sell debt securities, mostly in the form of bonds. These markets are important sources of funds, especially, in a developing economy like India. Fixed income instruments could be securities issued by Central and State Governments, Municipal Corporations, Govt. Bodies or by private entities like financial institutions, banks, corporates, etc. Debt markets are vital to the sustained growth of any economy since they offer efficient mobilisation and allocation of financial resources. Debt instruments are used to finance developmental activities undertaken by the Government. They also aid in managing the liquidity in the economy. Debt market is said to be a useful source of finance for Government of India. Currently, Indian economy has a deficit of 4.5% of GDP and is mainly financed through debt funding from different sources. The government securities form a major part of the Indian debt market. As we can see from the table below, the outstanding debt of the Indian government forms 39.5% of the GDP, which is at par with that of the other developing and developed economies. The investors in the Indian debt market also favour government securities.

8.1 Indian debt market can mainly be classified into two categories:

(i) Government Securities Market (G-Sec Market): It consists of central and state government securities. It means that, loans are being taken by the central and state government. It is also the most dominant category in the India debt market.

(ii) Bond Market: It consists of Financial Institution bonds, Corporate bonds and debentures and Public Sector Unit bonds. These bonds are issued to meet financial requirements at a fixed cost and hence remove uncertainty in financial costs.

In 2011, the outstanding issue size of Government securities or G-secs (Central and State Government) was close to INR 28 lakh crores or USD 622 billion (IndiaStat, 2012) with a secondary market turnover of around INR 53 lakh crores or USD 1.18 trillion (RBI, 2012). In contrast, the outstanding issue size of Corporate bonds was only INR 9 lakh crores or USD 200 billion (Khan, 2012) and secondary market turnover roughly INR 6 lakh crores or USD 133 billion (SEBI, 2010) in 2011. Turnover in the Indian equity market was roughly INR 47 lakh crores or USD 1.04 trillion (RBI, 2012) in the same time period.

The corporate debt market can be classified into Primary market and Secondary market. In the primary market, corporate debt is via private placements like corporate bonds placed with wholesale investors like banks, financial institutions, mutual funds, etc. The Secondary market for corporate debt is available on platforms offered by various exchanges in the country.

The secondary debt market in India can be broadly categorised into –

(a) Wholesale Debt Market – comprising of investors like Banks, financial institutions, RBI, insurance companies, Mutual funds, corporates and FIIs.
(b) Retail Debt Market — comprising of investors like individuals, pension funds, private trusts, NBFCs and other legal entities.

There are two types of transactions in the market -

1. Direct transactions between wholesale market participants. These account for approximately 25% of the wholesale market volumes.

2. Broker intermediated transactions i.e. where brokers undertake dealings for banks, institutions or other entities.

8.2 Why do we need a Debt Market?

Debt markets are vital for the sustained growth of any economy since they offer efficient mobilisation and allocation of financial resources. Debt instruments are used to finance developmental activities undertaken by the Government. They also aid in managing the liquidity in the economy. Borrowings from the debt market allow the Government to reduce its dependence on external sources of funding. It also reduces the pressure on institutional financing to fund public sector or private sector projects.