ii. Secondary Securities Market

Modernization of market infrastructure improves market transparency standard. The improvement of market micro-structure increases trading efficiency. Risk containment measures help in improving market integrity and safety. Rolling settlement enhances liquidity and also provides for faster settlement**.** These have been the main focus of the SEBI's efforts in the secondary market. The SEBI extends its oversight to 23 stock exchanges in the country and directs its efforts towards encouraging them to become more effective and efficient self-regulatory organisations. The measures taken by the SEBI in 1999-2000 in the secondary market are discussed below.

Depositories and paperless trading and other related issues

Dematerialisation of securities is one of the major steps for improving and modernizing market and enhancing the level of investor protection through elimination of bad deliveries and forgery of shares, and expediting the transfer of shares. Recognizing the far reaching benefits that would accrue to the market through the removal of physical securities, the speeding up of dematerialisation process has been high on the agenda of the SEBI. During the year 1999-2000, the SEBI continued its policy to enhance the growth of paperless trading and electronic book entry transfer but in a phased manner so as to allow time for required infrastructure to develop and to gain acceptance of the investors and the market. The following measures have been taken by the SEBI during the year under review :

- The SEBI issued directive to the companies included in the list of securities for dematerialisation to effect compulsory dematerialised trading for all investors and institutional investors on the scheduled dates announced and to sign agreements and complete all formalities with both the depositories and establish connectivity on time so that dematerialisation could proceed on schedule.

- Companies whose shares are being traded compulsorily in dematerialised form by all investors, are required to compulsorily provide for transfer and dematerialisation of securities simultaneously. This will help the investors in reducing the time taken for transfer of shares.

- The SEBI (Depositories and Participants) Regulation, 1996 was amended to include registrars to an issue or share transfer agents in the eligible category to become a depository participant.

- Introduction of procedures for interconnectivity between the various segments and components involved in the process of dematerialisation and its smooth functioning at various levels of participantion in dematerialised securities.

- In respect of the value of portfolio of securities of the beneficiary accounts, the broker DPs allowed to maintain client assets in custody to the extent of 100 times of broker's networth from the earlier limit of 35 times upto a networth of Rs.750 lakhs and 50 times above the networth of Rs. 750 lakh .

- The branch offices of DPs that are handling more than 5000 accounts shall either have direct electronic connectivity with the depository or with office of depository participant that is connected live to the depository. This would adequately equip the infrastructure of the depository participant branches so that the reach of the DPs could be increased and the branches could serve the investors better, while ensuring that the branches have adequate control systems.

- Every company is required to appoint the same registrars and share transfer agents for both the depositories.

- The registrars and share transfer agents are required to accept partial dematerialisation requests and will not reject or send back the complete lot of dematerialisation request to the DPs in cases where only a part of the request was to be rejected.

- A Standing Committee co-chaired by the Managing Directors of NSDL and CDSL was formed which will meet at least once a month to resolve issues between DPs, registrars and depositories which may arise from time to time. The other members of the committee are SHCIL, HDFC Bank, Standard Chartered Bank, Integrated Enterprises (I) Ltd., Karvy Consultants, ICICI Ltd. and three persons from RAIN.

- If a DP has sent information about dematerialisation electronically to a Registrar but physical shares are not received, the registrar will accept the dematerialisation request and carry out dematerialization on the indemnity given by the DP and proof of dispatch of document given by DP.

- CDSL and NSDL shall be required to persuade major DPs to open branches in cities where DP services are not available.

- The broker DPs who are also registered with SEBI as share transfer agents, shall be allowed to change their broker DP status to that of share transfer agent/Registrar DP.

- The committee on dematerialisation of shares was also seized of various issues as mentioned below :

- Standardization of various procedures related to trading in depository system:
- Safety features and standards for depository operations:
- Expansion of depository infrastructure and making the branch offices with 'live" connectivity:
- Systemic tracking of delays at the hands of the depository participants, share transfer/issuer companies and depositories:
- Adequacy/capability of the depository system and systemic changes necessary to cope with the workload present as well as future:
- One stage processing for transfer and dematerialisation:
- Reductions in the size of batch processing from the present level of 1000 requests per batch:
- Good/bad delivery norms to be made mandatory on the registrars:

Strengthening the safety and integrity of the secondary securities market

Intra-day trading and exposure limits

Safety and integrity of the securities trading system is an integral part of a healthy market. The SEBI has been continuously striving to achieve these objectives. The SEBI has introduced capital adequacy norms. As such both the gross exposure limit of 20 times the base minimum capital and additional capital deposited by the member brokers and intra-day trading limits of 33 1/3 times the base minimum capital and the additional capital as prescribed by the SEBI have already been implemented by all the stock exchanges. During 1999-2000, most of the major exchanges viz. National, Bombay, Calcutta and Uttar Pradesh Stock Exchanges monitored the exposure and intra-day trading limits on a real time basis.

Setting up of trade/settlement guarantee fund by stock exchanges

To ensure timely completion of settlements the SEBI had advised all the stock exchanges to set up a Trade/Settlement Guarantee Fund or Clearing Corporation. During the year 1999-2000, the Settlement Guarantee Fund schemes of Hyderabad, Cochin, Jaipur, Uttar Pradesh and Pune Stock Exchanges were approved. As at the end of March 2000, 16 out of the total 23 exchanges (the remaining 7 exchanges have nil/insignificant turnover) have already set up Trade/Settlement Guarantee Fund.

Table 1.4 : Stock exchange-wise SGF Details

S.No.	Name of Stock Exchange	SGF Schemes approved as on
1.	Bombay	May 12, 1997
2.	Ludhiana	February 27, 1998
3.	Bangalore	January 23, 1998
4.	Calcutta	March 10, 1998
5.	Delhi	April 03, 1998
6.	Vadodara	August 04, 1998
7.	Madras	August 21, 1998
8.	OTCEI	October 09, 1998
9.	ICSEIL	January 06, 1999
10.	Ahmedabad	February 02, 1999
11.	Hyderabad	July 09, 1999
12.	Cochin	August 10, 1999
13.	Jaipur	August 12, 1999
14.	UPSE	August 12, 1999
15.	Pune	August 12, 1999
Source : SEBI		

Rationalisation of margin system/ market safety

Specific margins introduced on March 13, 2000.

Market volatility is a matter of concern for the regulator . High volatility generates confusion and uncertainty in the mind of investors whereas steady rise or steady fall in equity prices helps the investors in perception formation for investment or disinvestment. The SEBI therefore is always keen to minimize or curb the volatility. The SEBI has therefore, taken several measures to curb the market volatility.

As such in June 1998, the volatility margins were prescribed to curb excess volatility in the market and to act as a deterrent to building up of excessive outstanding positions. This step had a salutary impact and volatility was reduced. In March 1999 again, the SEBI introduced following measures to reduce the volatility:

The brokers-specific measure included:

- Where the brokers had built up sizeable positions, they were asked to either make reduction in positions or to make advance pay-in in cases where they had built up high positions. Such brokers could also be subjected to ad-hoc margins by the stock exchanges.

- The scrip-specific measures included impositions of special margins on volatile scrips.

- The SEBI also directed five major exchanges to take incremental additional capital and margins from their top 25 brokers in the form of cash or FDRs only for next four weeks, and withdraw the existing facility of accepting additional capital/ margins by way of bank guarantees or securities. Exchanges were to select top 25 brokers in terms of the marginable gross exposure at the close of the third day of their trading cycle. The unutilized portion of bank guarantee and securities deposited by these brokers were not considered for margin and capital requirements from the next day and all incremental margin and capital requirements were made payable in cash/FDR only.

- Again in June 1999, some decisions were taken by the SEBI .It was decided that credit for mark to market gain in one scrip would now be given against mark to market losses in other scrips after completion of the trading cycle, when settlement dues get determined.

- Margin and exposure limits exemptions were made available only on actual delivery of securities.

- The volatility in the market declined following the imposition of margins. However, it was felt that this margin addressed volatility over a very short period of one week only.

- Volatility margins would be imposed if volatility computed as above exceeds 40 per cent and will be chargeable in four slabs ranging from 5 per cent to 20 per cent depending on the level of volatility.

- Volatility margin would not be applicable to scrips priced below Rs.40.

- To bring uniformity in the composition of Base Capital and Additional Capital amongst exchanges, it was decided that at least 25 per cent of Base Capital would be maintained in cash and FDRs, out of which 12.5 per cent must be in cash. Not more than 75 per cent can be in the form of FDR/ BG/ Securities. Additional capital would be deposited in the form of cash/ BG/ FDR/ securities subject to the condition that securities shall not exceed 75 per cent of the total additional capital.

- Only those securities would be accepted as part of Base Capital which are part of the BSE Sensex/ Nifty/ BSE 100/ Jr. Nifty, BSE 200/ CNX 200. The scrips, which are in compulsory dematerialised trading, would be accepted in dematerialised form only. Exchanges would be given 3 months time to ensure that no security other than those specified is given to exchange as Base Capital.

- It was also decided that Additional Capital available with the exchange would get first adjusted towards requirements for gross exposure limits/ intra-day turnover limits, and excess additional capital with the exchange in the form of cash/BG/FDR was allowed to be utilised for meeting margin requirements.

- Incremental carry forward margin was modified and a graded scale was introduced wherein the margin rate increases from 5 per cent to 30 per cent as against a flat rate of 10 per cent for every 1 per cent increase of the carry forward position.

- Based on the overall assessment of risk and the rationalized margin system proposed, concentration margin and 90 day special margin were discontinued.

Rationalization of risk management system for the equity market

The risk containment measures from time to time prescribed by the SEBI served the market well by ensuring adequate and timely collection of margins. However, as the margin system has evolved over time, there has been multiplicity of margins, which has made the system complicated. There was a need to simplify the margin system without sacrificing the objective of safety. Besides, there has been a view that under the rolling settlement, the existing margin system would be expensive and may be deficient in the phase of changing nature of emerging risks. As the market moves on to rolling settlement progressively, the market would need to have a new risk containment system.

Thus, taking the objectives of simplifying the margining system and to make the structure of margins the unified one for stock exchanges, the SEBI set up a group on Risk Management System with following terms of references:

1. Reviewing the entire risk management system comprising the margin system, exposure norms, circuit filter, capital adequacy, etc. and also to study the risk management measure in place in the cash markets in the developed and emerging market countries.
2. Rationalizing and simplifying the present risk management system for the account period settlement without compromising the present levels of safety and further strengthening the risk containment measures.
3. Recommending risk containment measures for the securities traded in the rolling settlement.

Enhancing efficiency and transparency in the stock exchanges

Weekly settlement cycle and auction

The stock exchanges were required to necessarily complete their settlement within seven days and to conduct the auction immediately *i.e.* not later than eight days, after the completion of the relevant trading period, in those cases where members have failed to give the delivery, as on date, the exchanges have a weekly settlement cycle.

Modified carry forward system

The SEBI had appointed a committee under the chairmanship of Prof. J R Verma to review the existing Revised Carry-Forward System recommended earlier by the G S Patel Committee. In October 1997, the Modified Carry-Forward System (MCFS) recommended by the J R Verma Committee was approved and all exchanges desirous of implementing Modified Carry Forward System were advised to approach the SEBI for prior approval.

Till 1998-99, Bombay, Delhi, Ludhiana and Calcutta Stock Exchanges introduced the facility to carry forward trades under the Modified Carry-Forward System. During the year 1999-00, Ahmedabad, Madras and Bangalore stock exchanges have introduced the Modified Carry-Forward System.

Uniform settlement cycle

Uniform settlement cycle for stock exchange can help in reducing the arbitrage across the country. The SEBI Committee on uniform settlement discussed the ways and means for the implementation of one common settlement cycle for the smaller exchanges and one for the larger exchanges vis-a-vis the introduction of rolling settlement for all exchanges in the shares which are being traded in dematerialised form for all investors. The Committee discussed the issues relating to one common settlement system and concluded that introduction of uniform settlement cycle to other stock exchanges has implications in terms of availability of infrastructure, particularly with the custodians and the depository participants.

Rolling settlement

In order to enhance liquidity and to shorten the carry forward cycle and to make feasible the availability of alternative hedging mechanism in the form of derivatives, the SEBI introduced rolling settlement in respect of shares wherein compulsory dematerialised trading for all the investors has been introduced. Initially, only ten scrips were placed for trading under rolling settlement system, based on the recommendations of the committee on Rolling Settlement. Trading was made compulsory in rolling settlement for all investors in the 10 scrips from January 10 ,2000 and an addition of 34 scrips from March 21, 2000 and in 119 scrips from May 8, 2000.

Inter-connectivity between NSDL and CDSL

In order to establish inter-connectivity of National Securities Depositories Limited (NSDL) and Central Depositories Services Limited (CDSL), it was decided that settlement of market transactions should begin with the clearing members opening accounts in both depositories and the clearing house or corporations for effecting the same pay-out of shares of each depository as a pay-in of shares in that depository. However, CDSL was permitted to adopt an alternate mode suggested by the BSE's clearing house which envisaged on-market inter-depository settlement. This model envisages on-market inter-depository transfer of securities through the segregation of inter-depository transfers resulting from settlement, at the level of the clearing corporation/clearing houses. To effect these transfers, each depository would be required to open an account with the other depository and this account would be debited or credited based on the net inter-depository transfer instructions from the clearing houses/clearing corporation. It was agreed that both the depositories will introduce this model for effecting inter-depository transfers, in addition to the model advised which is currently in operational. The depositories were advised to speedily make the necessary software changes for adoption of the new model. This mode was expected to entail some changes in the software of NSDL as well. The software experts of the two depositories were asked to work out the details of the changes to be made and determine the implementation within three months. The inter-depository transfer is essential for the smooth functioning of the market and charges if any, levied by a depository for such transactions, would have to take into account the interest of the investors. The SEBI opined that the charges for the services rendered will have to be determined objectively.

Revival of small stock exchanges

Over the recent past years, it has been observed that the regional stock exchanges are recording very low/insignificant turnover and the majority of their members have become inactive. The financial health of these exchanges has also been deteriorating. With a view to revive these exchanges, a group comprising of NSE, BSE, CSE and some of the smaller stock exchanges was formed, to discuss means and ways to reinvigorate the weak exchanges.

The suggestions, which emerged at the meeting, could be grouped into two categories. One, which deals with ensuring the financial viability of the exchanges and the other dealing with the issue of increasing the business opportunities for the brokers and exchanges. For the first category, the suggestions were that the existing infrastructure of the exchanges could be used for providing investor services, the exchanges acting as depository participants for holding the beneficiary accounts, using the exchange infrastructure for monitoring and surveillance on behalf of the larger exchanges, etc. For the second category, suggestions included mergers or alliances of small exchanges with larger exchanges or their subsidiaries becoming members of other exchanges, transfer of base minimum capital of the brokers of the regional exchanges to the Inter Connected Stock Exchange, reviewing of Trade Guarantee Funds without compromising the safety requirements.

After considering the recommendations of the group, the SEBI permitted the stock exchanges to promote/float a subsidiary company to acquire membership rights of other stock exchanges to provide the members of the regional exchanges access to the wider market for improving the trading volume.

As on date, Bangalore, Vadodara, Saurashtra-Kutch, Ludhiana, OTCEI, Cochin and Inter-connected Stock Exchanges have floated subsidiaries to acquire membership rights of

NSE/BSE.

Trade in securities by qualified participants

The SEBI has been seized of the issue of viability of OTCEI and small size of trade being done there. The Board examined OTCEI's proposal to provide a trading mechanism and price discovery for securities of public limited companies which are not listed or traded as permitted securities on any exchange. The proposal was made with the objective of business expansion of the exchange. Through the discussions, it was decided that only qualified participants (QPs) such as corporates/companies, banks and individuals with a net worth of Rs 2.5 crore, will be allowed to trade on the market. The scrips and the QPs will be selected by the exchange. The exchange will not guarantee the settlement of trade. The securities of the companies will be listed with suitable exemptions for which regulatory changes will be made. The above system will provide a transparent trading platform and exit opportunity for small capital companies, venture capital and private equity funds.

Negotiated deals

According to earlier guidelines of SEBI, all negotiated deals had to be reported to stock exchanges within 15 minutes of trade negotiated and information in respect of such trades was disseminated by the stock exchanges. A negotiated deal was defined as any transaction which either has a value of Rs.25 lakh or volume traded not less than 10,000 shares at one price not formed through the stock exchange and order matching mechanism.

In order to introduce transparency and price discovery in negotiated deals, the SEBI issued guidelines that such transactions will be permitted only if they are executed on the screen of exchange following the price and order matching mechanism of the exchanges just like any other deals on stock exchanges.

Market making

The extensive reforms by the SEBI over the last two years have enhanced the integrity, transparency and efficiency of operations of the securities market. The introduction of electronic trading and order matching system on all the 23 stock exchanges in the country have reduced transaction costs and have enhanced transparency and efficiency in respect of price discovery. However, there are still a large number of scrips that are not actively traded despite the fact that many of them have some intrinsic value. The Committee on 'Market Making' under the Chairmanship of Shri G.P. Gupta studied the various facets of market making, including the merits and demerits of the two trading systems, viz. the order-driven system and the quote-driven system. As market makers are obliged to offer continuously two-way quotes; they have to carry an inventory of stocks, which implies commitment to capital and exposure to market risks.

New products and procedures

The securities lending scheme, 1997

The Securities Lending Scheme was introduced by the SEBI in 1997. The securities lending scheme provides for lending of securities through an approved intermediary to a borrower under an agreement for a specified period. The scheme facilitates the timely delivery of securities which improves the efficiency of the settlement system and corrects the temporary imbalances between demand and supply. It also provides for the mobilization of idle stocks in the hands of FIs, FIIs, Mutual Funds and other large investors leading to additional income to the holder of securities. The SEBI has already given approval to six intermediaries to act as Stock Lenders. The activity is however yet to pick up and the SEBI is continuously discussing with the market participants to encourage the use of stock lending. At present National Securities Clearing Corporation Limited (NSCCL), registered as Intermediary under Stock Lending Scheme is providing this facility to the members of National Stock Exchange to reduce auction. The securities' lending is expected to pick-up following the more scrips coming under Rolling Settlement.

Committee on corporate governance

A committee on corporate governance set up by the SEBI under the chairmanship of Shri Kumar Mangalam Birla, member SEBI Board with the objective of strengthening and promoting the standard of corporate governance of listed companies, had made several recommendations. Corporate governance is an important tool of investor protection. This would be the first formal code of corporate governance in the country through the listing agreement. It is expected that the introduction of these measures will raise the awareness and make a good beginning for raising standard of functioning of corporate. The SEBI board accepted the recommendations of the committee followed by a notification issued to the concern agencies. The major recommendations of the committee accepted by the board are presented in the Box 1.4 below.

Box 1.4 : Major recommendations of Kumar Mangalam Birla Committee

- The board of directors of the company shall have an optimum combination of executive and non-executive directors with not less than fifty percent of the board of directors comprising of non-executive directors.
- All pecuniary relationship or transactions of the non-executive directors viz.-a-viz. the company, should be disclosed in the Annual Report.
- Board meeting shall be held atleast four times a year with a minimum time gap of atleast four months between any two meetings.
- The Committee recommended the constitution of Audit Committee in a listed company.
- The committee recommended that audit committee shall have minimum three members, all being non-executive directors, with the majority of them being independent, and with at least one director having financial and accounting knowledge, the chairman of the committee shall be an independent director.
- The audit committee shall meet at least thrice a year. One meeting shall be held before finalization of annual accounts and one every six months. The audit committee shall have powers which should include to investigate any activity within its terms of reference, to seek information from any employee, to obtain outside legal or other professional advice, to secure attendance of outsiders with relevant expertise, if it considers necessary.
- The committee will review with the management, the external and internal auditors, the adequacy of internal control systems, the adequacy of internal audit function including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure, discussion with internal auditors, reviewing the findings of any internal investigations by the internal auditors, discussions with external auditors.
- The audit committee will review the company's financial and risk management policies and will look into the reasons for substantial defaults in the payment to the depositors, debenture holders, shareholders (in case of non payment of declared dividends) and creditors.
- The committee has recommended that remuneration of directors including non-executive directors will be decided by the board of directors.
- A director shall not be a member in more than 10 companies or act as chairman of more than 5 companies in which he is a director. He will keep informed the company about the committee positions he occupies in other companies.

- As part of the directors' report or as an addition there to, a Management Discussion and Analysis Report should form part of the annual report to the shareholders. The management discussion and analysis will include industry structure and developments, opportunities and threats, segment–wise or product-wise performance, outlook, risks and concerns, internal control systems and their adequacy, discussion on financial performance with respect to operational performance, material developments in human resources / industrial relations front, including number of people employed.

- Disclosures must be made by the management to the board relating to all important financial and commercial transactions.

- In case of the appointment of a new director or re-appointment of a director, the shareholders must be provided with a brief resume of the director; nature of his expertise in specific function areas ; and names of companies in which the proposed directors holds directorship and the membership of committees of the board.
- Information like quarterly results and presentation made by companies to analysts, shall be put on company's web-site, or shall be sent in such a form so as to enable the stock exchange on which the company is listed, to put it on its own web-site.

- A board committee under the chairmanship of a non-executive director shall be formed to specifically look into the redressing of shareholders and investors' complaints like transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends etc.
- To expedite the process of share transfers, the board of the company shall delegate the power of share transfer to an officer or a committee or to the registrar and share transfer agents.
- A company will have to include separate sections on corporate governance in its annual report with details on compliance, non-compliance of any mandatory requirement. The company will have to obtain a certificate from the auditors of the company regarding compliance of conditions of corporate governance.

- Almost all the companies listed on stock exchanges or seeking listing for the first time will have to complete all mandatory corporate governance requirements in a phased manner by March 31, 2003. The companies seeking listing for the first time will have to complete corporate governance at the time of listing.

Internet based securities trading

A Committee on internet based securities trading and services was set up by the SEBI to develop regulatory parameters for use of internet in securities business and effective enforcement of internet trading. The report of the Committee was approved by the Board.

The Board decided that internet trading can take place in India within the existing legal framework through the use of order-routing systems, which will route orders from clients to brokers, for trade execution on registered stock exchanges. The Board also took note of the recommended minimum technical standards for ensuring safety and security of transactions between clients and brokers which will be enforced by the respective stock exchanges.