Improving Institutional Mechanisms and Trading Practices in our Stock Markets

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"...... I propose to take the following measures to improve institutional mechanisms and trading practices in our stock markets:

(a) Corporatisation of stock exchanges by which ownership, management, and trading membership would be segregated from each other. Administrative steps will be taken and legislative changes, if required, will be proposed accordingly.

(b) Extension of rolling settlement to 200 category "A" stocks in Modified Carry Forward Scheme, Automated Lending and Borrowing Mechanism and Borrowing and Lending Securities Scheme by July, 2001;

(c) Government intends to propose legislative changes to further strengthen the provisions in the SEBI Act, 1992 to ensure investor protection.

To conclude, I would like to reiterate that the Government and SEBI will continue to make every effort to ensure that capital markets operate in an orderly, transparent, safe and fair manner for all investors. I would like to assure the House that the guilty shall be brought to book without fear or favour and no one shall be spared."

This was stated by the Hon'ble Finance Minister (FM) on the floor of Parliament in early March 2001 while responding to a calling attention motion by the Hon'ble Leader of the Opposition on extreme volatility in the stock markets. The FM could have been spared of this embarrassment and the innocent investors would not have lost confidence if we were a little more systematic in our reform strategy. This is not to discount the fact that the markets today are much better regulated and orderly than it was ever before and not to say that the market would be absolutely safe if these three measures are implemented.

The measures proposed by the FM are long overdue. Many a committees and well wishers, who have been studying different episodes (Harshad, M. S. Shoes, CRB, Plantation companies, Vanishing companies, Videocon, Ketan) in the securities market, have been recommending these measures, among others, for a long time. A joint Bank-Fund mission, which is generally attributed to be the infallible source of wisdom, in their recent Financial Sector Assessment Programme, have recommended all the three measures in relation to securities market. They have observed: *"(a) authorisation of an exchange to act as an SRO should involve careful consideration of its governance structure, in order to ensure that the exchange will be able to impose sanctions on its members to protect the interest of the investors even at some expense to members. The current ownership and governance structure of many exchanges seem insufficient to deal with such potential conflict of interest; (b) The current system of a fixed date settlement combines with "badla" system of carrying forward futures positions to generate significant systemic risks in settlement arrangements. Rolling settlement and clear separation of the spot and futures market would improve the efficiency and systemic stability of equity markets substantially; and (c) The fragmentation of regulatory authority, and the responsibilities of SEBI, the Department of Company Affairs and the RBI create confusion, not only among the regulated but also the regulators charged with day-to-day regulations themselves. SEBI's regulatory powers and their scope are not adequate to its mandate of investor protection."*

All the three measures have been experimented in our market with different degrees of success. Many of the exchanges in the country are corporate entities. Even two of them are demutualised corporate entities from their birth. The concept of demutualised exchange most probably originated in India. Rolling settlement has been in vogue for about a decade now. OTCEI was born with rolling settlement. Trades in select corporate and in government securities are settled under rolling settlement. SEBI Act was enacted to establish SEBI with the prime objective of protecting interests of investors in securities. No other securities market legislation in the world has such a prime objective. The Act has been amended a number of times to strengthen

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'the provisions in the Act to ensure investor protection. SEBI's regulatory jurisdiction extends over corporates in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with the securities market. There have been a spate of judicial pronouncements, which have sanctified the powers of SEBI. All of us indisputably recognise the benign effects of these measures.

What is needed is a sincere will to implement these measures. The exchanges need to be corporatised in such a manner that the right to trade on the exchange is completely divorced from ownership and management. The rolling settlement should be adopted to settle all trades in all securities on all exchanges which should also offer continuos net settlement, securities lending and borrowing and counterparty guarantee to enhance liquidity. The SEBI Act should be amended in such a manner that it removes anomalies in the scheme of punishment, reduces regulatory overlaps and gaps and introduces accountability in the administration of the Act. In the following paragraphs, an attempt has been made to analyse the issues involved in operationalisation of these three measures.

I. Demutualisation of Stock Exchanges

Historical Background

Most of the Exchanges in the country are organised as "Association of Persons" or section 25 companies under the Companies Act. These are called "mutual" exchanges, which are considered beneficial in terms of tax benefits and matters of compliance. The trading members who provide broking services, also own, control and manage the stock exchanges. They elect their representatives to regulate the activities of the exchange, including their own activities. Some of the elected directors, however, at times fail resist temptation to misuse official position for personal gains. In case of dispute between brokers and the investors, investors' interests do not always receive the same utmost objective treatment. The regulatory and public interest role of the exchange conflict with private interests of the elected directors. As the self sometimes gets precedence over regulation, broker-owned exchanges does not offer an effective model for self-regulatory organisations.

This limitation has been realised time and again by the exchanges and the regulators. In early 1980s, the High Powered Committee on Stock Exchange Reforms had observed: *There is considerable disillusionment in the country with the functioning of the Governing Bodies. It is alleged that most of the stockbrokers have vested interest in maintaining the status quo as they have their own self-interest to protect. They also at times subordinate the interest of the genuine investors to those of the stockbrokers. Some of them are even alleged to have misused their position of trust for personal gains. They often fail to take disciplinary actions against erring members and allow crisis situations to develop in the Stock Exchanges by neglecting to take timely action to curb excessive speculation. The measure which they adopt, at times, for regulating business are either half-hearted or not implemented rigorously."* The committee recommended amendments in law to enable the government to change the organisation form of stock exchanges, which were then association of persons or companies limited by shares so that all the stock exchanges had an uniform organisational structure as companies limited by guarantee. It also recommended that at least 50% of the board members should be outside directors comprising of professionals, industrialists, financial experts, nominees of government and representatives of investor associations. The High Powered Study Group on Establishment of New Stock Exchanges in early 1990s reiterated these recommendations.

Reforms, therefore, focussed on reducing dominance of trading members in the management of stock exchanges by prescribing composition of governing council and strengthening the position of executive director. SEBI forced the exchanges in 1993 to reconstitute their governing councils to provide for at least 50% non-broker representation. Since then 21 exchanges in the country are being managed by governing councils comprising of elected trading members and nominees of SEBI (SEBI Nominees and Public Representatives) in the ratio of 50:50. By taking into account the executive director, who is supposed to be independent, non-broker members out number broking members in the councils.

This did not materially alter the situation. The composition of governing council is only theoretically a 50:50 ratio between brokers and non-brokers, while in practice the composition is titled in favour of brokers. This is mainly because (a) broker-directors, who have considerable hand in the choice of public representatives, may not choose independent persons or persons critical of brokers, (b) many of the non broker-directors, while distinguished in other walks of life, do not often understand the intricacies of functioning of stock exchanges and are not assertive enough nor very regular in attending meetings, and (c) the governing council is presided over by a broker-director, who dominates the show. It is not unusual for many non-elected directors to espouse directly or indirectly the interest of the brokers during the deliberations in the council, since they owe their nomination to the elected directors. On the other hand, the elected directors, who attend every meeting of the council, develop a coordinated approach in articulating their group interest. The obliging nominees facilitate them in achieving their group interest, which may be to the detriment of other participants.

The exchanges, therefore, witness different types of crises from time to time. The post-mortem of these has generally revealed complicity of elected directors. The investigations into the massive price rigging in prices of certain scrips during May-June 1998 revealed a number of systemic deficiencies including the composition of governing councils. It was felt that the 50:50 composition should be replaced by 40:60 to reduce dominance of elected directors in decision making. Non-brokers should be allowed to become president. A "code of ethics" could be prescribed requiring broker-directors, who are office bearers of stock exchanges, not to do proprietary trading while holding office. Before these systemic improvements could be affected, the market witnessed even a greater crisis in February-March 2001. Though the investigations are on, preliminary findings indicate complicity of elected directors. As follow up penal action, the guilty elected directors are unceremoniously removed from governing councils or the governing councils are superceded. In the recent past, three presidents of the Stock Exchange, Mumbai had to leave office in ignominy.

The above analysis leads to inevitable conclusion that the quality of administration of broker-managed exchanges is far from satisfactory. And the tinkering attempts (composition of governing council and strengthening of position of executive director) made for decades to improve the working of the exchanges while retaining the basic structure has not yielded any appreciable result. FM has realised that tinkering is not adequate to address the malaise and there is no alternative to demutualisation. He has, therefore, proposed a complete overhaul - not just corporatisation, but also demutualisation of exchanges.

Fortunately, Indian securities market has tasted benefits and merits of demutualisation. Two newly set up demutualised exchanges, namely, NSE and OTCEI, are managed by boards of directors, which do not include trading members. From the day one, these have been the purest form of demutualised exchanges where brokers do not own the shares and the management is free from broker control. The ownership, management and trading on these two exchanges are in the hands of three different sets of people. This has completely eliminated any conflict of interest and helped NSE to pursue market efficiency and investors' interests aggressively. Though crises have been hitting the stock market at regular intervals, NSE emerges unscathed every time. This proves that absence of brokers in the governing council or having a governing council consisting of professionals only brings about more efficiency and transparency in the working of an exchange.

NSE model, however, does not preclude, rather accommodates broker involvement, support and contribution in a variety of other ways. It's board comprises of senior executives from promoter institutions (leading financial institutions), eminent professionals, nominees of SEBI and a full time executive. While the board deals with broad policy issues, the executive committee (EC), which includes trading members, formed under the Articles of Association and Rules manages the day-to-day affairs of the exchange. The EC has constituted several other committees, like Committee on Trade Related Issues (COTI), Committee on Settlement Issues (COSI), which mostly consist of trading members and provide regulatory inputs from market.

"Mutual" Vs. "Demutual"

In a "mutual" exchange, the same set persons own the exchange, manage it and use it's services for trading. They are generally "not-for-profit" and tax exempted entities. The ownership rights are not freely transferable. Trading rights are not easily available. Membership (trading) cards carry a premium. This model eminently suited the open outcry market. In contrast, in a "demutual "exchange, three separate sets of persons own the exchange, manage it and use it's services. The owners usually vest management in a board of directors which is assisted by a professional team. A completely different set of persons use trading platform of the exchange. These are generally "for-profit" and tax paying entities. The ownership rights are freely transferable. Trading rights are acquired/surrendered in terms of transparent rules. Membership (trading) cards do not exist. This model eminently suits electronic market. These two models of exchanges are generally referred to as "club" and "institution" respectively.

The exchanges are required to frame and enforce rules, which may not always, further the public interest and the interests of trading members (private interest) simultaneously. Generally public interest gets precedence in a demutualised exchange while private interest gets precedence in a mutual exchange in framing rules. This is why the "mutuals" are generally very slow to adopt systems and practices that enhance market efficiency unless the regulators force them or competitive pressures threaten their market share. Similarly, a demutual exchange may be ruthless in enforcing compliance with rules while a mutual exchange may not be so ruthless.

On realising the limitations of mutual structure and discovering the advantages of demutual structure, the stock exchanges are increasingly organising themselves as commercial entities and undergoing a process of "de-mutualisation". The Stockholm Stock Exchange was the first major stock exchange in the world to become de-mutualised in 1993. Amsterdam, Australian and Singapore Stock Exchanges adopted demutualised governance structures in 1997, 1998 and 1999 respectively. The Australian Stock Exchange has gone one step further by becoming a listed company. The Toronto, Hong Kong and Paris Stock Exchanges are in the process of completing the demutualisation process. The London Stock Exchange, NYSE and NASDAQ have also announced their plans to become demutualised. The motivation for demutualisation ranges from expanding the business network, increasing fund raising capability, expediting decision making process, pursuing strategic alliances, internationalising their appeal, etc. The motivation for NSE, however, was to bring in discipline, cure typical stock market ills such as price rigging and avoid conflict of interest which was hindering the reforms and development in the securities market. Market integrity seems to have motivated FM's demutualisation proposal.

Concerns in Demutualisation

Successful demutualisation requires us to be aware about the following concerns:

- A "demutual" suffers from a different type of conflict of interest. Since it is a "for-profit" organisation, its commercial role may get precedence over the regulatory role. Every decision is likely to be tested against its impact on profitability. It may, for example, be either very lenient in enforcing the rules to encourage the volume of business or very strict in enforcement of rules to increase penal revenue. NSE has been able to strike a fine balance between its commercial and regulatory roles, which supplement each other.
- A demutualised exchange would like to be listed on an exchange. This would open up another arena for conflict of interest if it listed on itself as has the Australian exchange done. It is unlikely that the exchange would like to subject itself to same strict discipline as applicable to other listed companies. One solution could be to list the securities on another exchange, but permit trading on itself. A better solution would be to vest the listing powers in a body, like UK Listing Authority, separate from stock exchanges.
- In a mutual environment, the governing councils include nominees of regulators and public representatives. This is necessary in public interest to refrain the elected directors from pursuing their self-interest only. In the demutualised environment, such a check is also necessary to ensure that the board of directors do not act only in the best commercial interest of the organisation. This may be achieved by including a few public representatives, who should have specific responsibilities and be held accountable.

  The practice of having nominees of regulator must, however, be discontinued. This makes regulator vicariously liable for all the crises occurring in exchanges. The regulator cannot exonerate itself that the crisis is due to some lapse on the part of the exchange. Further, the regulator cannot be expected to make, at least in theory, a fair investigation into the affairs of the exchange, which is managed by it. Regulator should retain its regulatory role only and give up its role as management of the exchanges.
- In the demutual environment, the shares can be cornered by a few or undesirable persons. The

exchanges could be prone to hostile takeovers. Such probability can be reduced by prescribing ceiling on shareholdings and requiring regulator's approval for change in ownership beyond a threshold limit. Public representatives would be useful to prevent mismanagement in such cases.

- It is an undenying fact that a "mutual" has better access to expertise and knowledge of the market participants, which are critical inputs for framing rules. As the brokers are involved in framing the rules, a "mutual" generally ensures better compliance with such rules by them. The access to market expertise and knowledge and compliance with the rules have been successfully achieved by NSE through EC, COSI, COTI etc.
- Government and SEBI seem to be suggesting NSE model of demutualisation. They are implicitly hinting at capital contribution by financial institutions. A large number of financial institutions, banks and insurance companies have already contributed capital in OTCEI and NSE. Would they like to make similar contributions for 21 exchanges, more so when majority of them are only clinically alive? It is doubtful if there would be adequate response from public if all 21 exchanges are corporatised and their securities are evaluated professionally and offered for sale. But why should policy maker/ regulator suggest a particular model? If they have to, they should first look at consolidation of exchanges before they demutualise them.
- It is most desirable if the initiative for demutualisation comes from the exchanges themselves. The authorities have to just approve the memorandum and articles of association for demutualised structure as they did for NSE or OTCEI. It is heartening that some exchanges have already started working towards demutualisation. What if they do not demutualise voluntarily? The law provides enough stick for the authorities to enforce demutualisation. They have powers to recognise a stock exchange, renew the recognition or withdraw recognition in the interest of trade and/or in public interest. As a condition of recognition/renewal of recognition, a stock exchange is required to comply with such conditions as are or may be prescribed or imposed under the provisions of the SCRA and the SCRR from time to time. The authorities have also powers to direct stock exchanges to make rules or amend rules. In exercise of these powers, the authorities have been tinkering with the composition of the governing body. In the extreme case of noncompliance by any stock exchange, the authorities can withdraw recognition.
- The process of demutualisation would involve offering shares of a corporatised exchange to public, including trading members. It is possible that the trading members subscribe for the shares and in terms of their rights under the Companies Act, get themselves elected to the board of directors. This defeats the purpose of demutualisation. It would then be necessary to specify under the SCRA that a shareholder, who is also a trading member, can not join the board. There is thus an apparent conflict between the Companies Act and the SCRA in the sense that the former confers a right on the shareholder to join the management while the later deprives a broker-shareholder from joining the management. This conflict is easily resolved by the well-accepted principle that the special law (SCRA) prevails over the general law (Companies Act). A deep understanding of the laws, however. overshadows this conflict and makes it clear that both the Acts are seeking to fulfil the same objective. The Companies Act requires an interested director to refrain from participating in the deliberations in the board meetings. Since a broker-shareholder, if elected to board of directors of an exchange, would be a perpetually interested director. he has to refrain from attending the board meetings and hence can not really contribute to management. It is, therefore, desirable that such a shareholder refrains voluntarily from joining the board or is prevented from joining the board by the SCRA. Thus the SCRA would reinforce the objective of the Companies Act more explicitly.
- It is suggested in some circles that an exchange can be demutualised without corporatisation. The composition of the governing council can be tinkered to reduce brokers' presence further in the governing council and make them ineligible to be office bearers. Given the interest evinced by non-broker directors in management of stock exchanges, it would be a disaster. The directors must have a stake in the exchange in some form.

- It is reported that a few exchanges are seeking exemption from stamp duty on transfer of assets and tax exemption on capital gains arising from transfer of any asset of an exchange or membership in pursuance to corporatisation. These exemptions in respect of transfer of assets from the erstwhile non-corporate exchange to the emerging corporate exchange is understood. This should be granted to encourage corporatisation in public interest. But the need for exemption in respect of transfer of membership is difficult to appreciate. What does a member have to transfer - his membership card, his share in the reserves and surplus of the exchange or his right to trade? The membership card is a fictitious asset. According to a recent Supreme Court ruling, the membership card of a stockbroker is not a property. The reserves and surplus, which has grown because of so many concessions and tax benefits, of "not-for-profit" organisations can not be shared by the contributing members. What needs to be transferred is the right of a trading member to trade from erstwhile non-corporate exchange to the emerging corporate exchange, which should be automatic.
- The corporatisation-cum-demutualisation would result in two classes of members namely, trading members and shareholder-members. Since "member" under the SCRA means a member of the recognised stock exchange, it is apprehended in some circles that the SCRA may not accommodate different classes of members. Again, NSE model, which has these two types of members, provides the solution. It has been affirmed recently by the Supreme Court that there can be more than one class of members and they will fall within the definition of "members" under the SCRA.

II. Rolling Settlement

Historical Background

Clearing and settlement mechanism in Indian securities market has witnessed several innovations in the 1990s. These include use of the state-of-art information technology, compression of settlement cycle, dematerialisation and electronic transfer of securities, securities lending and borrowing, professionalisation of trading members, fine-tuned risk management system, emergence of clearing corporations to assume counterparty risk etc, though many of these are yet to permeate the whole market. The market seems to have reached a stage where further gains in settlement efficiency can be achieved only from rolling settlement (RS).

Indian securities market has been following a futures-style settlement, which combines the features of cash as well as of futures markets together. This makes development and regulation of both the markets difficult. The L. C. Gupta Committee, which was set up to develop regulatory framework for derivatives, recognised this difficulty and recommended that before derivatives were introduced, the cash market must be made a pure cash market. This could be achieved by introducing RS, which will shift speculation from the cash market to the futures market. The committee also recommended uniform settlement cycle among all stock exchanges, moving towards RS cycle, in order to prevent the cash market from being used effectively as an unregulated futures market. It was also realised that the RS, securities lending/borrowing and derivatives complement one another and their successful implementation requires all three to be introduced almost simultaneously.

The RS was first introduced by OTCEI. As dematerialiation took off, NSE provided an option to settle the trades in demat securities on rolling basis. With a view to prepare the market, culturally and infrastructurally, to adopt RS, the regulator held extensive consultations over years with all types of market participants. In January 2000, it made RS compulsory for trades in 10 scrips selected on the basis of the criteria that they were in the compulsory demat list and had daily turnover of about Rs.1 crore or more. This list, however, did not include scrips, which had carry forward trading facility. The RS started on T+5 basis. SEBI reviewed in February 2000 the progress of RS. Contrary to reports about decline in volumes, liquidity and delivery in the 10 scrips in RS across the board, analysis of the daily trading volume, and outstanding positions at the end of the day (which are also the deliverable positions) showed that in at least 5 scrips, trading volumes were higher on certain days than average of trading volumes in last six settlements prior to RS. Besides, in more than 5 scrips, deliveries had been higher on several days. Even comparisons of pre-RS and post-RS prices showed that, on some days, in at least 6 scrips, post-RS prices were higher. Consequent on the review, SEBI added a total of 156 scrips under

RS. 74 companies, which had changed names to infotech companies, were included in compulsory RS from May 8, 2000. 31 NBFCs, which are listed and traded on the BSE, but whose applications for certificate of registration were rejected by RBI, were covered under compulsory RS from May 8, 2000. 17 scrips, which exhibited high volatility (i.e., of more than 110% for 7 weeks or more in the last 10 weeks) were also included in compulsory RS from May 8, 2000. In addition, 34 companies out of 199 companies, which were already included in compulsory demat trading for all investors and did not have carry forward facility in any of the exchanges and had signed agreements with both the depositories were included for compulsory RS from March 21, 2000.

The stocks brought under the RS yet did not cover any of the stocks that are part of the MCFS, which are highly active and liquid and which account for over 98% of total turnover. The fear was that until we had a satisfactory alternative to the current MCFS system, which provides facility to carry over settlement of trades to the next settlement, it would be risky to cover the MCFS stocks under RS. SEBI appointed a Committee under the Chairmanship of Prof. J. R. Varma, one of its members to recommend modalities for carry forward mechanism under the RS. Following the recommendations of the Varma Committee, SEBI decided that at the end of each trading day, there would be carry forward sessions and the investor would have the choice of carrying forward a position for 1, 2, 3, 4 or 5 days. There would be separate screens where bids and offers could be posted for each of these five variants. It was also similarly proposed that the exchanges not having MCFS, but having ALBM, would be allowed to lend/borrow securities for 1, 2, 3, 4, or 5 days. This sort of carrying forward positions or lending/borrowing for 1 to 5 days were introduced in respect of 15 scrips (out of the scrips mandated for compulsory RS) on BSE and NSE and these came to be known as CFRS and ALBMRS.

Following FM's announcement on March 13, 2001 that the RS would be extended to 200 category "A" stocks in MCFS, ALBM and BLESS by July, 2001, SEBI has now decided that all (263) scrips included in the ALBM/ BLESS or MCFS in any stock exchange or in the BSE 200 list would be traded only in the compulsory RS on all the exchanges from July 2, 2001. This list is in addition to scrips, which are already under compulsory RS. The exchanges have been advised to develop necessary software and infrastructure by that date if they want the scrips to be traded on their exchanges. It will, however, be quite some time before the entire market is brought under the RS. By the time Indian market adopts T+5 and then moves to T+3 RS, the world would have moved further substantially by reducing the settlement cycle to say T+2 or even T+1.

Account Period vs. Rolling

The clearing and settlement agencies in India operate a well-defined settlement cycles. They aggregate trades over a trading period, net the positions to determine the liabilities of members and ensure movement of funds and securities for settlement of transactions. They operate two major types of settlement, namely, account period settlement and rolling settlement (RS). Under the account period settlement, the trades accumulate over a trading period of five working days and at the end of the period, these are clubbed together, positions are netted and the balance is settled about a week after the end of the trading period. The members realise the sale proceeds and securities in accordance with pay-in and pay-out schedules notified by the exchanges. Under the RS, which is operative in respect of a few securities as mandated by the regulator, all trades executed on a trading day are settled X days thereafter. This is called "T+X" RS, where "T" is the trade date and "X" is the number of business days after trade date on which settlement takes place. The RS has started with T+5 basis in India, implying that the outstanding positions at the end of the day 'T' are compulsorily settled on 5th day after the trade date.

The RS system offers several advantages. First, the account period settlement does not discriminate between an investor transacting on the first day and an investor transacting on the last day of the trading period, as they are clubbed together for the purposes of settlement and they realise the securities and / or funds together. Hence some investors have to wait longer for settlement of their transactions. Under RS, the investors trading on a day are treated differently from the investors trading on a preceding or a succeeding day. All of them wait for "X" days from the trade date for settlement. Second, the investors transacting under account period have to wait for both the trading cycle and the settlement cycle to end. In contrast, under RS, they have to wait only for the settlement cycle to end, not the trading cycle.

Hence the gap between the trade date and the settlement date is less under RS making both securities and funds easily convertible. The buyer and seller realise securities and funds quickly. Third, the account period settlement combines the features of cash as well as futures markets and hence distorts price discovery process. In contrast, RS, which segregates cash and futures markets and thereby removes excessive speculation, helps in better price discovery. Fourth, account period settlement allows build up of large positions over a trading period of five days and consequently, there is a pressure to close them out on the last trading day, leading to significant market volatility. This does not happen under RS, where positions can be built during a day only. Fifth, there is scope for both intra-settlement and intra-day speculation under account period settlement, which allows large outstanding positions and hence poses greater settlement risks. In contrast, since all open positions under RS at the end of a date 'T' are necessarily settled 'X' working days later, it limits the outstanding positions and reduces settlement risk. This is all the more desirable when trades do not enjoy counter party guarantee. Sixth, under account period, it is possible to shift positions from one exchange to another as they follow different trading cycles. RS removes such speculation arising out of shifting of positions from one exchange to another, as it makes trading cycle uniform.

G 30 recommendations relating to securities clearance and settlement systems have been driving best practices in the securities markets all over the world. One of the recommendations, that gained widespread acceptance, requires that all markets should adopt a RS system and final settlement of all trades should occur no later than T+3. The ISSA Recommendations 2000, which replace G30 recommendations, have mandated the adoption of trade date plus one settlement cycle in a form that does not increase operational risk. The CPSS-IOSCO Joint Task Force on Securities Settlement Systems, which is a joint effort of BIS and IOSCO, has recommended in January 2001 that T+3 settlement be retained as a minimum standard. Markets that have not yet achieved a T+3 settlement cycle should identify impediments to achieving the same and actively pursue the removal of those impediments. The Task Force has also recommended that each market should study the feasibility of introducing a cycle shorter than T+3 depending upon factors such as transaction volume, price volatility and the financial strength of participants.

Internationally, several markets have adopted T+3 settlement system wherein trades done on Monday are settled on the following Thursday. Many of them are considering a transition to T+1 settlement. The Securities Exchange Commission (SEC), the securities market regulator in the US, has called on the securities industry to clear and settle all trades within 24 hours, i.e. on T+1 basis, and this should be achieved by June 2002.

Concerns in Rolling Settlement

Since RS is a major cultural change for market participants, this is generally launched with a massive education package. Fortunately, many of our market participants have experience of RS on OTCEI and on NSE and in respect of transaction in securities for which RS is compulsory and in government securities. Still it is necessary to launch an education package to remove some of the apprehensions from the minds of market participants and to make them comfortable. A few of the concerns/apprehensions are discussed in the following paragraphs.

- It is apprehended that the RS adversely affects trading volumes and thereby drains liquidity from the market. This is apparently based on the volumes in a few scrips, which are already under compulsory RS. It is quite natural for the volume to decline if only a few illiquid scrips are subjected to discipline of RS. The volumes shift from illiquid to liquid scrips, which are not subject to discipline of RS. Despite this, a SEBI study has revealed higher volumes in some scrips under the RS. Further, the decline in volume and the decline in liquidity are not synonymous. Indian market has been witnessing increasing volumes and increasing number of illiquid scrips for about a decade now. While the trading cycles in India have shortened over the years, the volumes have gone up. The global experience suggests that shortening of trading period and shift to RS has led to increase in liquidity in the market as liquidity crucially depends on the confidence in safety of the settlement system. The recent experience of UK, which shifted from a fortnightly account period to T+5 RS, has proved the point. The main reason why RS leads to greater liquidity is that the risks in trading and settlement get substantially reduced. RS improves liquidity by allowing quick turnaround of portfolios and encouraging FII inflows. The liquidity improves further if RS is accompanied by a system of continuous net settlement and collateralised lending and borrowing of securities and funds.

- It is argued in some circles that EFT is a precondition for RS, as funds need to move within T+X time frame from investors to brokers and from brokers to clearing agency, while all these entities and the banks with which they have accounts are spread all over the country. There is some merit in this argument. RS will definitely be facilitated if funds can move instantaneously as demat securities, but it can not be held up till we have EFT. Under the account period settlement, funds are being paid-in and paid-out on the 5th and 6th day respectively from the last day of the trading period. Under T+5 RS, funds are paid-in and paid-out on 5th day from the trading date. Both require pay-in on the 5th day. If the account period can work with the existing state of EFT, there is no reason why RS can not work. In fact, RS should work better as clearing agency is paying-out funds earlier under the RS. If there is still apprehension that funds can not move and be paid-in in 5 days, let it move in 10 days and let us have T+10 RS. Further, it is not that there is no EFT. Transfer of funds has become quicker with the facility of EFT provided by private sector banks. Many nationalised banks also provide EFT in major towns where maximum trade is generated. The clearing banks are electronically connected to clearing agencies for quick movement of funds for settlement of trades and payment of various margins on T+1 basis. If we have to wait for EFT facility to be available all over the country, which is not going to happen in foreseeable future, we can never have RS.

- Doubts have sometimes been expressed about the adequacy of the existing infrastructure for RS. It may be noted that two depositories are in place and they have been transferring the securities electronically. Most of the securities are being held and traded in demat form. All the stock exchanges have screen based trading system. The facility of lending and borrowing of securities is available to facilitate timely delivery of securities. Even the software for CFRS and ALBMRS are operational. The existing infrastructure of stock exchanges and other market participants is adequate to settle at one go, all the transactions accumulated over a trading period. It will be easier to settle each day's transactions daily as back office work would be spread over five days under RS.

- Under rolling settlement, pay-in and pay-out of funds take place on the same day. At the advice of the clearing agency, the clearing banks debit (credit) accounts of members and credit (debit) clearing agency by pay-in (pay-out) amount by evening. However, the funds coming in and going out of a clearing bank do not match. In addition, there may be a shortfall in funds in a particular bank to be made good by the clearing agency out of its funds (the settlement guarantee function). These require movement of funds from one bank to another by using the RBI clearing system. For example, say funds pay-in is Rs. 100 crore of which Rs. 80 crore come into bank A and Rs. 20 crore into bank B. However, the pay-out is such that Rs. 60 crore is to be paid out in bank A and Rs.40 crore in bank B. This requires Rs. 20 crore to be moved from bank A to bank B. This movement is accomplished through RBI clearing on the next day. But before this, the clearing agency extends inter-day liquidity to effect same day pay-in and pay-out. This requires clearing agency to maintain high levels of deposits effectively adding to processing costs. Since volumes under rolling settlement are insignificant today, the clearing agency is able to provide inter-day liquidity. As volumes pick up, this will place a fair amount of strain and costs on the clearing agency as well as clearing banks and members, unless the payment systems are geared to deal with this requirement. This requires permitting the clearing agencies to participate in the RBI's clearing system which would enable them to have current accounts with RBI and issue instructions for transfer of funds directly.

- After a lot of deliberation, tradeable carry forward (carrying forward the position for 1, 2, 3, 4, or 5 days) has been permitted under rolling settlement. This means that the securities traded on a day can be settled on five different days and the securities traded on five different days can be settled on a day. Five different future contracts are open for trading on any day. This product is a futures contract on individual stock in disguise of carry forward and is being traded in cash market without the discipline of futures market. Further, though this was introduced to provide volume for scrips under RS, there has not been any perceptible difference in the volumes in the scrips in the pre and post CFRS and ALBMRS environment. There is also not enough demand for all the five variants. Thus we have a very complicated and risky product sans any gains in volumes.

- Under RS, securities are delivered everyday. At times, it may be difficult for a delivering member to do the same leading to auctions/closeouts. That is why there is a need to provide an alternative mechanism to auctions/close outs if a member fails to deliver. This facility is provided by CNS under which, the undelivered securities position is added and netted alongwith the next day obligations of the member. Similarly there should be an arrangement to borrow securities to facilitate timely delivery. These facilities are currently available in NSE in respect of select scrips and need to be extended to other exchanges to provide the much needed liquidity for the scrips under RS.
- In the interest of market safety, SEBI has recently allowed the stock exchanges to use settlement guarantee funds maintained by them for meeting shortages arising out of non-fulfillment/partial fulfilment of the funds obligations by the members in a settlement before declaring the concerned member defaulter as in the case of NSCCL. This essentially requires the clearing agency to provide novation (counter-party guarantee) for all the transactions and meet the payment obligations of members immediately without waiting to declare them defaulters. This is all the more required in rolling environment where obligations are to be discharged every day. The exchanges would be required to use the services of a clearing corporation who can become legal counter-party (provide novation) to net settlement obligations of every member and discharge all settlement obligations, regardless of members' default. It is not necessary that each stock exchange must have its own exclusive clearing corporation or clearing corporation must be owned/managed by trading members/stock exchanges. It may be better if the exchanges use the services of one or two clearing corporations as the depository services are shared by them.
- Nearly ten thousand securities are listed on Indian exchanges. Trades in about 400 scrips are proposed to be settled under RS by July 2001. If we can have RS for most liquid 400 scrips, why not for all 10,000? If it is administratively difficult at the present, all exchanges should follow uniform settlement cycle in respect of the balance scrips.

III. Amendments in SEBI Act, 1992

Historical Background

Till 1992, there was no legislation which aimed specifically at investor protection. Enactment of SEBI Act, 1992 was the first serious attempt towards integrated regulation of the securities market and protection of investors in securities. The Act established SEBI in 1992 with the objectives to (a) protect the interests of investors in securities, (b) promote the development of the securities market, and (c) regulate the securities market. The functioning of SEBI for a few years revealed inadequacy of its authority to carry out entrusted duties efficiently. The securities laws were amended in 1995 to confer additional powers on SEBI and expand its jurisdiction. The amendment extended SEBI's regulatory jurisdiction over corporates in issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with securities market. The Act also empowered SEBI to issue directions to all intermediaries and other persons associated with the securities market in the interest of investors or for orderly development of the securities market. It was vested with the powers of a civil court under the Code of Civil Procedure, 1908 to summon and enforce attendance of persons and examine them on oath, inspect any books, register and other documents, and discover and enforce production of books of account and other documents. These help SEBI considerably to carry out investigations, conduct inquiries and inspections and levy fines against the erring intermediaries, issuers of securities and other persons associated with the securities market. SEBI was also empowered to adjudicate a wide range of offences and impose monetary penalties on any intermediary or other participant, in addition to cancellation/suspension of certificates of registration of intermediaries. The securities laws were amended further in 1996 to empower SEBI to regulate the depositories and administer the Depositories Act, 1996. The laws were amended in 1999 again to strengthen the hands of SEBI to protect the investors in securities of plantation companies. It also empowered central government to delegate powers under the SCRA to RBI in addition to SEBI. The Companies Act was amended in 2000 to empower SEBI to administer the provisions contained in a number of sections so far as they relate to issue and transfer of securities and non-payment of dividend in case of listed public companies. In order to strengthen the hands of SEBI, it was given concurrent/delegated powers for various provisions under the Companies Act and the SCRA. In short, SEBI has the necessary autonomy and authority to regulate and develop an orderly securities market.

While interpreting the powers of SEBI, Gujarat High Court has held: ".. *It is a common knowledge that the SEBI has to regulate a speculative market and in case of speculative market varied situations arise and all such exigencies and situations can not be contemplated in advance, and therefore, looking in to the exigencies and the requirement, it has been entrusted with the duty and functions to take such measures as it thinks fit. SEBI has to rise to the occasion for taking appropriate measures to combat even such situations Therefore, the powers of SEBI has to be considered and interpreted under the provisions so as to see that the objects sought to be achieved by the Act is fully served, rather than being defeated on the basis of any technicality. In stead of general principles of law, in such cases, the matter is required to be considered on first principle. The first principle is that the provisions of an Act have to be given a meaning so as to advance the object sought to be achieved by that Act.*"

Remaining Inadequacies

- There are four basic pieces of legislation that provide regulatory framework for the securities market. These are (a) The Companies Act, 1956, which deals with issue, allotment and transfer of securities and disclosures to be made for public issues, (b) The Securities Contracts (Regulation) Act, 1956, which provides for regulation of transaction in securities through control over stock exchanges, (c) The Securities and Exchange Board of India Act, 1992, which provides for establishment of a regulatory authority to protect the interest of investors in securities and to promote the development of and to regulate the securities market, and (d) The Depositories Act, 1996, which provides a legal basis for establishment of depositories to maintain the ownership records of securities in a book entry form and effect the transfer of securities. In addition, there are a number of other legislations (The Income-tax Act, The COPRA, The Indian Trust Act, The Reserve Bank of India Act, the Unit Trust of India Act, The MRTP Act) which have substantial bearing on the securities market. All these have caused a lot of confusion not only in the minds of investors, but also among the various agencies who administer these legislations. The greater the number of laws, the greater is the scope for inconsistency among them and greater is the possibility for regulatory overlaps and gaps.

  There are also as many regulators as the number of laws. While the successive amendments have strengthened the hands of SEBI, these have not correspondingly reduced the ambit of the Department of Company Affairs and Department of Economic Affairs relating to securities market. Many a powers are exercised concurrently by SEBI with government. A few powers under the SCRA are now concurrently exercisable by RBI also. As a result the responsibility for supervision and development of the securities market is fragmented among different agencies. As the roles of various agencies overlap, they may at times work at cross purposes and result in duplicate and inconsistent regulations.

  Despite a host of legislation and a number of regulators who purportedly protect the interests of investors, the investor is still left high and dry. What is required is consolidation of all laws relating to securities market into a single piece of legislation, preferably called the Securities Act and assigning its administration to one agency, SEBI only. It would be better if a special mechanism, like consumer forum, is created to dispose of all investor grievances summarily. And this piece of legislation should prevail over general laws like the Companies Act, the UTI Act, the Consumer Protection Act, the Contracts Act, etc and the agency has to work in close coordination with regulators for other areas of financial market.

- The securities market is an integral part of the economy. It has the potential to destabilise other sectors. It is therefore necessary that the penalty for offences in the securities market is deterrent.

The first step in this regards is to make all the offences in the securities market cognisable, as a few offences under the SCRA are.

The penal provisions in the SEBI Act need a little more fine-tuning. The SEBI Act provides for two alternative types of punishment for violations of the provisions of the Act, in addition to prosecution and directions. They are: (a) suspension or cancellation of certificates of registration to be imposed by SEBI only as per Regulations framed by SEBI, or (b) monetary penalty to be imposed by an adjudicating officer, appointed by SEBI, as per Rules framed by the Central Government. These two types of punishments are mutually exclusive, not and/or punishments. If a violation is assigned to an adjudicating officer for adjudication or monetary penalty is imposed, penalty of suspension or cancellation of certificate of registration can not be imposed and vice-versa. As per the scheme of the Act, SEBI shall appoint an officer to adjudge if some body has contravened any of the provisions of sections 15A to 15F of the Act. Once such an adjudicating officer is appointed, the SEBI loses control over the case and the adjudicating officer decides the case on merit. The adjudicating officer can at best impose monetary penalty even if he finds that the violation really warrants suspension or cancellation of registration. Similarly, if SEBI initially considers a case for suspension or cancellation, it can not impose monetary penalty even if it concludes that the violation warrants monetary penalty. This happens because SEBI does not have power to impose monetary penalty and the adjudicating officer does not have power to suspend or cancel a certificate of registration. A corollary of this is that mind is made up about the type of punishment to be imposed on the erring party when the alleged violation is referred to adjudicating officer for adjudication or taken up by SEBI for imposition of suspension or cancellation of registration, that is, at a stage when the nature and gravity of the violation has not been ascertained. What would, therefore, be desirable is to authorise the adjudicating officers to try all offences under the SEBI Act and award suspension/cancellation of registration and/or monetary penalties so that SEBI can concentrate on developmental and regulatory work.

The maximum penalties prescribed under the SEBI Act appear at times too low where it should be high and too high where it should have been low. For example, the maximum penalty an adjudicating officer can levy for insider trading is a meagre Rs.5 lakh, which an insider would be too happy to pay after making a killing on the stock market with price sensitive information. On the other hand, the failure of a broker to issue, even if negligently, a contract note visits a fine as high as five times the contract value. Thus, a broker who fails to issue a contract note for Rs.20 lakh has to cough up Rs.1 crore. The penalty prescribed under the SCRA is ridiculously less. In addition to rationalising the rates of penalty, these needs to be increased substantially, may be ten fold, as has been done recently under the Companies Act.

- Securities market supervision is labour intensive and relies for success on the commitment, judgement and skill of the personnel involved. Conferring additional powers on SEBI would not make much difference unless it has right quality and quantity of people to administer the Act. Given the size and spread of the securities market, SEBI must increase its staff strength and pay them adequately. It has no reason to link its compensation package to that in government or any financial institution. The compensation package should bear some resemblance with the personnel working in the securities market so as to attract and retain professionals. Such professionals must be trained and retrained to remain in tune with developments in the market. They should be using at least the same level of technology as the market participants do. SEBI should not have problem to support these financially in view of its powers to levy fees upheld recently by the Supreme Court. A system should be evolved to monitor the performance of SEBI (not of market) and to hold it accountable. Like Public Undertakings Committee of the Parliament which reviews the working of the public undertakings, a Parliamentary Committee to review the working of all the regulators may be formed.

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