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INDIAN STOCK EXCHANGES : SOME SUGGESTIONS ABOUT RULES OF TRADING

THE stock exchange being essentially a market, should strive to provide a really organized, free and fair market for securities. To this end, it should have written and codified rules concerning all its various aspects so as to ensure smooth conduct of business on its floor. Its rules and regulations, procedures and practices pertaining to the transaction of business should be adequate to avoid misunderstandings amongst the transacting parties and to prevent artificial price fluctuations by the vested interests (that are so common in an embryonic stock market) so as to avoid the establishment of a false market. Above all, they should be such as to encourage a large volume of trade by inspiring confidence in the minds of investors at large—a class for whose benefit the market is supposed to exist. In fact, the entire rules, regulations, administration and practices of the stock exchange should be geared to securing a constant increase in the number of investors, for an increase therein shall mean more capital formation for the economy and more business to the Exchange and its members which shall enable the Exchange to provide an active, liquid and continuous market in securities. Obviously, an active market is more likely to be a fair market; narrow or inactive markets may lack competition sufficient to set fair prices. Business therein may be inadequate to impart the much needed continuity in dealings in most of the scrips. It is apparent that without continuity in dealings, there cannot be a continuous process of evaluation of securities, and without a continuous process of evaluation, there can be no real liquidity. Moreover, the large volume of business emerging from an increased number of investors shall lead to a reduction in the overhead costs of doing business and thereby, further improve the liquidity of the stock market.

It is in this background that the rules of trading prevalent at the Indian stock exchanges have been studied and suggestions have been made to improve upon the existing situation. The need for proper implementation of the rules may, however, be emphasised here. Any number of rules or regulations can hardly help an institution to achieve its objectives unless the rules are properly implemented without fear or favour and without negligence, connivance or exception. It is not unusual for an institution to have the best of rules and still be badly administered for it is one thing to have a code and another to observe it. The Indian stock exchanges also do not have a good record of performance in this respect. Mr. A. D. Shroff, who worked for 12 years on the Bombay Stock Exchange (the best administered one in India) in this connection observed "Many of the existing rules are excellent but their effect is lost either because of their half-hearted enforcement or failure to use them." The governors/directors or the president of the Exchange tend to avoid the enforcement of rules on the score of ignorance of their breach, till somebody actually reports the matter, though such breach is a matter of common knowledge. This has naturally encouraged undesirable practices on the part of brokers causing deterioration in the investment atmosphere in the country.

In fact, in India at present, the president and the secretary of a stock exchange cannot act with firmness. They are appointed by and serve at the pleasure of the governing body. Except at the Bombay Stock Exchange which has a full time non-active member president, the president continues to be an active-member of the Exchange. Naturally, therefore, he cannot afford to displease his fellow members by taking disciplinary action against them for the breach of rules which he himself might be committing very often.[1]

To make the administration really effective and impartial, it is suggested that the Indian stock exchanges like the New York Stock Exchange, should have a chairman as well as a president. The chairman should be the presiding officer of the governing board and should be elected by members to hold office for one year only. He must be a member of the Exchange. The president should be a whole time chief executive officer of the Exchange and should represent the Exchange in public matters. He should be elected by the goeerning body for a fixed term. He should be an *ex-officio* member of the governing body. The terms and conditions of his appointment should be subject to the previous approval of the Central Government. The person so appointed should not engage himself in any business directly or indirectly, during the period he holds the office and if he happens to be a member of the Exchange at the time of his election, he must dispose off his membership forthwith. The president so appointed should not be liable to dismissal or removal without the previous approval of the Central Government and he should not be liable to retirement by rotation. The appointment and removal of the secretary should also need the approval of the Central Government. These measures will definitely strengthen the position of the president and secretary and shall enable them to transcribe the rules into action without any fear or favour.

However, the following suggestions are being made to improve upon the existing rules relating to the transaction of business at the ndian stock exchanges.

FUNCTIONAL SPECIALISATION OF MEMBERS :

Functional specialization of members at the stock exchange helps a lot in making it a fair and continuous market. It is, therefore, common at the leading foreign stock exchanges. In India the stock exchange rules and regulations do not prescribe any functional classification but still it is observed in practice, in varying degrees at the different stock exchanges. But this functional specialisation is inadequate as it does not safeguard the interests of investors. The members of the stock exchange perform two distinct functions—(a) that of a broker acting as the agent, buying and selling securities for others on a commission basis; and (b) that of trader or dealer as a principal buying and selling securities on his own account for a profit. Apparently, these functions involve a conflict of interest and as such members should not be permitted to act both as brokers and dealers simultaneously. If the broker is authorised to trade on his own account, he may take an unfair advantage to the detriment of the investing public by disposing off his own holdings to the clients at his own price or by buying the investments of his clients at lower prices.

But in India, the members are permitted to act both as brokers and dealers. This has led to serious abuses. Though there does exist something like an official division of members on the Bombay Stock Exchange between the Commission Brokers and the Taravaniwalas, but this division is not at all rigid and nothing binds a broker from dealing at the same time on his own account or *vice versa*. The Taravaniwala, like the Specialist of New York, generally specialises in a few securities and deals on his own account. He has often been likened to a jobber on the London Stock Exchange, but this resemblance is more formal than real. Unlike the London jobber, the Taravaniwala is not there in the market to quote two prices nor after making a price he is bound to accept a stipulated amount offered or asked for. The London jobbers normally keep an 'open' position overnight, while the Bombay Taravaniwalas are particularly noted for squaring up their position by the end of each day. Above all, the Taravniwalas can and often act as Commission Brokers also. While "the system of jobbers in London often provides a barrier against violent price fluctuations, the Taravniwalas in Bombay are noted for causing wild price fluctuations."

At present, however, to deal with the problem of conflict of interest, Section 15 of the Securities Contracts (Regulation) Act provides that no member can enter into a contract as a principal with any person other than a member of a recognised stock exchange unless he secures in writing the consent or authorisation of such person and in case of closing out of an outstanding contract, discloses in the note, memorandum or agreement of sale or purchase that he is acting as a principal.

This Section provides no remedy whatsoever to the evils associated with Taravni business. It does not even prohibit members from working in dual capacity of brokers and dealers; it merely insists on brokers while working as a principal, to do so with the full knowledge of the client. It is claimed that this rule shall provide adequate protection to clients and ensure dealings at fair prices. However, the practical utility of this rule is doubtful in a country like India for more than one reasons. Firstly, in case of outstation clients, the obtainment of their written consent may involve a pretty long time—even a fortnight but in no case less than a week. This is so long a period that the security prices move to the detriment of the clients, who generally rush in to buy in a rising market and to sell in a falling market.

Secondly, the outside clients, particularly those living in distant corner have no means to verify the reasonableness of prices charged to them. Newspapers do not give the prices of all securities; they give only the closing prices and not all the prices at which transactions were done in a particular security on a particular date. And the brokers, in the contract notes which they submit to their clients do not show the commission charged by them separately from the price at which the deal has been effected.

To deal with the problem of conflict of interest (and the abuses of Taravni business) the effective remedy lies in the clear-cut division of members into two watertight compartments of (1) brokers and (2) jobbers on the same lines as in London. The rules of the Indian stock exchanges should, therefore, prescribe to that effect. Under no circumstances should a broker be allowed to act as a jobber, even for matching orders. In the beginning of each year, members should be asked whether they propose to act as jobbers or brokers. All the partners of a member firm must be allowed to work in one capacity only. This will make the brokers distnterested middlemen which in turn, shall inspire the confidence of the investors in them. It may be pointed out here, that both the Atlay and the Morison Committees favoured this division of members but did not recommend it for introduction at that time because they considered the volume of business at the Indian stock exchanges to be insufficient for the purpose. Now, when the business in securities has sufficiently grown up, the reform may be introduced, to begin with, at least at the Calcutta and the Bombay Stock Exchanges. The jobber by his presence in the trading ring, shall make business in securities quick and easy and shall help keeping markets free and continuous. The presence of jobbers shall enable the brokers to go straight to a certain spot in the Exchange and effect deals without any loss of time. They would be sure of selling or buying. Today, the broker has to spend an hour or two every time he wants to buy or sell in looking for a broker who wants to do the opposite in the same amount of the same stock, and in haggling about the price, and still sometimes he returns to his office with many expectations unfulfilled. With the introduction of jobbers, the difficulties of the brokers would be so much reduced that they could possibly work for commissions lower than those now being charged, so that what the public would pay extra by way of jobber's turn would be more than compensated by reduction in commissions and the quickness and convenience in dealing.

On the other stock exchanges where the volume of business is inadequate to permit this change, Taravni business may be allowed to continue to provide a continuous market but with adequate restrictions, *e.g.*, to prevent a Taravniwala from making a false bid or a false offer and then backing out of it, the stock exchange rules should prescribe that a bid or offer of stock in the market, where no amount is stated, shall be binding, at the bargain price, upto a particular amount to be fixed by the Exchange. The amount recommended for the purpose by the Morison Committee was Rs. 10,000. But since the Taravniwala deals in much greater amounts in very active securities and there is the practice of bidding the market against the broker, a much higher amount—in no case less than Rs. 25,000 need be fixed for active securities. In addition, the business of Taravniwala must be properly defined.

Alternatively, at the smaller stock exchanges, members may be permitted to continue to act as brokers and/or jobbers, but they should, in the beginning of the year, be asked to let the Exchange know the particular capacity in which they propose to work during the ensuing year. The Exchange should then, prepare separate lists of members working as (i) brokers, (ii) jobbers or dealers, and (iii) in dual capacity. These lists should be made available to the investing public on request. Members should be asked to mention on all communications relating to stock exchange business whether they act as brokers, dealers or in dual capacity. The Exchange should make rules to the effect that orders for the accounts of customers shall have priority over all other orders executed on the trading floor. Orders for the accounts of customers shall not include an order for the account in which a member or a partner, director, officer, shareholder or employee of a member has an interest, direct or indi ect, other than interest in commission charged. This ruling shall be an important step forward in ensuring the public of complete priority in obtaining the best possible price in the purchase or sale of the securities. There should be nothing difficult in its implementation in India as this is already being practised in many other countries.

ENFORCEMENT OF MINIMUM BROKERAGE :

At present, the Indian stock exchanges prescribe the maximum rates of brokerage to be charged by the brokers to their clients. As such, there is an unfortunate tendency to continuously reducing scales of brokerage in order to attract large speculative business. This practice is unfair both to the members and also to the profession. It arouses cut-throat competition amongst the brokers resulting in sharp underhand practices. Reasonable scales of brokerage are essential both for enabling efficient service to be given to the public and for the maintenance of proper standards among the members of the Exchange. The present 'maximum scales of brokerage' should, therefore, be replaced by the 'minimum scales of brokerage' and any reduction by individual members below the prescribed minimum rates, to attract business should be severely dealt with by the stock exchange authorities. It may be added here that it is the common practice with the foreign stock exchanges to fix minimum scales of brokerage which in practice, tend to be the maximum scales of brokerage because of the severe competition amongst the brokers.

BROKERAGE TO BE SHOWN IN CONTRACT NOTES :

At present, the brokerage charged by the stock exchange brokers is not required to be shown separately in the Contract Notes that they submit to their clients. It is merged into the price at which the deal has been effected for and on behalf of the investors. The brokers simply certify that the brokerage charged does not exceed the prescribed rates. Under this arrangement, the upcountry investor is left with no means to verify either the reasonability f the price charged or allowed to him or to find out the exact amount of the brokerage charged. Apparently, this is a very undesirable state of affairs. So, to inspire confidence in the upcountry investors, it is essential that the amount of brokerage charged should be shown separately in the Contract Notes.

HOURS OF BUSINESS AND HOLIDAYS :

In view of the development of the kerb markets which operate in almost all the stock exchange centres after the usual stock exchange business hours, it seems desirable to extend trading sessions where they are unduly limited. The only two and a half hours' trading session on week days and that of one and a half hours on Saturdays seem to be very short. The brokers, therefore, are left with the time and anxiety to trade in securities which finds an outlet in the kerb markets. Trading sessions have already been extended at the Calcutta and the Delhi Stock Exchanges. This has had a healthy effect and the kerb trading has very much minimised there.[2] The trading sessions can, therefore, be extended with advantage to five hours on week days and three hours on Saturdays. It is hoped that this will go a long way in minimising kerb trading.

For a public institution like the stock exchange, it hardly needs to be emphasised that there should not be too many holidays as they hamper business and cause a great inconvenience to the investing public. At present, the number of holidays that the Indian stock exchanges observe, are too many and need a curtailment. It is proposed that they should be limited to those observed by the banks in that area.

TRADING LOTS :

In order to encourage small and medium investors at the Indian Stock Exchanges, it is essential that the trading lots should be reasonably small. Dealing in odd lots involves too much trouble and expense to the small investors; they pay more as purchasers and get less as sellers as compared to prices for marketable lots. Sometimes, the price difference is quite material. Besides, it takes more time to deal in odd lots as compared to marketable lots.

The question of prescribing smaller trading lots was considered at a meeting of the Stock Exchange Presidents.[3] Therein it was decided that in future the marketable lots may be of the value of Rs. 1,000 in the case of existing companies and in the case of new issues, it should be in the lots of Rs. 500 or Rs. 1,000 depending on whether the share is of Rs. 10 or 100. This decision also is on the high side and is neither in keeping with the requirements of the time nor in accordance with "the declared objective of the Government to making more and more people share-minded and to diversify the shareholdings in existing companies".[4]

In fact, the trading lots have to be much smaller if small and medium investors are to be encouraged in stock dealings and corporate shareholding. They should, in no case, exceed half the amounts decided by the Presidents. Now, whenever an issue is oversubscribed, the small applicants have to be favoured in the matter of allotment. This is in accordance with the Government directions. Many a time, the small applicants get allotments which fall very short of the marketable lots. The marketable lots, have, therefore, to be smaller so that the petty investors are not losers while dealing at the stock exchange. This is particularly important in view of the fact that in times to come the Indian industry is going to rely more and more for industrial investment on smaller and smaller investors.

UNIFORMITY IN TRADING LOTS AND PRACTICES:

To inspire confidence in the investors at large, it is essential to simplify the stock exchange business. To this end, it is necessary that there should be uniformity in practices and trading lots at the different stock exchanges in India. This will remove many complications and smoothen the transaction of business in securities. Inspite of the attempts made by the Indian stock exchanges in this direction, in some cases the marketable lots are still different at the different stock exchanges for the same scrip. There is no uniformity in trading practices or in actions to deal with special development. Uniformity in all possible respects is very much desirable and should be attained.

THE MARKING OF BARGAINS:

The marking of bargains in the Official List is a record of business actually transacted and provides an index to the established price level. On the Indian stock exchanges at present, only the prices at which the bargains were struck are noted. No record is made of the volume of shares that changed hands. The marks are, therefore, no criterion either of magnitude or modesty of the transaction. They cannot be even an index to the activity of trading in that scrip as the marking is not compulsory. Neither do they reflect the price trend on a particular day as they need not be in the same order in which the bargains took place.

In order to enable the upcountry client to verify the price at which his order is reported to have been executed by the broker, the marking should be made compulsory. The investor will then be in a position to satisfy himself by looking into the Official Quotation List. In addition, the stock exchanges ought to publish not only the prices at which business has been done but also the number of shares which have been dealt in. At present, the "stock brokers do their business by minding their own business; large transactions often take several days to complete and would probably never be done at all if the prices and the number of shares dealt in had to be published. The size of many stock exchange transactions would stagger the man in the street if he knew about them; they are only possible because being the private concern of the principals, they are kept private."[5]

APPOINTMENT OF FLOOR GOVERNORS

The members of the recognised stock exchanges are required to transact business according to certain set rules and practices which are there to keep a restraint on their manipulative tendency. Experience has shown that there has always been the temptation and the tendency to disregard the rules and regulations, not only those framed by the stock exchanges but even those of law. It is no secret that option dealing, though illegal, is widely prevalent at the Indian stock exchanges. Street trading, private compromises (to avoid declaration of default) and evasion of margin regulations are very common with the stock exchange members. This is very undesirable. To prevent all this, at some foreign stock exchanges *e.g.*, the Toronto Stock Exchange, there is the practice of appointing the 'Floor Governors' who supervise floor procedures during business hours. The Floor Governors have the authority to make decisions whenever a dispute arises between members over a transaction. They have also the power to discipline floor traders and the clerks. The same practice can be adopted with advantage in India also. It will not cost anything to the Exchange. The Floor Governors will be honorary and will be appointed by the governing body from amongst the responsible members of the Exchange selected on the basis of their past record.

PRINTED MEMORANDUM BOOKS :

During the business hours the operators carry with them a small memorandum book for noting therein the details of a bargain as soon as it is struck. At present, the members make their own arragement of the memorandum books which are usually made of plain paper. The entries therein are made mostly by pencil. These books are very important as they contain the primary information of each business transaction done at the floor of the Exchange. If the arrangements could be made for the supply of these books by the Exchange—free or at cost—with the book number, the page number and also the serial numbers at which the bargains are to be recorded, printed on each page and if members are required to make entries only in ink, manipulation will become difficult, if not impossible. The memorandum books will then be more authentic and will provide the auditor with the primary record. It will be easier for the Exchange to exercise a stricter control on the business done by its members. The accuracy of the various business statements submitted by members would be easily checked under this arrangement. It is hoped that this along with the practice of compulsory marking and the appointment of Floor Governors will go a long way in promoting fair business at the Indian stock exchanges.

COST OF DEALING :

It has to be ensured by the stock exchanges in India that the small and medium investors are not precluded from share ownership by reason of the cost of dealing being too high. The major variable part of the cost of dealing is the brokerage. Admittedly, the charge on account of brokerage cannot be *ad valorem*, for the simple reason that the fixed part of the broker's expense remains the same irrespective of the size of the order. Therefore, the cost of service for executing small orders has to be comparatively higher. But it should not be unreasonably unfair. It can even be suggested that the investors upto a particular amount (say Rs. 500) may be served on no profit no loss basis or in their case, the margin of profit should be minimal. Admittedly, the sharebrokers are not a unique race of selfless idealists. But this is essential, atleast in the early stages of tho growth of shareownership. For once the business increases due to the growth in number and size of the investors, brokers' sacrifice in the beginning will be more than compensated. This point has to be borne in mind in laying down the minimum scale of brokerage.

ESTABLISHMENT OF THE STOCK EXCHANGE COMMISSION :

There is a basic need in our country for the setting up of the Stock Exchange Commission on the lines of the Securities Exchange Commission in the United States. The Government has assumed wide supervisory powers under the Securities Contracts (Regulation) Act, 1956. Since the Government may not necessarily be an expert in securities business, it will be desirable on its parts to have the advice of an independent body, the members of which are well versed in stock exchange members, before it proceeds to issue orders in exercise of some of its more drastic powers. Such a body can also watch the development of any undesirable trend in regard to dealings in securities both within and without the stock exchanges, and can keep the Government informed well in time of any such development needing urgent action. It will also provide a central machinery for the control and co-ordination of practices at the different stock exchanges. It will also be the function of this body to advise the Government in all matters pertaining to the stock exchanges including the educational, professional and financial qualifications required for entry into the stock exchange business. Accordingly, the establishment of a Stock Exchange Commission is proposed. The Commission should have not more than three members, all of whom should be disinterested persons having no direct or indirect dealings at the stock exchange. The knowledge and experience of all he three members in matters pertaining to the stock exchange should be undoubted, because it is on their advice that the Government will take any action under the Securities Contracts (Regulation) Act, 1956.

REFERENCES

[1] In one case, even an ex-President of a recognised Stock Exchange so grossly violated and contravened the Rules and Bye-laws of the Exchange that he had to be expelled from membership of the Exchange.

[2] Claimed by the Presidents of the Calcutta and Delhi Stock Exchanges at the first meeting of the Standing Committee of the Presidents of Stock Exchanges held at Bombay on October 4, 1961.

[3] Second Meeting of the Standing Committee of the Presidents of Stock Exchanges held at Calcutta on December 15 and 16, 1961.

[4] Statement of Sonde, V.D., Government nominee at the Eleventh Meeting of the Presidents of Stock Exchanges.

[5] Berman, H.D., *The Stock Exchange*, Sir Isaac Pitman and Sons Ltd. London p. 73.