Model Answer/suggested solution: **Stock Market Operation**

M. Com (IIIrd Sem) Examination, 2013 **Paper Code: AS-2378**

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Note: These model answers are a depiction of important points which an examinee must have to mention to secure high marks in particular question. The length of the answer may vary as per the examinee's understanding, interpretation and his/her ability to comprehend the content.

Q.1 Short answer type question:

1. Mention two main significance of Stock Exchange.

i. Provides ready market of securities…..
ii. Protects investors….
iii. Provides quoting of market prices.
iv. Mobilisation of savings……
v. Promotion of capital formation……

- Brief explanation is required for any two…

2. What are future contracts?

Ans. Future contracts are those contracts which are entered today for buying & selling of securities at some future date. A futures contract is a contract between two parties where both parties agree to buy and sell a particular asset of specific quantity and at a predetermined price, at a specified date in future. The payment and delivery of the asset is made on the future date termed as delivery date. The buyer in the futures contract is known as to hold a long position or simply long. The seller in the futures contracts is said to be having short position or simply short.

3. What is SENSEX?

Ans. SENSEX is an indicator of performance of stock market movement of BSE.SENSEX consists of free-float market-weighted stock market index of 30 well-established and financially sound companies listed on Bombay Stock Exchange.

4. Mention the type of speculators present in stock market.

i. Bulls.
ii. Bear.
iii. Lame Duck
iv. Stag.

5. What do you mean by Depository Participant?

Ans. A depository Participant (DP) is an agent of the depository through which it interfaces with the investor. A DP can offer depository services only after it gets proper registration from SEBI. They are the intermediaries between depository and the investors. A depository can be compared with bank, likewise a DP may be compared with a branch of a Bank.

6. Mention two differences between Exchange Market & OTC Market.

Exchange Market	**OTC Market.**
There are regulators	No regulators.
Less chances of price manipulation	Can manipulate price
Ensure transaction security	OTC market are prone to fraud & dishonest traders.
Related to financial instruments	Related to commodities.

7. Name any two depositories of India.

Ans. a) National Securities Depository Ltd. (NSDL)

b) Central Depository Securities Ltd. (CDSL)

8. Write full form of NASDAQ.

Ans. National Association of Securities Dealers Automated Quotation

9. Who is a jobber?

Ans. A jobber is an independent dealer in securities. He is not allowed to deal with the public directly. He deals with the brokers who are engaged by the investors. Thus, the jobbers buy securities and sell them to the members who are operating on the exchange as brokers. He works for profit rather than on commission basis.

10. What do you mean by Foreign Institutional Investors?

Ans. Foreign Institutional Investors are an institution established and incorporated outside India, which proposes to make investment in Indian Securities. They are eligible to make purchase shares and convertible debentures issued by Indian Companies under the Portfolio Investment Scheme. There are three routes through which FIIs can Invest in the Indian Stock Market. The first is the direct route, the second is participatory notes and the third is through FII sub account.

Q.2 Long answer type question:

1. **What is stock exchange? Discuss the organization and management of stock exchanges in India.**

Ans. According to Securities Contact Regulation Act,1956 "Stock Exchange is an association, organization or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling business in buying, selling and dealing in securities."

Organisation and Management

The organization, management, membership and functioning of stock exchanges in India are governed by the provisions of the Securities Contracts (Regulation) Act, 1956. This Act permits only recognized stock exchanges which have to function under the rules, by –laws and regulations approved by the Central Government.

At present the stock exchanges in India have one of the following organizational forms:

• Voluntary non-profit- making association
• Public limited company
• Company limited by guarantee.

A stock exchange is managed by a governing body consisting of:

1. a president,
2. a vice-president,
3. an executive director,
4. the elected directors,
5. the public representatives, and
6. the nominees of the Government(s)

The governing body is responsible for policy formulation and smooth functioning of the exchange. They have the following wide-ranging powers:

1. Elect office bearers and set up committees
2. Admit and expel members
3. Manage the properties and finance of the exchange
4. Interpret rules, by –laws and regulations of the exchange
5. Adjudicate disputes
6. Conduct the affairs of the exchange.

Major stock exchanges are managed by Executive Directors. He is a full-time employee or the exchange with substantial powers. Smaller stock exchanges are managed by Secretaries. He is also a full-time employee of the stock exchange. He attends to the day-to-day functioning of the exchange.

2. **Explain in brief about NSE and trading system on NSE.**

Ans. NSE incorporated in 1992 was given recognition as stock exchange in April 1993 and started operation in June 1994.NSE was set up by IDBI and other financial institutions with paid up equity capital of Rs.25 crores. It is India's first national online stock market with segment for both debt and equity securities.NSE was set to establish a nation wide trading. Its aim was to provide equal access to investors all over the country and to ensure fairness, efficiency and transparency in trading of securities to make Indian securities market confirm to global standards.

There is no trading floor in this exchange. The trading is screen based, meaning that the brokers are connected to the exchange by PC terminals. This makes trading very transparent and it is also cost effective. The settlement cycle on this exchange is at T+3 and some time in near future it will become T+1.This means transaction on the exchange will be much faster, and seller will get their money and the buyer their securities very quickly. The exchange provides facility of screen based trading with automated order matching. The system is order driven and conceals the identity of all parties. All orders received are sorted at best order price getting the first priority for matching i.e the the best buy order matches with the best sell order.

The trading system is very flexible, and this enables the investors to place several time, price and volume related orders. The system provides complete market information online. Due to this it is possible for the investors to know the actual position of the market, before placing the order. Trading system on NSE may divided into two segments :

1) **In Capital Market Segment**: It covers trading on equities and retail trade in debt instruments like Non- Convertible instruments and hybrid instruments.NSE provide the complete flexibility to members in the kind of orders that can be placed. Orders, as and when they are received for the first time are processed for a potential match. If the order is not matched, then the the ordered are stored in different books,in the price time priority as passive orders.
2) **Wholesale Debt Market Segment :** WDM or money market is a market where pure debt instruments such as government securities, treasury bills, public sector bonds, corporate debentures, commercial paper, certificates of deposits etc. are traded. A few large usually institutional investors and a very high volume of trade dominate this segment. Trades on this market are settled on the basis of trade for trade i.e each transaction are settled individually. The trading system is an order driven, automated order matching system which does not reveal the identity of the parties to an order or to a trade.This help orders, whether large or small. Trading system provides flexibility to the users in terms of type of orders that can be placed on the system. Several time related ,price related and volume related condition can easily be applied.

3. Discuss provisions of SCR Act,1956 relating to recognition of Stock Exchange.

Application for recognition of stock exchanges(Section 3)

3. (1) Any stock exchange, which is desirous of being recognised for the purposes of this Act may make an application in the prescribed manner to the SEBI.

(2) Every application under sub- section (1) shall contain such particulars as may be prescribed, and shall be accompanied by a copy of the bye- laws of the stock exchange for the regulation and control of contracts and also a copy of the rules relating in general to the constitution of the stock exchange

Grant of recognition to stock exchanges(Section 4)

4. (1) If the SEBI is satisfied, after making such inquiry as may be necessary in this behalf and after obtaining such further information, if any, as it may require:

(a) that the rules and bye-laws of a stock exchange applying for registration are in conformity with such conditions as may be prescribed with a view to ensure fair dealing and to protect investors;

(b) that the stock exchange is willing to comply with any other conditions (including conditions as to the number of members) which the Central Government, after consultation with the governing body of the stock exchange and having regard to the area served by the stock exchange and its standing and the nature of the securities dealt with by it, may impose for the purpose of carrying out the objects of this Act; and

(c) that it would be in the interest of the trade and also in the public interest to grant recognition to the stock exchange;

it may grant recognition to the stock exchange subject to the conditions imposed upon it as aforesaid and in such form as may be prescribed.

(2) The conditions which the Central Government may prescribe under clause (a) of sub-section (1) for the grant of recognition to the stock exchanges may include, among other matters, conditions relating to-

(i) the qualifications for membership of stock exchanges;

(ii) the manner in which contracts shall be entered into and enforced as between members;

(iii) the representation of the Central Government on each of the stock exchanges by such number of persons not exceeding three as the Central Government may nominate in this behalf; and

(iv) the maintenance of accounts of members and their audit by chartered accountants whenever such audit is required by the Central Government.

(3) Every grant of recognition to a stock exchange under this section shall be published in the Gazette of India and also in the Official Gazette of the State in which the principal office as of the stock exchange is situate, and such recognition shall have effect as from the date of its publication in the Gazette of India.

(4) No rules of a recognised stock exchange relating to any of the matters specified in sub- section (2) of section 3 shall be amended except with the approval of the SEBI.

Withdrawal of recognition **(Section 5)**. If the SEBI is of the opinion that the recognition granted to a stock exchange under the provisions of this Act should, in the interest of the trade or in the public interest, be withdrawn, the Central Government may serve on the governing body of the stock exchange a written notice that the Central Government is considering the withdrawal of the recognition for the reasons stated in the notice and after giving an opportunity to the governing body to be heard in the matter, the SEBI may withdraw, by notification in the Official Gazette, the recognition granted to the stock exchange:

Power of SEBI to call for periodical returns or direct inquiries to be made(Section 6) Every recognised stock exchange shall furnish to the SEBI such periodical returns relating to its affairs as may be prescribed.

(2) Every recognised stock exchange and every member thereof shall maintain and preserve for such periods not exceeding five years such books of account, and other documents as the Central Government, after consultation with the stock exchange concerned, may prescribe in the interest of the trade or in the public interest, and such books of account, and other documents shall be subject to inspection at all reasonable times by the SEBI.

(3) Without prejudice to the provisions contained in sub- sections (1) and (2), the SEBI if it is satisfied that it is in the interest of the trade or in the public interest so to do, may, by order in writing,-

a. call upon a recognised stock exchange or any member thereof to furnish in writing such information or explanation relating to the stock exchange as the SEBI may require; or
b. appoint one or more persons to make an inquiry in the prescribed manner in relation to the affairs of any of the members of the stock exchange in relation to the stock exchange and submit a report of the result of such inquiry to the SEBI.

(4) Where an inquiry in relation to the affairs of a recognised stock exchange or the affairs of any of its members in relation to the stock exchange has been undertaken under sub-section (3),-

(a) every director, manager, secretary or other officer of such stock exchange;

(b) every member of such stock exchange;

(c) if the member of the stock exchange is a firm, every partner, manager, secretary or other officer of the firm; and

(d) every other person or body of persons who has had dealings in the course of business with any of the persons mentioned in clauses (a), (b) and (c) whether directly or indirectly;

shall be bound to produce before the authority making the inquiry all such books of account, and other documents in his custody or power relating to or having a bearing on the subject-matter of such inquiry and also to furnish the authorities within such time as may be specified with any such statement or information relating thereto as may be required of him.

Annual reports to be furnished to SEBI by stock exchanges (Section 7). Every recognised stock exchange shall furnish the SEBI with a copy of the annual report, and such annual report shall contain such particulars as may be prescribed.

Power of Central Government to direct rules to be made or to make rules (Section 8) Where, after consultation with the governing bodies of stock exchanges generally or with the governing body of any stock exchange in particular, the SEBI is of the opinion that it is necessary or expedient so to do, it may, by order in writing together with a statement of the reasons therefore, direct recognized stock exchanges generally or any recognised stock exchange in particular, as the case may be, to make any rules or to amend any rules already made in respect of all or any of the matters specified in sub-section (2) of section 3 within a period of two months from the date of the order.

(2) If any recognised stock exchange fails or neglects to comply with any order made under sub-section (1) within the period specified therein, the Central Government may make the rules for, or amend the rules made by, the recognised stock exchange, either in the form proposed in the order or with such modifications thereof as may be agreed to between the stock exchange and the Central Government.

4. **Explain the duties of Brokers.**

Ans. Broker means a person searching out buyer and sellers to execute a transaction on behalf of his principal.Broker charge commission on each purchase and sell they arrange for. Stock Broker are the member of recognized stock exchange who buy or sell securities on behalf of their client.

The duties of Broker can be divided into three categories:

a) **General Duties:**
   i. Integrity and fairness.
   ii. Exercise skill and care
   iii. Not to indulge in manipulation or fraudulent transactions.
   iv. Not to create false market.
b) **Duties Towards investors:**
   i. Execute orders at best available price.
   ii. Not to refuse to deal with small investors.
   iii. Prompt payment and delivery of Securities.
   iv. Issuing the contract note.
   v. Not to disclose confidential information about clients.
c) **Duties towards other brokers and sub-brokers**
   i. Not to advertise.
   ii. Not to induce client of other brokers.
   iii. Co-operate with other brokers.
   iv. Fulfill his obligations.
   v. Not to deal with defaulting clients.

- Brief explanation is required for each point.

5. **Write a short note on NSE.**

Ans.NSE incorporated in 1992 was given recognition as stock exchange in April 1993 and started operation in June 1994.NSE was set up by IDBI and other financial institutions with paid up equity capital of Rs.25 crores. It is India's first national online stock market with segment for both debt and equity securities.NSE was set to establish a nation wide trading. Its aim was to provide equal access to investors all over the country and to ensure fairness, efficiency and transparency in trading of securities to make Indian securities market confirm to global standards.

National Stock Exchange was set up with the objectives of:

(a) establishing a nationwide trading facility for all types of securities,

(b) ensuring equal access to all investors all over the country through an appropriate communication network,

(c) providing a fair, efficient and transparent securities market using electronic trading system,

(d) enabling shorter settlement cycles and book entry settlements and

(e) meeting the international benchmarks and standards prevalent in the securities market.

Within a short span of time, above objectives have been realized and the Exchange has played a leading role as a change agent in transforming the Indian Capital Markets to its present form.

NSE has set up infrastructure that serves as a role model for the securities industry in terms of trading systems, clearing and settlement practices and procedures. The standards set by NSE in terms of market practices, products, technology and service standards have become industry benchmarks and are being replicated by other market participants.

It provides screen-based automated trading system with a high degree of transparency and equal access to investors irrespective of geographical location. The high level of information dissemination through on-line system has helped in integrating retail investors on a nation-wide basis.

The Exchange currently operates four market segments, namely Capital Market Segment, Wholesale Debt Market Segment, Futures and Options segment and the Currency Derivatives Segment.

6. Who are Speculators? What are the types of Speculators?

Ans. Some individual purchase and sell securities for indulging in speculation. They do not invest to get income in the form of dividends or interest, their sole aim is to earn by speculating the prices of securities in future. The person who indulge in speculative dealings are categorized according to their reaction or attitude to a situation. Such type have been named after various animals, the characteristic behavior of which suggests the particular attitude. Speculators are thus called bulls, bears, stag, and lame duck.

A person who trades derivatives, commodities, bonds, equities or currencies with a higher-than-average risk in return for a higher-than-average profit potential. Speculators take large risks, especially with respect to anticipating future price movements, in the hope of making quick, large gains.

DIfferent types of speculators in broader sense are as under:

1. Jobber :-
Jobber is a professional speculator who has a complete information regarding the particular shares he deals. He transacts the shares of profit. He conducts the securities in his own name. He is the member of the stock exchange and he deals only with the members.

2. Broker :-
Broker is a person who transact business in securities on behalf of his clients and receives commission for his services. He deals between the jobbers and members our side the house. He is an experienced agent of the public.

3. Bull :-
He is a speculator who purchases various types of shares. He purchases to sell them on higher prices in future. He may sell the shares and securities before coming in possession. If the price falls then he suffers a loss.

4. Bear :-
He is always in a position to dispose of securities which he does not possess. He makes profit on each transaction. He sells the various securities for the objective of taking advantages of an expected fall in prices.

5. Lame Duck :-
When bear fails to meet his obligations he struggles to meet finance like the Lame Duck. Generally a bear agrees to dispose off

certain shares on specific date. But sometimes he fails to deliver due to non availability of shares in the market. In such case he finds himself cornered. If the other party refuses to postpone the delivery them lame duck suffers heavy losses.

6. Stag :-
He is also a speculator. He purchases the shares of newly floated company and shown himself a genuine investor. He is not willing to become an actual shareholder of the company. He purchases the shares to sell them above the par value to earn premium. A stag also suffer a loss.

7. Contango :-
Contango means to came over dealing to the settlement. The broker is paid a reward to carry the settlement, it is also known as contango. It is paid the buyers, to the brokers. In some cases buyers in unable make the payment of securities on any particular date. So he requests the broker to carry on the dealing to the next settlement.

8. Backwardation:- It is an interest which is paid by the sellers of securities to the buyers who wants to postpone transaction to the next account.

7. **Discuss the functions and importance of Clearing House in Stock Market.**

Ans. Clearing House provides range of services related to guarantee of contracts, Clearance and settlement of trades, management of risks of their members and associated exchanges. The clearing house acts as a medium of transaction between the buyer and seller. Every contract between the buyer and seller is substituted by two contracts, so that clearing house becomes the buyer to every seller and the seller to every buyer. Importance of clearing house are as under:

1. It ensures adherence to the system and procedure for the smooth trading.
2. It minimizes the credit risk by being counter party to all the trades.
3. It involves daily accounting of gains and losses.
4. It ensures delivery of payment for assets on the maturity dates for all outstanding contracts.
5. It monitors the maintenance of speculation margin.

A **clearing house** is a financial institution that provides clearing and settlement services for financial and commodities derivatives and securities transactions. These transactions may be executed on a future exchange or securities exchange, as well as off-exchange in the over-the-counter (OTC) market. A clearing house stands between two clearing firms (also known as member firms or clearing participants) and its purpose is to reduce the risk of one (or more) clearing firm failing to honor its trade settlement obligations.

Clearing house is defined as entity which is different from the exchange , although it works closely with the exchange so that day to day operations of the exchange can run smoothly .Clearing house is integral part of derivative market.

Here are some of the important functions performed by the clearing house:-

1. As clearing house give guarantee to all the transactions and acts as a counterparty for all the transactions it will never have open position in the market.
2. It ensures that all the parties adhere to the system and procedures so that various parties in the market can do trading smoothly which in turns leads to more confidence of the player on the market and hence it increases liquidity in the market.

3. It ensures a proper risk management system in place by stipulating that margin is maintained which is of two types-initial and maintenance margin and hence accounting is done for all the gains and losses on daily basis and hence chances of default are reduced considerably.
4. It ensures the delivery of the underlying assets is consistent in terms of quality, quantity, size etc…so that thre is no confusion among parties, in other words all contracts are standardized.

Hence from above we can say that clearing house is the backbone of the derivative market and is very important for smooth running of derivative market.

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