Lecture 3

Method of trading in Indian stock exchange/ Various stages involved in Trading in Stock Exchange

A transaction involving buying and selling of securities in a stock exchange is called "trades". Execution of a transaction on the floor of stock exchange is highly technical in nature. Only members of the stock exchange are permitted to enter into the stock exchange for trading purposes. These members who buy and sell securities in the stock exchange on behalf of their customers are known as brokers.

Stages involved in trading in stock exchange Various stages involved in trading of securities in a stock exchange are explained below:

1. Choosing a broker

As a non-member is not allowed to enter into the hall of stock exchange, he has to depend on member brokers to buy or sell his securities. Bankers can become the members of stock exchange and act on behalf of their customers. So, an investor should first select a broker for trading in stock exchange. Generally, the investors would prefer brokers who render the following services:

1. Ability to provide valuable information about investment alternatives

An efficient broker is one who is able to provide information about the various investment options available. The prospects of the investment depend upon the

1. capital structure,
2. earnings,
3. dividend policies; and
4. reputation of the company concerned.

So, a broker should guide the investor in selecting a good investment alternative by furnishing all relevant information. Apart from this, he should be capable of giving advice on tax implications, portfolio planning and investment management.

2. Provision of adequate investment literature

To enable to take correct investment decision, the investor should be better informed. Financial periodicals, prospectuses and various reports of the companies provide valuable information in this regard for investment analysis. If brokers supply adequate investment literature, a prospective investor will make best use of the them. The investor can scientifically analyze the information provided and refrain from taking any decision merely on hunches and intuition.

3. Prompt and quick execution of transaction

As trading in a stock exchange is highly technical, the registered brokers appoint competent clerks to assist them. Such clerks also assist investors in solving their various problems relating to investment, ensuring excellent service by often calling at the door-step of the investors. Ultimately, transactions on behalf of investors are executed promptly. Brokers employing competent assistants are able to execute the transactions very quickly.

2. Opening an account with the broker

After having selected a broker, the investor proceeds to place an order for the purchase or sale of securities with the broker. The broker in turn, opens an account in the name of the investor in his books. The broker should be given in advance a token amount, known as the margin money. The investor who intends to sell his securities should deposit with the broker the share certificate and the transfer deed. When the broker is satisfied with the genuineness and credit worthiness of the investor, both the broker and investor can enter into an agreement.

3. Placing orders

The next important step is the placement of an order with the broker for the purchase or sale of securities. An order contains customer's specification as to the price and also the time until which the order is valid. The broker should get the best possible price to the customer. Orders are placed in different forms. Some important ones are explained below:

1. At best order

"At best order" is one which does not specify any price. Such orders should be executed promptly at the best possible price. If the clients specify the time frame, then the order should be executed within the time specified. For example, "Buy 100 Ponds India Limited within one month".

2. Limit order

A limit order is just opposite of 'At best order'. The limit order fixes the price at which the broker is to buy or sell the securities. This type of order is advantageous to the buyer or seller when he foresees price movement of securities acting in his favour. Thus, a limit order safeguards the customer against paying more or selling for less. But at the same time, there is also the possibility of losing out a desired purchase or sale for insignificant margins.

3. Open Order-or Discretionary Order

Open order is one which does not specify any time or price for the purchase or sale of securities. The broker uses his discretion to buy or sell shares at whatever price he thinks reasonable.

4. Stop Order

A stop order is otherwise known as stop loss order. The purpose of the stop order is to protect the capital gain or to limit the amount of loss occurring to the customer. Stop orders are to be used for buying securities when the price rises to a level and also to sell as soon as the price has fallen to a level. Generally, speculators and investors used to place stop orders with their brokers.

4. Execution of Orders

The manner in which the brokers execute their orders varies considerably. Generally, big brokers appoint authorized clerks to assist them in transacting the business. On the contrary, small brokers execute the orders placed with them personally. The trading ring of a stock exchange works during specified hours on all working days, say for example from 12 noon to 2 p.m. Orders are executed during these trading hours. Trading outside the trading hours is known as “Kerb dealings”.

On the basis of the nature of securities dealt in, the floor of the stock exchange is divided into pits (markets). The members gather at the respective pits for purchase and sale of securities. The bargain is settled at a price mutually acceptable to the parties concerned. After finalizing the transactions, they are recorded in a rough note book called Chaupuri. Subsequently, confirmation memos (Souda Block Books) are issued by stock exchanges. On the next day, the prices at which scrips have been traded are published in the newspapers.

5. Preparation of Contract Notes

A broker whose volume of business is greater is assisted by his authorized clerks. At the close of the working day, the clerk furnishes the details of business transacted to the broker. Then the broker carefully examines the transactions and prepares a contract note. The contract note is an authenticated record of purchase and sale of securities. It provides details such as the number of shares, name of the company, date of purchase or sale of securities, the brokerage chargeable, etc.

6. Settlement of transactions

The last step in trading of securities is the settlement of the contract by the broker for his client. The broker delivers to his client the share certificates along with the transfer deed duly signed by the seller. Generally, settlement can be made in any one of the following methods.

1. Spot delivery settlement

Spot delivery settlement is otherwise known as ready delivery contracts. Under this method, delivery of securities and payment for them can take place on the date of the contract itself or on the next day. There is no postponement of the time of settlement.

2. Hand delivery settlement

Under this method, securities are delivered and payment is made within the time specified in the agreement or 14 days from the date of the contract, whichever is earlier. Hand delivery settlement is the most common method of settlement of transactions.

3. Special delivery settlement

Under special delivery settlement, delivery of securities and payment may be effected at any time exceeding 14 days from the date of contract.

4. Investment through clearing house

In stock exchanges, there are certain securities which are very frequently traded. Transactions in respect of such active securities are settled through clearing houses. The clearing house maintains a record of the securities purchased and sold by different parties. Buyers and sellers have to give or receive the dues after adjusting against the various transactions carried out by them. On the date of clearing itself, the share certificates and transfer deeds are delivered to the clearing house. Thus, cleared securities are delivered and paid for through a clearing house.