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The Daily Star **Special** on Automation of Stock Exchanges

Good bye to cry-out system, clicking the buttons will do it all

By Toufique Imrose Khalidi

The capital market is set to stop crying hoping to see the investor return

Just go sit at a stock broker's office. You can see how it is done, understand what is being done, and probably do it yourselves (if it is allowed by your broker!) if you have the elementary knowledge of computers and the stock market ways of operation. Things cannot be easier than this in a country where people at times are notoriously technology shy.

With an automated trading system installed at the 42-year-old Dhaka Stock Exchange, these are enough reasons to be optimistic. And with all the notoriety the stock brokers in Bangladesh have earned over the years -- especially after the high drama in 1996 -- something of the sort was desperately needed. True, the DSE members were not too keen on going on line. Their money and muscle helped them to resist it in one way or the other. For the "manipulators", operation through a transparent system that can be accessed and witnessed by hundreds simultaneously is an uneasy situation indeed. It is good that the DSE has finally embraced it, belatedly though.

Eventually, paradoxically enough, the DSE members rushed to it. They woke up to the dangers of not getting automated only when the three-year-old Chittagong Stock Exchange had gone on line with a wide area network (WAN) that enabled it to trade from three cities simultaneously. Naturally, the DSE was losing business to CSE, which was reflected in the volume of trade.

Internal rivalry, if not sheer reluctance and incompetence, contributed to missing a couple of deadlines from the regulators. "Get automated or face punitive action" did not work on DSE. At one point, they were running short of money, forcing them to beg for government funds, reflecting the poor state of affairs at DSE as an institution.

In comparison, the CSE did it all with its own funds, was well ahead of the deadline set by the regulator. Its WAN backed by VSAT established links with Dhaka and Sylhet and is capable of implementing plans to bring 19 more cities under the network. So DSE had to hurry.

The DSE also paid the price for the frenzied rush. A lot of bad publicity marred much of the hopes after the first day's mess, which was the obvious result of inadequate rehearsal for the big jump. The brokers' representatives were not properly trained to do the job, which, according to market sources, resulted in misplacement of buy or sell orders worth some Tk 20 lakh.

This is a small price given the magnitude of the changes the system brought about or is expected to bring about in the whole business of the capital market in Bangladesh. When clicking a mouse button matters, the "foul" entries by the (not properly trained) operators which reportedly 'blocked' the system will probably be forgotten and has already been forgiven.

Return of the Investor

But the key element in the entire changeover is the dream to see the return of the investor. Will that happen? Everyone hopes so.

The hopes hinge on the fact that automated trading systems will bring in transparency, ensure accountability through much more effective surveillance and monitoring by regulators and finally, and most importantly, instil confidence in the shaky investors.

If these are the targets, the DSE system has failed on one major count. Its surveillance software was not ready in right shape and drew most criticism. While the CSE got it right from the day one and had a terminal installed at SEC for the inspectors to keep vigil, the DSE's failure goes against the grain. When deals are executed through super fast machines, it is a bit difficult for human beings to do the monitoring at a similar pace. Early fixing of the surveillance mechanism will testify to DSE's good intentions.

Central Depository

A key component in the entire scheme of things for the ailing market to turn around is having a central depository system (CDS). This will not only make transactions scripless but also provide an enormous speed for clearing and settlement of deals. This is crucially important when volume of transactions goes high, the manual system simply collapses, which was more than evident in those bubble days in 1996. If CDS is there, for which steps are underway to enact a law, this speed of clearing and settlement will raise the volume of trade and thus help create a vibrant market.

The CDS will also do away with any scope for manipulation by company sponsors, some of whom are alleged to have been engaged in trading on the secondary market in different fictitious names using their access to market-sensitive information. The cost of companies will go down significantly as CDS will eliminate the necessity of having what they call share departments.

Rules rule out foreign investors

For the moment, until the CDS comes into being, current transactions rules need to be changed to facilitate foreign participation on the secondary market. With the current system of settlement, the international investor sitting in London, New York or Hong Kong finds it too difficult.

According to present transaction rules, it takes a whole week to complete a deal under the so-called T+3 and T+5 clearing and settlement system.

For a deal done on Sunday, the first day of the week, the buyer broker will make payment to the Exchange on Wednesday. On the same day, the seller broker will hand over the securities along with the transfer deed to the Exchange. On Saturday, the sixth working day, the Exchange will pay the seller broker and deliver the share certificates to the buyer broker.

Things are different for spot deals. Here the rule is defined as T+1, which stipulates a Sunday transaction has to be settled by 10.00 Monday morning.

For a foreign investor, spot deals are out of question, which is natural. What is not acceptable is the rule that the seller broker has to deposit the share documents with the bourse on the third day after the trading day and the buyer broker his money. One knows this is simply impossible if one is aware how the foreign investors operate.

Generally, an international investor asks his broker (who may be based in HK) to sell the stocks deposited with a custodial bank in Bangladesh. The international broker approaches a local broker to do the deal, who executes it and confirms it through fax. The international broker then informs his client who sends an instruction to his bank to deliver the shares to the local broker in exchange for money. When the local broker goes to the bank (T+3), he has to pay the money to the bank when he has not received the money from the buyer. Because the buyer has deposited the money with the bourse which will pay the seller only after it has received the share documents.

Thus in case of selling by an international investors, the local broker has only to manage the money as he will get paid in two days (T+5). But when it comes to buying by a foreign investor, it is outright impossible. Because the bank would not pay without getting the share documents. Even if the local broker pays the Exchange the required money, he is not getting the share documents until two days later.

Can the process be completed in three days? So, the rules should be rewritten for foreign investors.

Now that the bourses are being congratulated for saying good bye to the cry-out system, thousands of helpless investors who fell victim to the late 1996 bust may be compensated by only a stronger market. Their cries still reverberate the capital market in Bangladesh.

A Case Study

Central Depository Systems (Pvt.) Ltd., Colombo

A lot has been said about the need of a central depository for the capital market to exploit the full benefits of automated trading systems. Now that both bourses have gone on line, the necessity will be felt more than ever. Most market operators do not have any idea about what it should be like or how it is like in other countries. For the readers of The Daily Star, we present a case study on the CDS in Sri Lanka. The organisation and operation of the central depository have received attention in the study published recently in a local journal.

The Central Depository System (CDS) of Colombo caters for the need of different groups of stock market like investors, listed companies, stock exchange etc. through its database facilities. The CDS paves the way for scripless trading on the floor by providing clearing and settlement services to the stock exchange. It eliminates the necessity of maintaining a full-fledged share division of the listed companies by facilitating share registration services. It also ensures safe keeping of valuable share certificates on behalf of the investors, both local and foreign. The CDS is operated basically in the form of book keeping entry by making due debit and credit entries in client accounts. Run by a unique management consisted of the representatives of different user groups, the CDS has become the vital element of the Colombo stock market.

The Central Depository Systems (Pvt.) Ltd. is a wholly-owned subsidiary of the Colombo Stock Exchange (CSE). It is run by the board of directors which comprises of representatives of users of the system like 1) Stock Brokers, 2) Listed Companies, 3) Investing Public, 4) Banks, 5) Secretaries & Registrars, 6) Legal Firms, 7) Stock Exchange Management.

The reason behind such composition of the Board is to ensure that the needs and concerns of all participants are addressed by the Depository. At present 15 Stock Brokerage Firms (members of CSE) and 10 commercial banks (registered under the Banking Act) who provide custodial service for foreign and local investors have been granted participatory status (participants) with the CDS. These participants are authorised to directly utilise the facilities and services offered by CDS.

The main objective of the CDS, as they define it, "is to function as a depository to hold shares in trust form shareholders of quoted companies, pending transactions on the trading floor of the Colombo Stock Exchange, and to act as a safe keeper of quoted securities." But the facilities and services rendered by the CDS can be classified into three main categories which are as follows:

A. Custodial services
a. Deposit of shares
b. Withdrawal of shares
c. Transfer of shares
B. Trading related services
a. Clearing
b. Settlement
C. Registration services
a. Registration
b. Handling Right Issue and Bonus Issue
c. Handling Initial Public Offering

Services provided by the CDS

The first thing to be done for getting the CDS rendered custodial services is opening an account with the CDS. The individuals who want to transact in shares in the CSE will have to open a Securities Account with the CDS though a participant to the CDS. The CDS on receipt of an account opening form enters the relevant data in the computer and assigns a client identification number to such account through the respective participant. The CDS allows multiple registration i.e. opening accounts through more than one participant under some conditions.

But only the account opening is not sufficient to start transaction on the trading floor. Account holders must have deposited shares with the CDS before giving any order for selling shares through their participants or brokers. Shareholders shall have to forward the relevant share certificates along with a duly completed sold transfer form and a deposit slip through a participant. Immediately on receipt of such a document for deposit, the CDS numbers the document and acknowledges and returns the duplicate copy of the deposit slip by franking. The documents are then checked for completeness and thereafter entered into the computer to credit the relevant customer's account. At the end of the day, a report of all deposits is generated from the computer and dispatched to the Secretaries/Registrars of the relevant company for due transfer to the name of the CDS.

This process applies in case of share withdrawal also. The shareholder who wishes to withdraw shares from the CDS in order to obtain a certificate, shall forward a bought transfer form and a withdrawal form in duplicate through the respective participant. The CDS, on receipt of a request for withdrawal, acknowledges such receipt by franking and returning immediately the duplicate of the withdrawal form. The withdrawal documents are then checked for completeness and thereafter entered into the computer to debit the respective account. At the end of the day, a report of all withdrawals is generated from the computer and is dispatched to Secretaries/Registrars of the relevant companies who are required to submit share certificates to the CDS for onward transmission to the client through respective participant.

The CDS offers to its client Intra-Account Transfer facilities also. The client who wants to transfer shares between accounts opened through different Brokers/Participants is required to forward a duly-completed Intra Account Transfer Form in duplicate through his/her respective participant. Immediately on receipt, the CDS acknowledges by franking and returning the duplicate copy of such transfer. Once the document is checked for accuracy and completeness, the transfer is effected in the system.

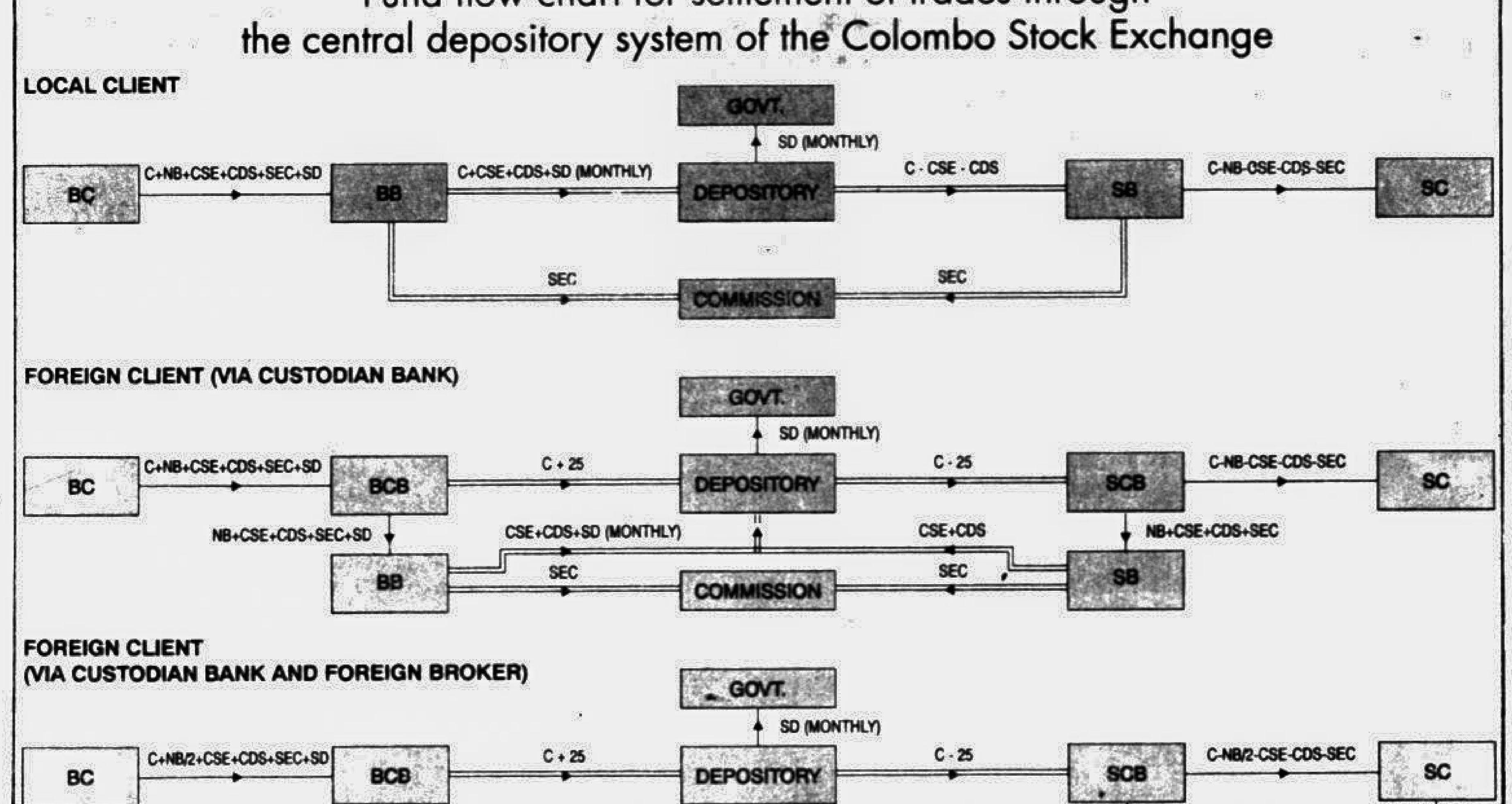
The CDS facilities stated above are also provided to individuals who want custodial services. But the most important feature of the CDS is that it has paved the way for scripless trading by providing scripless clearing and settlement facilities for the stock exchange.

The CDS permits trading transactions to be recorded in the form of book keeping entry by making due debit and credit entries in client accounts. For example, if one account holder purchases some shares, his/her account (as buyer) will get credited with the relevant number of shares while the seller's account will be debited accordingly. The responsibility of indicating the correct Account Holder's client identity number for purchases and sales lies with the respective brokers/participants. The brokers are required to enter the relevant client identification numbers for transactions concluded on the trading floor directly from their respective computer terminals into the CDS. This information once fed into the computer will update client accounts accordingly.

Not only clearing but also the settlement with transactions on the trading floor of the stock exchange is done by the CDS. The settlement process in the CDS is in the form of a two-tier system (rolling system). A client is required to settle the value of a trade in respect of purchase within trade day plus five market days, while on account of a sale, a client will receive his cheque from his broker/participant on trade day plus seven market days. Accordingly, the broker to broker settlement of trades is done on trade day plus seven market days. The CDS-nominated settlement bank coordinates the settlement process. All participants are required to maintain accounts with the settlement bank and the net settlement amounts are debited and credited accordingly to each participant's account on the date of settlement. The CDS generates a schedule daily, listing out the net settlement with due advise to the settlement bank to facilitate this process.

The following fund-flow chart clearly shows how the settlement process works through the CDS.

Fund flow chart for settlement of trades through the central depository system of the Colombo Stock Exchange



Abbreviations

C	- Consideration	GOVT	- Government of Sri Lanka
BB	- Buying Broker	SB	- Selling Broker
BC	- Buying Client	SC	- Selling Client
BCB	- Buying Custodian Bank	SCB	- Selling Custodian Bank
DKPOSITORY	- Central Depository System	COMMISSION	- Securities and Exchange Commi. of Sri Lanka
	- Fund flow included in Settlement		
	- Fund flow not included in Settlement		

The CDS offers its services to the listed companies also. It has taken over the registration function of all listed companies in respect of shares traded through the CSE. The CDS maintains a part of the share ledger on behalf of the listed companies, and it is updated daily with the day to day transactions. Accordingly, the CDS makes available the shareholdings (break-up beneficial owners) of any listed company on request. Lists of shareholders are generated and dispatched to the relevant companies for payment of dividends, Issue of Rights, bonus etc. as of the relevant date of entitlement.

On behalf of the listed companies, the CDS handles Rights and Bonus Issues. In respect of a Right Issue, the CDS co-ordinates and receives payments from the clients who subscribe to Rights through the respective participants on the day of renunciation and forward the same to the relevant company secretary. Once the company completes the issue and files the affidavit of compliance with the CSE, the relevant number of Rights is converted into normal shares in the system by the CDS, thus eliminating the need to issue share certificates. Similarly in respect of Bonus Issues, once the issue is completed the CDS will convert such bonus share allotments deposited in the system into normal shares.

Similar facilities are offered by the CDS in the case of Initial Public Offerings (IPOs). The clients who are allotted shares in IPO may request the registrars to the issue to directly credit their depository account with new shares allotted on such applications without generating a share certificate. (Provision is given on all share applications to make such a request.)

The key strength behind the ability of the CDS to offer such varieties of services to the various groups of stock market is its huge database as well as participatory policy making system. Since the Board of CDS, the policy making body of the organisation, is formed with representatives of all the users of the system, the CDS knows the needs of its users exactly and is able to modify itself according to the changing situation.

Private mutual funds make a better case now

This is an article that responds to queries on how private Mutual Funds are managed. In today's context of Bangladesh, when the capital market is struggling to come out of the bear's grip, their scopes, options and the legal aspects are discussed in detail.

Private Mutual Funds, now being considered to be the most effective weapon to revive the country's ailing capital market, are to operate under the Securities and Exchange Commission (Mutual Fund) Regulations, 1997. The regulation, made public on May 14, 1997, speaks of four groups of professionals -- *Sponsors, Trustee, Asset Management Company* and *Custodian* -- in the business.

Who does what in the process?

Mutual funds are floated by **Sponsors**
managed by a **Trustee**
scheme designed and operated by **Asset Management Company**
asset keeping by **Custodian**
The key features of the existing legal framework under which a private mutual fund can function:

Formation

The Mutual Fund is to be constituted in the form of a Trust under the Trust Act, 1882 (II of 1882). But the Country Mutual Funds can be formed as per the rules and regulations of the country in which the fund is to be listed.

Intermediaries

A Mutual Fund is to be floated by the Sponsors who have at least five years experience in the relevant field of financial services with a sound track record. The "sound track record" shall mean net worth, dividend paying capacity and profitability. The Sponsors must have professional competence, financial soundness, general reputation of fairness and integrity in all business activity. The loan defaulters cannot be Sponsors of a Mutual Fund.

The Sponsors will appoint a company (in special cases, more than one company) as Trustee (or Board of Trustees in case of more than one company) to manage the Mutual Fund. The company which acts as Trustee must have experience in financial services. It cannot be a loan defaulter and convicted of "economic offence". The particulars of the Trustee shall be forwarded to the SEC for approval.

The Sponsors or, if so authorised by the trust deed, the Trustee will appoint an Asset Management Company which is approved by the SEC to manage the affairs of the Mutual Fund and operate the schemes of such fund.

To keep the assets of the Mutual Fund under safe custody, an SEC-approved Custodian will be appointed. The Custodian or any of its directors cannot be associated with any Asset Management Company.

Minimum amount, Sponsors' contribution

The minimum amount to be raised in respect of each close-ended and open-ended scheme is three crore taka and six crore taka respectively. For an open-ended scheme, there is no maximum limit.

The Sponsors' contribution will not be less than 40 per cent of total amount to be raised under any scheme of a Mutual Fund.

Announcement, Advertisement

The Asset Management Company is allowed to announce a particular scheme of Mutual Fund subject to approval of the Trustee and the SEC. The letter of offer and other advertising materials cannot be issued without the approval of the SEC.

The marketing and publicity brochure for each scheme must properly disclose the investment objectives, the method and periodicity of valuation of investment, the exact method and periodicity of sales, purchases and other details considered by the SEC to be essential for the protection of the investors.

Subscription, Refund, Allotment & Listing

The subscription list of the scheme of the close-ended Mutual Fund and open-ended Mutual Fund will remain open for 10 days and 45 days respectively.

The Trustee and the Asset Management Company will be liable to refund to the investors the entire amount collected if it fails to collect the minimum amount (three crore taka for close-ended and six crore for open-ended) or 60 per cent of the targeted amount whichever is higher.

The refund warrants, allotment letters and unit certificates will have to be dispatched within 40 days of the closure of subscription lists.

The close-ended scheme will have to be listed with any stock exchange immediately on receipt of approval of the SEC. But the Country Mutual Fund will be listed with any stock exchange of a country in which the fund intends to be registered.

Restrictions on investment

- The money collected under any scheme of a Mutual Fund other than Property Unit Trust and Mudaraba Unit Trust are allowed to be invested only in transferable securities whether in the money market or in the capital market or in privately-placed debentures or securitized debts.
- Property Unit Trust is allowed to invest in transferable land, building and security.
- Mudaraba Unit Trust will invest according to the Islami Shariah.
- In any case, the Mutual Fund cannot invest in such derivatives as options trading, short selling or carry forward.
- The securities in which Mutual Fund wants to invest are to be rated by a Credit Rating Agency. If the securities are not rated, then the Asset Management Company will seek a special approval of SEC.
- In any case, Mutual Fund is not allowed to give term loans and advances
- Investment in shares of any one company will not be more than 10 per cent of total assets of any single scheme of a Mutual Fund.
- Mutual Fund is not allowed to own under all its schemes more than 15 per cent of the paid-up capital of any single company.
- Mutual Fund is not allowed to invest under all its schemes taken together in shares, debentures and other securities of any single company or any single group more than 20 per cent of the same.
- Mutual Fund cannot invest under all its schemes in shares, debentures and other securities of any one industry more than 25 per cent of its total assets unless such fund is floated to invest in one or more industries and necessary declaration is made in the letter of offer to do so.
- Investment by way of privately-placed debentures, securitized debts and other unquoted debt instrument shall not be more than 10 per cent and 40 per cent of total assets of any single scheme in case of growth scheme and income scheme respectively.

NAV, Pricing

Each Mutual Fund will follow the SEC-approved Net Asset Value (NAV) calculation formula to calculate the NAV of its schemes. The calculated NAV will have to be published in at least two newspapers at intervals of not exceeding 15 days in case of open-ended scheme, and one month in case of close-ended scheme.

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