

**TRADING, SETTLEMENT AND CLEARING PRACTICES
IN NEPAL STOCK EXCHANGE LIMITED**

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INTRODUCTION

Background of the Study

There is an old saw in the military that amateurs talk tactics, but professionals talk logistics. There is a clear parallel in financial markets; although the logistics of the financial markets—clearing and settlement—attract little popular attention, they are matters of primary importance to market professionals.

Of late, however, the organization of clearing and settlement functions has assumed a greater public profile. In particular, the integration of the clearing, settlement, and execution of transactions within a single firm has drawn considerable criticism and anti-trust scrutiny, especially in Europe.

This has also become a central issue in the proposed Chicago Mercantile Exchange-Chicago Board of Trade merger. The primary objection to the “vertical silo” model of financial trading is that due to the substantial scale and scope economies in clearing, an exchange integrated into all three functions can deny access to its clearing and settlement facilities to foreclose entry by another firm offering execution services in the products traded on the integrated exchange. It has long been understood, however, that vertical integration can also be an efficient way to organize transactions, because it can eliminate double marginalization, mitigate holdups, and provide superior incentives to invest in specific assets. Understanding the motives for vertical integration in financial markets and its welfare effects therefore requires a detailed micro-analytic analysis of the economics of trading, clearing and settlement.

The Competition Commission found that merger of the LSE and either Deutsch Borse or Euronext would give the combined entity “the incentive and ability to foreclose entry and expansion in the UK at the trading level.” European industry groups have also expressed opposition to vertical integration on competitive grounds.

“The organization of the trading of securities (and to lesser degree derivatives) has been a subject of enduring controversy. The network nature of liquidity

means that financial trading faces many of the same challenges and conundrums as other industries, such as telecommunications and electricity, where network effects are also present (and more widely recognized).” (Craig; 1991: 2) Clearing and settlement contribute additional sources of scale and scope economies that further challenge competition in financial markets. As in any network industry, there are no easy organizational answers. Suffice it to say that there are strong economic reasons to integrate trade execution, clearing, and settlement, and these functions have been commonly integrated in practice.

Although this integration is unlikely to produce a first best outcome, because the integrated entity is likely to exercise market power, alternative forms of organization do not obviously increase competition appreciably, and plausibly create other distortions.

Nepal Stock Exchange [NEPSE]

Nepal Stock Exchange, in short NEPSE, is a non-profit organization, operating under Securities Exchange Act, 1983. The basic objective of NEPSE is to impart free marketability and liquidity to the government and corporate securities by facilitating transactions in its trading floor through member, market intermediaries, such as broker, market makers etc. NEPSE opened its trading floor on 13th January 1994. Government of Nepal, Nepal Rastra Bank, Nepal Industrial Development Corporation and members are the shareholders of NEPSE.

The history of securities market began with the floatation of shares by Biratnagar Jute Mills Ltd. and Nepal Bank Ltd. in 1937. Introduction of the Company Act in 1964, the first issuance of Government Bond in 1964 and the establishment of Securities Exchange Center Ltd. in 1976 were other significant development relating to capital markets.

Securities Exchange Center was established with an objective of facilitating and promoting the growth of capital markets. Before conversion into stock exchange it was the only capital markets institution undertaking the job of

brokering, underwriting, managing public issue, market making for government bonds and other financial services. Nepal Government, under a program initiated to reform capital markets converted Securities Exchange Center into Nepal Stock Exchange in 1993.

Members of NEPSE are permitted to act as intermediaries in buying and selling of government bonds and listed corporate securities. At present, there are 23 member brokers and 2 market makers, who operate on the trading floor as per the Securities Exchange Act, 1983, rules and bye-laws.

Besides this, NEPSE has also granted membership to issue and sales manager securities trader (Dealer). Issue and sales manager work as manager to the issue and underwriter for public issue of securities whereas securities trader (dealer) works as individual portfolio manager.

NEPSE, the only Stock Exchange in Nepal, introduced fully automated screen based trading since 24th August, 2007. The NEPSE trading system is called 'NEPSE Automated Trading System '(NATS) is a fully automated screen based trading system, which adopts the principle of an order driven market. NEPSE facilitates trading in Shares (Equity Shares & Preference Shares), Debentures, Government Bonds and Mutual Funds. Trading on equities takes place on all days of week (except Saturdays and holidays declared by exchange in advance). On Friday only odd lot trading is done.

The market timings of the equities are:-

Market Open: - 12:00 Hours Market Close: - 15:00 Hours

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The stock exchange provides floor for trading the shares of listed companies creating the liquidity in shares markets. The liberal financial policy adopted by Nepalese Government after the restoration of democracy tried to reform the financial market of Nepal. That result open practice of buying and selling of

securities in the open floor of NEPSE maintaining the suitable market price of the shares. In general, the prices are determined according to the demand and supply of the shares. This study attempts to examine the different determiners of the share price relating the MPS with major financial indicators.

Statement of the Problem

An important but often overlooked, component of capital market is the trading, clearing and settlement process. Confidence in this process is essential for well functioning markets. Without an effective trading, clearing and settlement process, the transfer of ownership of securities to the buyer and the final payment of fund to the sellers may put at risk or result in unnecessary costs for market participants. Some emerging markets however, continue to have serious clearing and settlement problems, including settlement delays, high transaction, financing cost and liquidity risk.

Every transaction must be settled within very short period of time. The short-settlement period helps to reduce risk to participants. The longer the settlement period, the higher will be the chance that one of the counterparty faces replacement cost risk with price volatility between the date of transaction and date of settlement.

One of the core operational processes that underline a securities market is the process of clearance and settlement. The clearance and settlement process determines to a large extent, the efficiency and effectiveness of a securities market. Securities markets having inefficient and settlement system suffer by serious problem.

Today Stock market has become a global phenomenon however, the stock market in Nepal is still in its infancy stage. Clearing and settlement currently performed in Nepalese securities market is on rolling settlement basis, trade-by-trade. Individual transaction should be settled separately. The increase in number of transactions create problem to the market participants to settle the transaction individually. It would be extremely inefficient if every security transaction had to end with a physical transfer of stock certificates from the

seller to the buyer. The physical transfers of securities also involve risk associated with lost and stolen.

Presently NEPSE is adopting T+3 rolling settlement and trade-by-trade basis. Each transaction should settle individually within in the three days after the date of transaction. Where as the Mexican Stock Exchange, Korean Stock Exchange and Dhaka Stock Exchange each has been adopting T+2 settlement system. Similarly, Taiwan Stock Exchange is adopting T+1 settlement system. Since the longer the settlement period, the higher the chances of incurring the settlement risk, the question may arise whether NEPSE should also follow T+2 or T+1 settlement system?

The transfer to ownership in the register of shareholder is another aspect of clearing and settlement process. The buying broker should dispatch the securities in the company for the transfer of title, after the date of settlement. But the stock exchange membership and transaction By-law does not provision at what time the securities should be dispatched? After the amendment of the Company Act, the allocable period has reduced for 35 days to 15 days, although the investors are not protected by this amendment. Some company registrars have interpreted this period to exclude the delivery of securities to he new owner. In some companies completion of the transfer process may takes weeks or even months. For example, share dispatch for transfer in 7th April, 2001 was returned on 18th September, 2001 by Nepal Bank Ltd., likewise SBI Bank returned the shares on 9th August, 2001 dispatched in 13th July, 2001. Standard Chartered returned on 25th December, 2001 dispatched in 5th September, 2001. There are inconsistencies in the procedure for registration, for example some companies may require two directors to approve every transfer and overall processes of registers are slow and cumbersome. The signature verification process is slow.

Not only these, the long processing cycle freezes the securities from trading that affect the liquidity of the market, decrease the number of transactions, number of share traded, market capitalization and the index. The decrease in

the transactions also reduced the government revenue, income to Stock Exchange as well as commission to the brokers.

Objectives of the Study

This research work is concerned with studying the trading, clearing and settlement system in Nepalese security market. The main objective is to study and analyze the trading, clearing and settlement system in Nepalese securities market. The other objectives of the studies are:

- a. To analyze the present provisions regarding trading, clearing and settlement system in Nepal stock exchange Ltd. (NEPSE).
- b. To analyze the application of present provisions regarding clearing & settlement process.
- c. To evaluate the investor cost within the clearing and settlement period.
- d. To analyze the investor awareness regarding the trading, clearing and settlement system in NEPSE.

Research Questions

This research work deals with the following issues:

- a. Are present provisions of trading, clearing and settlement adequate?
- b. Are present provisions strictly followed in practice?
- c. If present provisions are strictly followed, what is the investor cost within the clearing and settlement period?
- d. Are investors aware of the clearing and settlement system in Nepal stock exchange?

Significance of the Study

Trading, Clearing and Settlement system in securities market is an emerging issue in the world. Different advance trading, clearing and settlement system have been developing in different countries, such as Central Depository System, Netting etc. In the CDS system physical certificates are dematerialized and book entry system is followed to transfer the title. This process helps to immediate transfer of title and shortens the securities processing cycle. In the Netting system, transactions are settled on the net basis than trade-for-trade

basis. The current system followed by the Nepalese securities market is a complicated process and creating problem to the participants as well as to the investors. After completing this study different sector of the securities market such as policy makers, administrators, investors, brokers and market makers will be benefited. Findings of the study will be helpful to develop new rules, regulations to bring efficiency and to modernize the securities market. On the other hand, this study may be guidelines to the further researcher as literature.

Limitations of the Study

This study has certain limitations. The main limitations and constraints are as follows:

- a) The study is confined to the trading, clearing and settlement system of Nepal Stock Exchange.
- b) Primary data regarding investors' views are collected from the Brokers, Market Makers, Nepal Stock Exchange, Security Board of Nepal and Listed Companies.
- c) This Study is based on Primary as well as secondary data.
- d) Calculation of the study is fully dependent on the accuracy of the data provided by the respected organizations and respondents.
- e) The non-availability of various references and resources also act as constraints.

Research Gap

All of the past research made represented try to show the relationship of MPS with other financial and non financial indicators. However, past studies have ignored the trading, clearing and settlement of NEPSE of the stock market. So to fulfill such gap, the present study has been conducted by analyzing the trading, settlement and clearing of Nepal Stock Exchange alone with tracing the major determinants.

Major Findings

The major findings after the detailed analysis of Trading, Clearing and Settlement practices in NEPSE are mentioned below.

- ❖ Securities Exchange Act (1983) does not mention any provision of central depository system of securities for efficient clearing and settlement of securities. Also the Act remains silent in the establishment of Clearing House.
- ❖ The bylaws contains loophole in exactly how many days after the date of settlement the securities should have to be forwarded for the transfer of title and should have to be handed over after the transfer of title. The SEA and bylaw do not state any provision of refusal of transfer of title.
- ❖ The mandatory provision of Company Act (1996), section 143, 2(F), to submit the shares about pledge and transfer of title, to the board of directors has constrained from empowerment.
- ❖ The clearing and settlement system of Nepal's Securities Market was found to be efficient. Also more efficient clearing system can increase the confidence of participants and investors of Nepal's capital market.
- ❖ 58% of the respondents said that the existing CSS is insufficient to ameliorate Nepal's capital market and 48% of the respondents said that the existing CSS is inadequate to reduce the risk that arise in trading, clearing and settlement period. And 80% of the respondents strongly recommended the substantiality of DVP system to avoid the risk.
- ❖ About 66% of the respondents opined that T+3 settlement period adopted in Nepal's Securities transaction is appropriate and meets the international standard. And 66% of the respondents said that Trade-for-Trade system is outdated and cannot cope with the increasing volume of transaction. Almost 85% of the respondents selected Netting System as the best alternative to reduce such congestion of transactions.
- ❖ The majority of the respondents (62%) opined that 1-2 days (shorter period) will be the reasonable period to forward the share for title transfer. Similarly, 38% of the respondents opined that within 15 days after the date

of application is appropriate to transfer the title by the Company.

- ❖ Almost half of the respondents (54%) suggested that Central Depository System is an effective tool in CSS and substantial for Nepal's Capital Market. And 63% of the respondents affirmed that the current provisions are insufficient to implement effective CDS in Nepal.
- ❖ The majority of the respondents (80%) said that the member who does not settle the transaction in time (T+3) is restricted to transact the share in the stock exchange. And 68% of the respondents specified that the title transfer occur within the time specified.
- ❖ Cash Settlement, Certificate and other were ranked 1, 2, 3 respectively. Thus, the respondents considered cash settlement as the main factor to effect adversely in the transaction of share.
- ❖ The lax of authorities, the disobedient of companies and insufficiency of time were ranked 1, 2 and 3 respectively. So authorities are not regulating strictly is considered the main factor for adversely affecting the promptness of title transfer.
- ❖ Bank, Finance companies, Insurance companies, Hotel, Trading Companies, Other and Manufacturing companies were ranked 1, 2, 3, 4, 5, 6 and 7 respectively. Bank (commercial and developing) companies were considered the best in short time taking to transfer the title.
- ❖ 94% of the respondents said that investors are fully aware about the term T+3 Settlement periods. 78% of the respondents said that investors are fully aware about the processing of title mentioned in the Company Act. Similarly, 72% of the respondents said that investors are satisfied with the current system of Clearing and Settlement practices.
- ❖ More than half of the respondents (54%) said that investors have to bear a cost ranging from 5% to 10% annually within the clearance and settlement period (18 days) i.e. 3 days for settlement and 15 days for title transfer.

Summary

Capital markets are a vital part of the financial development and economic development of a country. They provide an alternative vehicle for financial resource mobilization. In the past decade, many developing countries have also established securities markets. In Nepal, the Stock Exchange was established in 1994, providing a marketplace for securities trading by private brokers. The objective of this paper is to provide a synthesis of Trading, Clearing and Settlement System that are practiced in Nepal's Capital Market.

While capital markets had its beginnings much earlier through the establishment of the Securities Exchange Center, a market based system of securities trading was adopted only in 1994. The amendment in the Securities Exchange Act which enabled this change allowed the entry of private intermediaries and set up an oversight agency - the Securities Exchange Board. Following this change, the capital market in Nepal has witnessed high growth. The primary market, in - particular, grew almost five times and has sustained this growth over the past three years. The secondary market too, has grown; with market capitalization almost triple the levels three years ago and price index climbing to almost double the level when the Stock Exchange opened.

With the realization of the fact that NEPSE activities cannot be effective without the transparency on how securities are Traded, Cleared and Settled. The study is conducted and the basic objective of the research is to study, evaluate and highlight the system of Trading, Clearing and Settlement System that have been practicing in Nepal's Capital Market. The study could be significant to the potential investors, Brokers, Companies and SEBON & NEPSE and even to general public also. For the fulfillment of the objectives of research, various laws, Acts and both primary and secondary data have been utilized and analyzed with the abet of various statistical tools. Major portion of data has been collected from primary sources by conducting questionnaire and partially from secondary sources such as prospectus and website of NEPSE and SEBON. The study has been organized in five main chapters consisting of (i)

Introduction, (ii) Review of Literature, (iii) Research Methodology (iv) Presentation and Analysis of Data and (v) Summary, Conclusion and Recommendations.

Conclusion

After analyzing and studying the laws, Acts and the collected data, the researcher considered that the practice of trading, clearing and settlement system in Nepal is efficient. Besides having some loophole in Securities Exchange Act (1983), the CSS is satisfactory. The bylaws remain silent in mentioning the exact period within which the securities should have to be forwarded for the transfer of title and should have to be handed over after the transfer of title. Also there is no provision in SEA (1983) of establishing Clearing House. There is a positive relationship between efficient CSS and the confidence of participants and investors of Nepal's capital market. Present CSS was found to be inefficient in reducing the risk that arises in settlement period and sought the role of DVP to abate such risk. Trade-for-Trade is also inadequate to handle the increasing number of transactions and netting system can be substantial to cope with the increasing number of transactions.

Also the market is demanding shorter period to forward the shares, after settlement, for transfer of title and sought within fifteen days is appropriate for transfer of title. Similarly, Central Depository System can play a substantial role in Nepal's Capital Market and the current provisions are inadequate to implement effective CDS. The member who does not settle the transaction within three days (T+3) were found to be restricted to further settle the transactions in stock exchange while the transfer of title has been found mostly to have practiced within fifteen days as mentioned in the Company Act.

Cash settlement is the main cause for adversely affecting the transaction of share and the negligent of authorities in the regulation of transactions is the main cause in affecting the promptness of title transfer. Similarly, Bank has been found to take the shortest time in title transferring whereas Manufacturing

and Processing companies have been found to take the longest time in title transfer.

Most of the investors are aware about the term T+3 and also fully aware about the processing of title mentioned in the Company Act. Similarly they are also satisfied with the existing trading, clearing and settlement practices adopted in the country. There is uncertainty among investors and other whether they gain or lose if the CSS process is prolonged. Also, it has been revealed that investors have to bear a cost ranging from 5% to 10% annually during eighteen days of clearing and settlement, three days for settlement and 15 days for title transfer.

Recommendations

On the basis of analysis of the practices of trading, clearing and settlement system, some suggestions are required to enhance the effectiveness of CSS system for its better operation in future. So the study recommends the following aspects to improve the CSS.

- ❖ Efficient Clearing and Settlement is the demand of today's market. So Securities Exchange Act (1983) should be amended and the provision on clearing and settlement should be mentioned.
- ❖ The bylaws should mention the exact time period that should be allowed for forwarding the shares for transfer of title after the settlement period.
- ❖ The SEBON should launch more program to make clearing and settlement more efficient and thus to increase the confidence of investors.
- ❖ The existing CSS practices should be ameliorated in order to enhance the Nepal's Capital market and thus to reduce the risk that arises in trading, clearing and settlement period.
- ❖ Netting system should be extensively used to handle the increasing number of transaction and Trade-for-Trade should be withdrawn from securities settlement.

- ❖ Current provision should be amended in order to implement an effective Central Depository System. Also provision should be amended to establish a separate Clearing House.
- ❖ A strict restriction should be initiated to those members who do not settle the transaction in time. Also, fine and penalties should be imposed on those members.
- ❖ The barricade for transaction such as Cash Settlement, Certificate and others should be reduced to make the CSS system more effective. Authorities should also act strictly on those members who delay the transfer of title.
- ❖ To protect the investors from high cost, the concerned body should try to reduce the processing period at minimum, which will automatically reduce the cost.
- ❖ Awareness program regarding the activities of SEBON and rules and regulation for CSS should be launched to increase the public awareness and attract them in share transaction.