Stock Auctions

Of auctions and their origin

The word auction, in simple terms, implies a public sale in which property or items of merchandise are sold to the highest bidder.

Did you know that auctions used to take place way back during the Homeric period in Greece? It was a means of transferring the ownership of slaves from one person to the other. This same underlying concept of auction has taken a more refined form in recent times - like the auction of commodities or the belongings of famous personalities. Have you ever been to an auction house like Christie's or Sotheby's, where works of art are sold to the highest bidder in auction?

Now, you are probably beginning to wonder what we are doing discussing auctions of slaves and commodities or art auction houses like Christie's and Sotheby's here, in the investment jungle! Allow us to clarify that our intention is not to discuss art auctions per se, but auctions conducted on the bourses. Auctions are not conducted only to sell merchandise or works of art in big auction houses; they are also a common feature on stock exchanges.

Why conduct auctions in the stock market?

Auctions are conducted on the exchanges when, for some reason, shares (physical or demat) are not delivered to the exchange on time.

Exchanges conduct auctions to penalise the party for defaulting on delivering the shares on time, and thereby to protect the sanctity of settlements. It is a necessary evil - imagine the chaos if the defaulting party went scot-free and delivered shares at its own free will. This would trigger a chain reaction of defaults.

If the defaulting party fails to deliver the shares on time to the exchange, the exchange in turn is unable to deliver the shares to the party who purchased them. The purchasing party in turn might have already sold those shares before receiving them from the exchange and now it would be unable to deliver those shares on time. This vicious chain could go on and on.

Therefore, it becomes imperative that auctions are held so that pay-in and pay-out of shares take place on time, in accordance with the settlement cycle of the respective exchanges.

Reasons for shares to go on auction

Shares come under the hammer when they have been either delivered short or found to be objectionable by the exchange. Based on the reasons why shares qualify for auction, they have been categorised into two types:

- Auction due to shortages
- Auction due to objection

Auction due to shortages

As has been discussed above, an auction due to shortages takes place when the delivering party fails to deliver its share on time to the exchange, thereby triggering the vicious chain reaction of the exchange being unable to deliver the shares on time to the purchasing party and purchasing party in turn being unable to deliver shares on time if it has already sold it and so on... One of the common reasons why shares come under auction due to shortages is the confusion that arises about the delivery date of the shares, if they are going into the 'no delivery' period.

Auction due to objection

Physical shares go in for auctions not only if they are delivered short, but also if they are found to be objectionable and not rectified on time by the party concerned. There are many reasons why shares could come under objection. To list a few:

- Transfer deed attached to the share certificate is out of date
- Details like distinctive number, folio number, certificate number, transferor names etc are not filled or filled incorrectly on the transfer form attached with the share certificate
- Witness stamp or signature on transfer deed is missing
- Signature of the transferor is missing
- Delivering broker's stamp is missing on the reverse of the

transfer deed

§ Stamp of the registrar of the company is missing

When a share is returned to the broker by the exchange as objection, the broker is liable to inform the client and get the objection rectified. If the party fails to rectify the objection within a stipulated time period, then the shares go for auction. The defaulting party is then penalised by having to bear the auction price.

Does one always suffer a big loss in an auction?

The defaulting party does suffer a loss when their shares go in for auction. Imagine the rate at which the auction would take place if the market is rising and there is a great demand for the stock. The defaulting party would be required to pay for the difference between the higher auction price and the actual sale price of the stock.

Even in the case of a falling market when stocks are taking a beating, the defaulting party does not stand to gain the difference in the auction price and the actual sale price. The defaulting party instead has to forgo the entire sale proceeds it had earned.

Or even worse is the case when there are no participants in an auction. In such a case, the auction price is decided by the exchange. It varies with exchanges and is called the 'close-out' price.

How is the close-out price arrived at in three simple steps?

Step one: The exchange decides upon a 'fixed' price and adds 20% to it. Incidentally, the fixed price varies with exchanges.

For the Bombay Stock Exchange the fixed price is the 'standard rate/ hawala rate' decided by the exchange. This standard rate is calculated on the last day of the settlement. It is the simple average of all the trades executed on that particular day.

The National Stock Exchange, on the other hand, takes the closing price of the stock under auction as the fixed price. The closing price is arrived at by taking the weighted average of all the trades executed in the particular scrip in the last thirty minutes of the trading session.

Step two: The resulting price is then compared with the highest price for the stock in the settlement in which the defaulting party sold the

scrip.

Step three: The higher of the two prices, ie the settlement price and the fixed price plus a 20% premium, is considered as the close-out price.

Which means if the fixed price decided by the exchange is higher than the settlement price, the settlement price is deemed as the close-out price. Alternatively, if the settlement price is higher than the fixed price, the stock is 'closed out' at the settlement price.

Understand things with Reliance
Let us understand this better with an example. Let us assume that a party has defaulted on shares of Reliance Industries (RIL). And his shares are up for auction on the BSE. The BSE 'fixes' the 'hawala' price for RIL at Rs320. And as per rule, it also adds 20% to the fixed price and arrives at the final price of Rs384.

Let us make another assumption at this stage. That the highest price in the settlement in which the defaulting party had sold the stock, was Rs400.

Now, obviously, the close-out will take place at the **settlement price of Rs400**, as it is higher than the **fixed price (Rs384)**.

Other side of the coin
What if the settlement had taken place at a price less than the fixed price of Rs384? What if it had taken place at, say, Rs305? Well, then the fixed price will be taken as the 'close-out' price as it is higher than the settlement price. And the stock will be auctioned at Rs384.

By now you must have got a fair idea about the kind of losses and inconveniences that one is forced to face if his shares go into auction. Which is why it becomes imperative that as responsible market players we maintain the sanctity of settlements by ensuring our shares get delivered on time.