

NISM

National Institute of Securities Markets

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Workbook for

NISM – Series – VII: Securities Operations and Risk Management Certification Examination

**Workbook
for
NISM-Series-VII: Securities Operations and Risk Management
Certification Examination**

NISM Certification on Securities Operations and Risk Management – Workbook

This workbook has been developed to assist candidates in preparing for the National Institute of Securities Markets (NISM) Certification Examination for Securities Operations and Risk Management.

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About NISM

In pursuance of the announcement made by the Finance Minister in his Budget Speech in February 2005, Securities and Exchange Board of India (SEBI) has established the National Institute of Securities Markets (NISM) in Mumbai.

SEBI, by establishing NISM, has articulated the desire expressed by the Indian government to promote securities market education and research.

Towards accomplishing the desire of Government of India and vision of SEBI, NISM has launched an effort to deliver financial and securities education at various levels and across various segments in India and abroad. To implement its objectives, NISM has established six distinct schools to cater the educational needs of various constituencies such as investor, issuers, intermediaries, regulatory staff, policy makers, academia and future professionals of securities markets.

NISM brings out various publications on securities markets with a view to enhance knowledge levels of participants in the securities industry.

NISM is mandated to implement certification examinations for professionals employed in various segments of the Indian securities markets.

Acknowledgement

This workbook has been developed by NISM in cooperation with the Examination Committee for Securities Operations and Risk Management Examination consisting of representatives from the Indian Securities Market and Industry Experts. NISM gratefully acknowledges the contribution of all the committee members.

About the Author

This workbook has been developed by the certification team of NISM in co-ordination with Ms. Sumithra Ramesh, Resource Person engaged with NISM. This version of the workbook has been reviewed by Ms. T.S. Jagadharini, Resource Person empanelled with NISM.

About the Certification Examination on Securities Operations and Risk Management

The examination seeks to create a common minimum knowledge benchmark as the requisite standard for associated persons of a registered stock-broker /trading member / clearing member in recognized stock exchanges, involved in (a) assets or funds of investor or clients (b) redressal of investor grievances, (c) internal control or risk management and (d) activities having a bearing on operational risk.

Examination Objectives

On successful completion of the examination, the candidate should:

- Know the basics of the Indian securities market, the different products traded and the various market participants and the respective roles they play in the Indian securities market.
- Understand the regulatory framework and the role of the Securities Exchange Board of India.
- Understand the trade life cycle, the steps and participants involved in the trade life cycle.
- Know the various functions of the Front Office, Middle Office and Back Office in a Securities Broking Firm.
- Understand how the risks are managed in a securities broking firm, the clearing and settlement process.
- Understand the various procedures for redress of investor grievances

Assessment Structure

The examination consists of 100 questions of 1 mark each and should be completed in 2 hours. The passing score on the examination is 50%. There shall be negative marking of 25% of the marks assigned to a question.

Examination Structure

The exam covers knowledge competencies related to the basics of securities market, the trade life cycle, knowledge about the functioning of the front office, middle office and back office in a broking firm. The risk management practices and the clearing and settlement process for a trade executed in the secondary market.

How to register and take the examination

To find out more and register for the examination please visit www.nism.ac.in

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CHAPTER 1: INTRODUCTION TO THE SECURITIES MARKET

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Meaning of securities market and its role in the Indian Economy
- Two different segments of securities market
- Products traded in Indian securities market

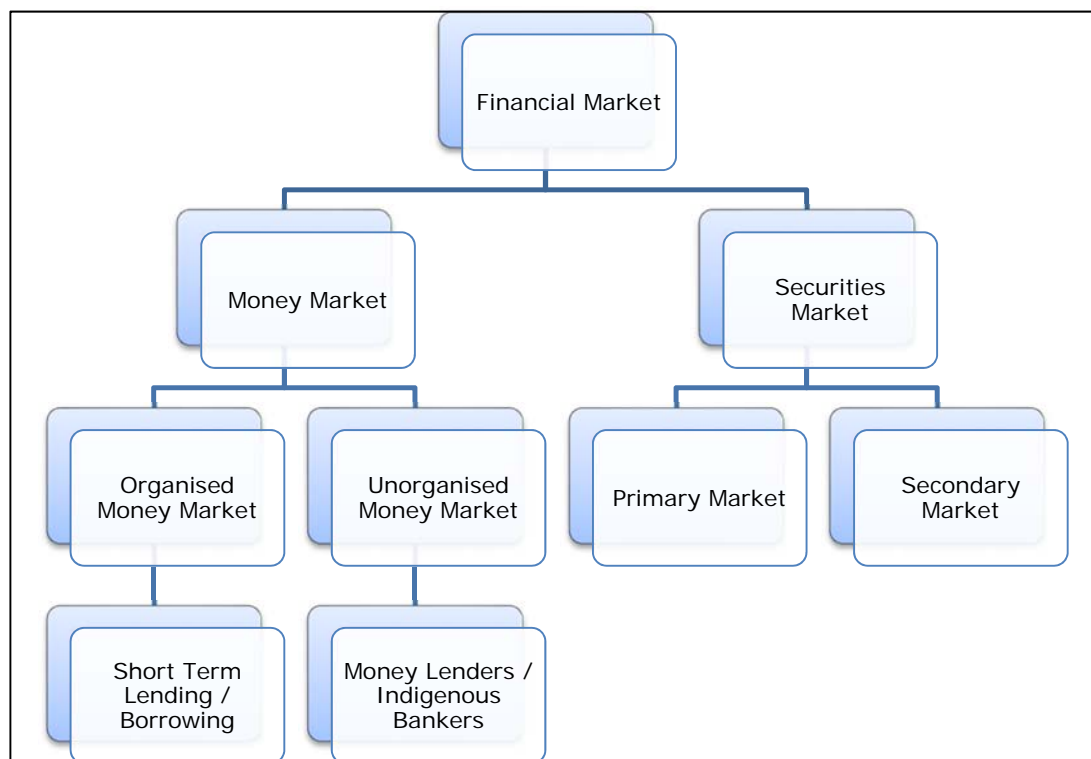
1.1 Introduction

The financial markets enable efficient transfer and allocation of resources for productive activities in the economy. Users of funds include businesses, governments and households who seek funds to run their activities. Households, businesses and governments also act as providers of surplus funds. Intermediaries such as banks, financial institutions, mutual funds and insurance companies, among others, channelize the available surplus funds from lenders to the users.

The function of the financial markets is to ensure that economic activity is enabled by providing access of funds to those that need it for consumption or productive activity. They provide a way for aggregation of funds from a large number of investors and make it available for productive economic activity. In the absence of financial markets such aggregation may not be possible. An efficient financial market ensures that the transfer of funds happens at a cost that makes it attractive for savers to save and lend and for users to borrow funds. The markets must enable the dissemination of relevant information to all the participants in the market so that the decision on price of funds is made after integrating all available information. It must also allow the participants to review their funding decisions given new information and to re-allocate the resources accordingly. Therefore, providing liquidity and exit options are an important function of financial markets. Financial market regulations and regulators focus on setting up systems and processes in place to streamline the activities associated with the transfer of funds.

The Indian financial market can be broadly divided into money market and securities market as illustrated in Figure 1.1.

Figure 1.1: Financial Markets in India



In this book however, we are going to focus specifically on securities market. The term ‘security’ means an instrument of claim (return or share of profits) from the user of funds.

Securities market help in transfer of resources from those with idle resources/surplus to others who have a productive need for them. To state formally, securities markets provide channels for allocation of savings to investments and thereby decouple these two activities. As a result, the savers and investors are not constrained by their individual abilities, but by the economy’s abilities to save and invest respectively, which inevitably enhances savings and investment in the economy.

1.2 Securities Market

The securities market has two interdependent and inseparable segments, viz., the new issuers (the primary market) and stock (secondary) market.

The **primary market** is used by issuers for raising fresh capital from the investors by making initial public offers or rights issues or offers for sale of equity or debt. On the other hand the **secondary market** provides liquidity to these instruments, through trading and settlement on the stock Exchanges. An active secondary market promotes the growth of the primary market and capital formation, since the investors in the primary market are assured of a continuous market where they have an option to liquidate their investments. Thus, in the primary market, the issuer has direct contact with the investor, while in the secondary

market, the dealings are between two investors and the issuer does not come into the picture.

Primary market is the market that ensures availability of adequate capital at reasonable rates to finance expansion, diversification or consolidation of companies. A secondary market on the other hand is the market where the buyer of securities in the primary market can transfer /sell these securities to another buyer.

The resources in the primary market can be raised either through the private placement route or through the public issue route by way of Initial Public Offer (IPO) or Follow on Public Offer (FPO). It is a **public issue**, if anybody and everybody can subscribe for it, whereas, if the issue is made to select group of people then it is termed as **private placement**. In cases, where fresh shares are issued to existing shareholders at a price, it is referred as **Rights Issue**, whereas such issues without involvement of any cost is referred to as **Bonus issue / stock split**.

The secondary market on the other hand operates through two mediums, namely, the Over-The-Counter (OTC) market and the Exchange Traded Market.

OTC markets are the informal type of markets where trades are negotiated. In this type of market, the securities are traded and settled bilaterally over the counter.

The other option of trading is through the **stock exchange route**, where trading and settlement is done through the Stock Exchanges and the buyers and sellers don't know each other. The settlements of trades are carried out as per a fixed time schedule. The trades executed on the exchange are settled through the clearing corporation, who acts as a counterparty and guarantees settlement.

There are several major players in the primary market. These include the merchant bankers, mutual funds, financial institutions, foreign institutional investors (FIIs), individual investors; the issuers including companies, bodies corporate, lawyers, bankers to the issue, brokers, and depository participants. The stock Exchanges are involved to the extent of listing of the securities.

In the secondary market, there are the Stock exchanges, stock brokers (who are members of the stock exchanges), the mutual funds/asset management companies (AMCs), financial institutions, foreign institutional investors (FIIs), investment companies, individual investors, depository participants and banks.

The Registrars and Transfer Agents, Custodians and Depositories are capital market intermediaries which provide important infrastructure services to both the primary and secondary markets. These would be discussed in detail in the later sections of this workbook.

1.3 Money Markets

Money market is a market for financial assets that are close substitutes for money. Such financial instruments are also known as cash equivalents. It is a market for short term funds and instruments having a maturity period of one or less than one year. Money market provides short term debt financing and investment. The money market deals primarily in

short-term debt securities and investments, such as bankers acceptances, negotiable certificates of deposit (CDs), repos and treasury bills (T-bills), call/notice money market, commercial papers. Government securities are also a part of the money market.

1.4 Products Traded in the Indian Securities Market

Investors in the Indian securities market have a wide choice of product base to choose depending upon a person's risk appetite and needs. The different types of products available in equity, derivatives and debt markets are discussed below.

1.4.1 Equity Markets and its Products

The equity segment of the stock exchange allows trading in shares, debentures, warrants, mutual funds and exchange traded funds (ETFs).

Equity Shares represents the form of fractional ownership in a business venture. Equity shareholders collectively own the company. They bear the risk and enjoy the rewards of ownership.

Debentures are instruments for raising long term debt. Debentures in India are typically secured by tangible assets. There are fully convertible, non-convertible and partly convertible debentures. Fully convertible debentures will be converted into ordinary shares of the same company under specified terms and conditions. Partly convertible debentures (PCDs) will be partly converted into ordinary shares of the same company under specified terms and conditions. Thus, it has features of both debenture as well as equity. Non-Convertible Debentures (NCDs) are pure debt instruments without a feature of conversion. The NCDs are repayable on maturity. Partly Convertible debentures have features of convertible and non-convertible debentures. Thus, debentures can be pure debt or quasi-equity, as the case may be.

Warrants entitle an investor to buy equity shares after a specified time period at a given price.

Mutual Funds are investment vehicles where people with similar investment objective come together to pool their money and then invest accordingly. A mutual fund company pools money from many investors and invests the money in stocks, bonds, short-term money-market instruments, other securities or assets, or some combination of these investments, depending on the objectives of the fund.

Exchange Traded Fund is a fund that can invest in either all of the securities or a representative sample of securities included in the index. Importantly, the ETFs offer a one-stop exposure to a diversified basket of securities that can be traded in real time like an individual stock. ETF units with underlying security of Gold are also traded on stock Exchanges.

Indian Depository Receipt (IDR): Foreign companies are not allowed to directly list on the Indian stock exchanges. However, they are allowed to raise capital in Indian currency through an instrument called Indian Depository Receipt (IDR).

IDRs are issued by foreign companies to Indian investors. IDRs are depository receipts which have the equity shares of the issuing company as the underlying security. The underlying shares are held by a foreign custodian and the DRs are held in the Indian depository. IDRs are listed in the Indian stock exchanges. The investor can either hold the IDR, trade in them in the stock exchange or request for redemption into the underlying shares. Redemption is permitted after 1 year from the date of listing. Two way fungibility of IDRs is permitted i.e. the depository receipt can be converted into underlying shares and the underlying shares can be converted into depository receipt. However, the number of shares that can be converted into depository receipt should be within the headroom available i.e. the number of IDRs issued less number of IDRs outstanding and IDRs already converted into underlying shares.

1.4.2 Derivative Market and its Products

Derivative is a product whose value is derived from the value of one or more basic variables, called bases (underlying asset, index, or reference rate), in a contractual manner. Derivative products are in the form of Forwards, Futures, Options and Swaps.

Forward contract is a promise to deliver an asset at a pre- determined date in future at a predetermined price.

Future is an agreement between two parties to buy or sell an asset at a certain time in the future at a certain price. These are basically Exchange traded, standardized contracts. Futures contracts are special types of forward contracts in the sense that the former are standardized Exchange-traded contracts.

Options give the buyer (holder) a right but not an obligation to buy or sell an asset in future. Options are of two types - calls and puts. Calls give the buyer the right, but not the obligation, to buy a given quantity of the underlying asset, at a given price on or before a given future date. Puts give the buyer the right, but not the obligation, to sell a given quantity of the underlying asset at a given price on or before a given date.

The two types of Exchange derivatives instruments are futures and options. In India, futures and options are traded on equity stocks, equity indices, currency and commodities.

Apart from these indices, trading on VIX (Volatility Index) has been introduced in the year 2014. Volatility indices indicate investor's perception of market's volatility in the near term.¹

Index Futures and Options: Currently in the Indian markets, future and options contract are available for trading on the blue-chip indices such as BSE's SENSEX and NSE's CNX NIFTY and sectoral indices of banks, PSU etc.

¹ A high VIX number would suggest that the market expects significant change in the market index and a low VIX number would indicate that the market expects minimal change. The VIX index contracts can be used by investors hedge their portfolios against changing volatilities.

Index option contracts are available for one month, two month, three month, three years and five years expiry cycle. The three year and five year options contracts are referred to as long term option contracts.

All option contracts expire on the last Thursday of the expiry month and have maximum of 3 month expiry cycle. In case the last Thursday is a trading holiday, the contracts expires on the previous trading day. A new contract is introduced on the next trading day following the expiry of the near month contract. All the derivative trades are settled in cash.

Stock Futures and Options: Individual stock options and futures on specific listed stocks are chosen by the stock Exchange based on the guidelines and criterion (such as market capitalization, trading volume) defined by SEBI.

Currency Derivatives trading was introduced in the Indian financial markets with the launch of currency futures trading in the USD-INR pair in 2008.² In India, currency futures are traded on four currency pairs i.e. USD-INR, GBP-INR, EUR-INR and JPY-INR at the NSE, MCX-SX and USE however currency options contracts are available only on US dollars.

In case of currency derivatives segment for example, the underlying for USD-INR pair would be the rate of Exchange between one USD and INR and the contract will have a maximum of 12 months of trading cycle. The new contract would be introduced following the expiry of the current contract. All contracts expire on the last working day (excluding Saturdays) of the contract months. The last day for the trading of the contract shall be two working days prior to the final settlement. All these contracts are cash settled. The settlement price would be the Reserve Bank Reference Rate on the date of expiry.

Derivatives on Foreign Stock Indices: In January 2011, SEBI permitted the stock Exchanges to introduce derivative contracts (futures and options) on the foreign stock indices subject to certain eligibility criteria (like market capitalization, volume of turnover, minimum number of constituent stocks and maximum weight of single constituent in the index) mentioned by SEBI. Currently, derivatives contracts on global indices such as S&P 500, Dow Jones Industrial Average (DJIA) and FTSE 100 are traded on Indian stock Exchange.

Commodity Derivatives markets are markets where raw or primary products are exchanged. These raw commodities are traded on regulated commodities exchanges, in which they are bought and sold in standardized contracts for a specified future date. Commodity markets facilitate the trading of commodities such as gold, silver, metal, energy and agricultural goods.

Interest Rate Futures/Bond Futures. In India, interest rate future or bond futures are based on 10- year Government of India Security and 91-day Government of India Treasury Bill. The lot size (i.e. the minimum amount that can be traded on the Exchange) is 2000 bonds at the rate of Rs. 100 per bond i.e. with the total face value of Rs.2,00,000. New contracts can be introduced by the Exchange on any day of a calendar month. 3 serial months contracts are

² Currency futures were launched at the National Stock Exchange of India on August 29, 2008 and subsequently currency trading at BSE was introduced on October 1, 2008, and MCX-SX on October 7, 2008.

available for trading on the bond futures along with spread contracts of Near-Mid, Near-Far and Mid-Far. Last trading day is the last Thursday of the expiry month. If the last Thursday is a holiday, previous trading day will be the last trading day. The contract are cash settled.

Debt Market and its Products

Debt market consists of bonds and debentures, which provide financing through the issuance of bonds, and enable the subsequent trading thereof. These instruments can be traded in OTC or Exchange traded markets. In India, the debt market is broadly divided into two parts: government securities (G-Sec) market and the corporate bond market.

Government Securities Market: The Government needs enormous amount of money to perform various functions such as maintaining law and order, justice, national defence, central banking, creation of physical infrastructure. For this, it generates revenue by various ways including borrowing from banks and other financial institutions.

The government raises short term and long term funds by issuing securities. These securities do not carry default risk as the government guarantees the payment of interest and the repayment of principal. They are therefore referred to as gilt edged securities. Government securities are issued by the central government, state government and semi government authorities. The major investors in this market are banks, insurance companies, provident funds, state governments, FIs. Government securities are of two types--treasury bills and government dated securities. .

Corporate Bond Market: The corporate bond or corporate debt market is a market where debt securities of corporate such as corporate bonds, T-bills, commercial papers and certificate of deposits are issued and traded. Corporates adopt either the public offering route or the private placement route for issuing debentures/bonds. Corporate bonds are bonds issued by firms to meet their needs for expansion, modernization, restructuring operations, mergers and acquisitions. The investors in this market are banks, financial institutions, insurance companies, mutual funds, FIs etc.

Review Questions

1. Which of the following best describes the term “Private Placement”?

- (a) Issue made to all investors in the Indian securities market.
- (b) Issue made to select group of people.
- (c) Issue made to those investors who already hold shares of the company.

Ans: (b)

2. State which of these statements is true?

- (a) Call Option gives the buyer the right but not the obligation to buy the underlying asset.
- (b) Call Option gives the buyer the right but not the obligation to sell the underlying asset.
- (c) Put Option gives the buyer the right but not the obligation to buy the underlying asset.

Ans: (a)

3. Interest rate futures trading is based on _____.

- (a) Notional 12 year coupon bearing GOI security.
- (b) Notional 10 year coupon bearing GOI security.
- (c) Treasury Bills.

Ans: (b)

4. Derivative contracts expire on the _____.

- (a) Last Friday of the month
- (b) Last Thursday of the expiry month.
- (c) Last trading day of the month.

Ans: (b)

Chapter 2: Market Participants in the Securities Market

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Different types of securities market participants
- Different types of investors based on their investment objectives
- Different types of issuers and the instruments through which they raise money in securities market
- Role of different kinds of intermediaries in the securities markets
- Regulatory framework of securities and some key regulations

2.1 Introduction

As already discussed in the previous chapter, in every economic system, there are savers (who are surplus-generators) and there are spenders (deficit-generators). Securities market provides a platform for savers to place their surplus funds in financial claims or securities at the disposal of the spenders and in turn get benefits such as interest, dividend, capital appreciation, bonus etc. These investors and issuers of financial securities constitute two important elements of the securities markets.

Another important element of the markets are the intermediaries who act as conduits between the investors and issuers.

Regulatory bodies, which regulate the functioning of the securities markets, constitute another significant element of securities markets. The process of mobilization of resources is carried out under the supervision and overview of the regulators. The regulators develop fair market practices and regulate the conduct of issuers of securities and the intermediaries. They are also in-charge of protecting the interests of the investors. The regulator ensures a high service standard from the intermediaries and supply of quality securities and non-manipulated demand for them in the market.

Thus, the four important participants of securities markets are the investors, the issuers, the intermediaries and regulators. We now discuss these different participants in detail in the following sections.

2.2 Investors

An investor is the backbone of the securities market in any economy, as investor is the one lending surplus resources for funding to companies (for their set-up or for expansion plans) in return for financial gains. Investors in securities market can be broadly classified into Retail Investors and Institutional Investors.

Retail Investors are those individual investors who buy and sell securities for their personal account, and not for another company or organization.³ This category also includes high net worth individuals (HNI) which comprises people who invest above rupees two lakh in a single transaction.

Institutional Investors comprises domestic financial institutions (DFIs), banks, insurance companies, mutual funds and FIIs (a Foreign Institutional investor is an entity established or incorporated outside India that proposes to make investments in India).

2.3 Issuers

The public and private sector enterprises, banks and other financial institutions tap the securities market to finance their capital expansion and growth plans. Even mutual funds which are an important investment intermediary mobilises the savings of the small investors. Funds can be raised in the primary market from the domestic market as well as from international markets.

Indian companies can also raise resources from international capital markets through Global Depository Receipts (GDRs)/American Depository Receipts (ADRs), Foreign Currency Convertible bonds (FCCBs) and External Commercial Borrowings (ECBs).⁴ To learn more about the different international market instruments for raising capital from overseas market please see Box 2.1.

Latest development on reforms has allowed foreign companies to raise capital from Indian markets. They can issue IDR (Indian Depository Receipts). This will be in rupee terms. Standard Chartered Bank is the first entity to raise capital through issuing IDR.

³ Source: <http://www.investopedia.com/terms/r/retailinvestor.asp>

⁴ The 1991 reforms allowed Indian companies to raise resources by way of equity issues in the international markets.

Box 2. 1: Instruments for raising capital from overseas markets

Global Depository Receipts (GDRs) are equity instruments issued abroad by authorized overseas corporate bodies against the shares/bonds of Indian companies held with nominated domestic custodian banks.

American Depository Receipts (ADRs) are negotiable instruments, denominated in dollars and issued by the US Depository Bank.

Foreign Currency Convertible Bonds (FCCBs) are bonds issued by Indian companies and subscribed to by a non-resident in foreign currency. They carry a fixed interest or coupon rate and are convertible into a certain number of ordinary shares at a preferred price.

External Commercial Borrowings (ECBs) are commercial loans (in the form of bank loans, buyers credit, suppliers credit, securitized instruments, floating rate notes and fixed rate bonds) availed from any internationally recognized source such as bank, export credit agencies, suppliers of equipment, foreign collaborators, foreign equity holders and international capital market. Indian companies have preferred this route to raise funds as the cost of borrowing is low in the international markets.

2.4 Intermediaries

Intermediation is the process of enabling the saver or buyer of securities (through information and facilitation) to buy or sell the securities and help them acquire all the rights related to the security.

The intermediaries play a very important role in the securities market; they put together the demands of the buyers with the offers of the security sellers. A large variety and number of intermediaries provide intermediation services in the Indian securities markets.

2.4.1 Stock Exchanges

The stock Exchanges provide a trading platform where the buyers and sellers (investors) can meet to transact in securities. In the olden days investors and stock brokers met in the trading hall or the “Ring” of the Stock Exchanges to transact in stocks, whereas in the modern world, on-line trading takes through computers connected through VSATs, leased lines and Internet.

The Securities Contract (Regulation) Act, 1956 (SCRA) defines ‘Stock Exchange’ as (a) *any body of individuals, whether incorporated or not, constituted before corporatisation and demutualisation under sections 4A and 4B, or* (b) *a body corporate incorporated under the Companies Act, 1956 (1 of 1956) whether under a scheme of corporatisation and demutualisation or otherwise, for the purpose of assisting, regulating or coordinating the business of buying, selling or dealing in securities.*

2.4.2 Clearing Corporation/Agency/House

A Clearing Corporation/Agency is a part of an Exchange or a separate entity, which performs three main functions, namely: **clearing** and **settlement** of all transactions executed in the stock market (i.e. completes the process of receiving and delivering shares/funds to the buyers and sellers in the market) and carrying out **risk management**. The Clearing Corporation acts as a central counterparty i.e. it provides financial guarantee for all transactions executed on the Exchange. This process is called novation.

Important Terminologies pertaining to clearing corporations

Pay-In is a process whereby a stock broker and Custodian (in case of Institutional deals) bring in money and/or securities to the Clearing House/ Corporation. This forms the first phase of the settlement activity.

Pay-Out is a process where Clearing House/ Corporation pays money or delivers securities to the brokers and Custodians. This is the second phase of the settlement activity.

The clearing agency determines fund/security obligations and arranges for pay-in of the same.⁵ It collects and maintains margins, processes for shortages in funds and securities. For carrying out settlement of trades, the clearing corporation is helped by the clearing members, clearing banks, custodians and depositories. Thus, these entities are also important intermediaries of securities market.

2.4.3 Trading Member /Clearing Member

An important constituent of the securities market is a trading member/ stock broker who is a member of the stock exchange. A trading member is allowed to buy and sell securities on stock exchanges on behalf of individuals and institutions. A trading member can be an individual (sole proprietor), a partnership firm, corporate or a bank who is a member of a Stock Exchange⁶. Sub-broker is not a member of a Stock Exchange but acts on behalf of a trading member as an agent for assisting the investors in buying, selling or dealing in securities through such trading members.

Clearing Members help in clearing of the trades. There are three kinds of clearing member- Professional Clearing Members (PCM), Trading Cum Clearing Member (TCM) and Self Clearing Member (SCM).

⁵ The process of delivering securities or funds by the trading member to the clearing house/corporation to effect settlement of a sale/purchase transaction is known as pay-in.

⁶ Banks are permitted to become trading and clearing members of the currency futures market of recognized stock Exchanges subject to fulfillment of minimum prudential requirements.

Professional Clearing Members and Trading cum Clearing Members

Professional Clearing Members (PCM) have the right only to clear trades. The PCM does not have any kind of trading rights. These types of members can clear trades of all members associated with him. SEBI registered Custodians and Banks registered by the Exchange are eligible to become Professional Clearing Members (PCMs).

Trading cum Clearing member (TCM) has both trading and clearing rights. He can clear his own trades as well as the trades of others. Any member of the equity segment of the Exchange is eligible to become trading cum clearing member of the Derivatives Segment.

Custodians

Custodians are also clearing members like PCMs but not trading members. They settle trades on behalf of the clients of the trading members, when a particular trade is assigned to them for settlement. The custodian is required to confirm whether he is going to settle that trade or not.

Self-Clearing Members (SCM)

As the name implies, self-clearing members can clear the trades done by him. The only difference between SCM and TCM is that SCM does not have the rights to clear the trades of other members; he can only clear his own trades, whereas TCM can clear the trades of any other member.

Any member of the cash segment of the Exchange is eligible to become Self-Clearing member of the Derivatives Segment.

2.4.3.1 Eligibility Criteria for a Trading Member

The admission as a trading member on the Stock Exchanges is based on the various criteria like age, capital adequacy, financial track record, education, experience and fulfillment of criteria of “fit & proper person” as laid down in the SEBI (Intermediaries) Regulations, 2008. The Exchanges may stipulate additional requirements over and above the SEBI prescribed rules.

Base Minimum Capital

BMC is the deposit given by the member of the exchange against which no exposure for trades is allowed. The Base Minimum Capital is discussed in detail in Section 4.1.1.4 of this workbook.

Eligibility Criteria

For ***individual trading membership***, the eligibility requirements are as follows:

Criteria	
Age	Minimum Age: 21 years
Status	Indian Citizen

Education	At least HSC or Equivalent qualification
Experience	Applicant should have an experience of not less than two years as a partner with, or an authorized assistant or authorized remisier or apprentice to a member

A separate eligibility criteria is applicable for other types of members like Partnership firm, corporations, companies, Institutions or subsidiaries of such corporations, companies or Institutions set up for providing financial services.

Fit and Proper Person

For the purpose of determining whether an applicant or the stock broker, sub-broker, trading member and clearing member is a fit and proper person, the SEBI Board may take into account the following eligibility criteria (but not limit itself to)”:

- (a) Integrity, reputation and character
- (b) Absence of convictions and restraints order
- (c) Competence including financial solvency and net worth of the applicant.

2.4.4 Depository and Depository Participants (DPs)

There are two Depositories in India, Central Depository Services Limited (CDSL) and National Securities Depository Limited (NSDL), which were established under the Depositories Act 1996, for the purpose of facilitating dematerialisation of securities and assisting in trading of securities in the dematerialised form. The Depository provides its services to clients through its agents called depository participants (DPs).

These agents are appointed by the depository with the approval of SEBI. According to SEBI regulations, amongst others, three categories of entities, i.e. Banks, Financial Institutions and SEBI registered trading members can become DPs.

Besides providing custodial facilities and dematerialisation, depositories offer various transactional services to its clients to effect buying, selling, transfer of shares etc. Through a system of paperless securities, depositories have facilitated smooth securities market operations for Stock Exchanges, clearing houses/corporations, stock broking firms, equity issuing companies, share transfer agents etc.

2.4.5 Custodian

A Custodian is an entity that is responsible for safeguarding the securities of its clients. Besides safeguarding securities, a custodian also keeps track of corporate actions on behalf of its clients. It also helps in:

- Maintaining a client's securities account
- Collecting the benefits or rights accruing to the client in respect of securities

- Keeping the client informed of the actions taken or to be taken by the issuer of securities, having a bearing on the benefits or rights accruing to the client.

Custodians are clearing members but not trading members. They settle trades on behalf of the clients of the trading members, when a particular trade is assigned to them for settlement. The custodian is required to confirm whether he is going to settle that trade or not. In case the custodian fails to confirm then the onus of settling the trade falls on the trading member who has executed the trade.

2.5 Regulators

The regulators in the Indian securities market ensures that the market participants behave in a desired manner so that securities market continue to be a major trusted source of finance for corporates and Government and the interest of investors are protected. The different regulators who regulate the activities of the different sectors in the financial market are as given below:

- Securities and Exchange Board of India (SEBI) regulates the securities market.
- Reserve Bank of India (RBI) is the authority to regulate and monitor the banking sector.
- Insurance Regulatory and Development Authority of India (IRDAI) regulates the insurance sector.
- Pension Fund Regulatory and Development Authority (PFRDA) regulate the pension fund sector.
- Ministry of Finance (MOF)
- Ministry of Corporate Affairs (MCA)

We would be concerned about the role of SEBI as it is the regulatory authority for the securities market in India. The orders of SEBI under the securities laws are appealable before a Securities Appellate Tribunal (SAT).

Most of the powers under the SCRA are exercisable by the Department of Economic Affairs (DEA) of Ministry of Finance while a few others by SEBI. The powers of the DEA under the SCRA are also concurrently exercised by SEBI.

The powers in respect of the contracts for sale and purchase of securities, gold related securities, money market securities and securities derived from these securities and ready forward contracts in debt securities are exercised concurrently by RBI. The SEBI Act and the Depositories Act are primarily administered by SEBI. The rules under the securities laws are framed by Government and regulations by SEBI. All these are administered by SEBI. The powers under the Companies Act relating to the issue and transfer of securities and non-payment of dividend are administered by SEBI in case of listed public companies and public companies proposing to get their securities listed. The Self Regulatory Organizations (SROs) ensure compliance with their own rules as well as with the rules relevant for them under the securities laws.

2.5.1 Role of Securities Exchange Board of India (SEBI)

The Securities and Exchange Board of India (SEBI) is the regulatory authority in India established under Section 3 of SEBI Act, 1992 under an act of Parliament. SEBI's primary role is to protect the interest of the investors in securities and to promote the development of securities market and regulate the securities market, by measures it thinks fit.

Role of SEBI:

- Protecting the interests of investors in securities.
- Promoting the development of the securities market.
- Regulating the business in stock exchanges and any other securities markets.
- Registering and regulating the working of stock brokers, sub-brokers etc.
- Promoting and regulating self-regulatory organizations
- Prohibiting fraudulent and unfair trade practices
- Calling for information from, undertaking inspection, conducting inquiries and audits of the stock exchanges, intermediaries, self-regulatory organizations, mutual funds and other persons associated with the securities market.

2.5.2 Regulatory Framework for Securities Market

The process of liberalization of the Indian securities market started in 1992. The aim was to liberalize the securities market, ensure protection of the interests of the investor, to have a regulated market and to develop the securities market. Various Acts were promulgated and legislations amended towards this goal. The four main Acts governing the securities market are:

- The SEBI Act, 1992
- The SC(R)A, 1956
- The Depositories Act, 1996
- The Companies Act, 2013.

Apart from the four Acts the following Regulations are also of high importance in the regulation of Indian Securities Markets:

- SEBI (Stock Broker and Sub-Brokers) Regulation, 1992
- SEBI (Prevention of Insider Trading) Regulations, 1992
- The Prevention of Money laundering Act, 2002
- SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to the Securities Market) Regulations 2003
- SEBI (Custodian of Securities) Regulation, 1996
- SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997

SEBI Act, 1992

The SEBI Act, 1992 was enacted to empower SEBI with statutory powers for

(a) Protecting the interests of investors in securities,

- (b) Promoting the development of the securities market, and
- (c) Regulating the securities market.

Its regulatory jurisdiction extends over corporates (who list or propose to list their securities) in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with securities (more specifically the capital market) market. It can conduct enquiries, audits and inspection of all concerned and adjudicate offences under the Act. It has powers to register and regulate all market intermediaries and also to penalise them in case of violations of the provisions of the Act, Rules and Regulations made thereunder. SEBI has full autonomy and authority to regulate and develop an orderly securities market.

Securities Contracts (Regulation) Act, 1956

It provides for direct and indirect control of virtually all aspects of securities trading and the running of Stock Exchanges and aims to preventing undesirable transactions in securities.

It gives Central Government the regulatory jurisdiction over

- (a) Stock Exchanges through a process of recognition and continued supervision
- (b) Contracts in securities, and
- (c) Listing of securities on Stock Exchanges

As a condition of recognition, a Stock Exchange complies with conditions prescribed by Central Government. Organized trading activity in securities takes place on a specified recognized stock Exchange. The Stock Exchanges determine their own listing regulations which have to conform to the minimum listing criteria set out in the Rules.

Depositories Act, 1996

The Depositories Act passed by Parliament received the President's assent on August 10, 1996. It was notified in a Gazette on August 12 of the same year. The Act enables the setting up of multiple depositories in the country. This was to ensure that there is competition in the service and more than one depository in operation. The Depositories Act facilitated the establishment of the two depositories in India viz., NSDL and CDSL. Only a company registered under the Companies Act, 2013 or (hitherto Companies Act 1956) and sponsored by the specified category of institutions can set up a depository in India. Before commencing operations, depositories should obtain a certificate of registration and a certificate of commencement of business from SEBI. A depository established under the Depositories Act can provide any service connected with recording of allotment of securities or transfer of ownership of securities in the record of a depository. A depository however, cannot directly open accounts and provide services to clients. Any person willing to avail of the services of the depository can do so by entering into an agreement with the depository through any of its Depository Participants. The rights and obligations of depositories, depository participants, issuers and beneficial owners are spelt out clearly in this Act.

Companies Act, 2013

The Companies Act of 2013 deals with issue, allotment and transfer of securities and various aspects relating to company management. It provides for standard of disclosure in public issues of capital, particularly in the fields of company management and projects, information about other listed companies under the same management, and management perception of risk factors. It also regulates underwriting, the use of premium and discounts on issues, rights and bonus issues, payment of interest and dividends, providing annual reports and other information.

SEBI (Stock Broker and Sub-Brokers) Regulation, 1992

The SEBI (Stock Broker and Sub-Broker) Regulation, 1992 lays down the rules and regulation for registration of Stock Broker and Sub-broker. It also prescribes the fees applicable to be paid to SEBI on grant of registration certificate from SEBI and the general code of conduct by the stock broker and its sub brokers holding certificate of membership. The schedule II, regulation 7 of the SEBI (Stock Broker and Sub-brokers) states that the stock broker shall --

- “Maintain high standards of integrity, promptitude and fairness in the conduct of all his business.
- Act with due skill, care and diligence in the conduct of all his business.
- Not indulge in manipulative, fraudulent or deceptive transactions or schemes or spread rumors with a view to distorting market equilibrium or making personal gains.
- Not create false market either singly or in concert with others or indulge in any act detrimental to the investors’ interest or which leads to interference with the fair and smooth functioning of the market”.

In its duty to the investor, the stock broker, in his dealings with the clients and the general investing public shall faithfully execute the orders for buying and selling of securities at the best available market price. The broker as per the regulation shall issue without delay to his client a contract note for all transactions in the form specified by the exchanges.

This regulation also prescribes the brokers and sub-brokers to maintain the different books of accounts, records and documents. These have been discussed in the chapter 3, under section 3.4.5.

Prevention of Money Laundering Act, 2002

The term money-laundering is defined as “whoever acquires, owns, possess or transfers any proceeds of crime; or knowingly enters into any transaction which is related to proceeds of crime either directly or indirectly or conceals or aids in the concealment of the proceeds or gains of crime within India or outside India...”

The Prevention of Money-Laundering Act, 2002 (PMLA), is an act to prevent money-laundering and to provide for confiscation of property derived from, or involved in, money-laundering and for related matters.

Chapter II, section 3 of this act describes the offence of money-laundering thus: whoever directly or indirectly attempts to indulge, or knowingly assists or knowingly is a party or is actually involved, in any process or activity connected with the proceeds of crime including its concealment, possession, acquisition or use and projecting or claiming it as untainted property shall be guilty of the offence of money-laundering.

The offences are classified under Part A, Part B and Part C of the Schedule of the Act. Under Part A, offences include counterfeiting currency notes under the Indian Penal Code (IPC) to punishment for unlawful activities under the Unlawful Activities (Prevention) Act, 1967. Under Part B, offences are considered as money laundering if the total value of such offences is Rs 30 lakh or more. Such offences include dishonestly receiving stolen property under the Indian Penal Code to breaching of confidentiality and privacy under the Information Technology Act, 2000. Part C includes all offences under Part A and Part B (without the threshold) that has cross-border implications.

Section 6 of the PMLA confers powers on the Central Government to appoint an Adjudicating Authority to exercise jurisdiction, powers and authority conferred by or under the Act.

According to section 9, in the event of an order of confiscation being made by an Adjudicating Authority (AA) in respect of any property of a person, all the rights and title in such property shall vest absolutely in the Central Government without any encumbrances.

Section 11 of the Act makes it clear that the Adjudicating Authority shall have the same powers as are vested in a civil court under the Code of Civil Procedure while trying a suit, with regard to the following matters:

- a) Discovery and inspection
- b) Enforcing the attendance of any person, including any officer of a banking company or a financial institution or a company and examining him on oath
- c) Compelling the production of records
- d) Receiving evidence on affidavits
- e) Issuing commissions for examination of witnesses and documents
- f) Any other matter which may be prescribed

All the persons summoned as mentioned above shall be bound to attend the proceedings in person or through authorized agents and shall be bound to state the truth and produce such documents as may be required. Further, every proceeding under the section shall be deemed to be a judicial proceeding within the meaning of sections 193 and 228 of the Indian Penal Code (IPC).

Section 12 of PMLA stipulates that every banking company, financial institution and intermediary shall maintain a record of all transactions, the nature and value of which may be prescribed, whether such transactions comprise a single transaction or a series of transactions integrally connected to each other, and where such series of transactions take

place within a month and furnish information of transactions and verify and maintain the records of the identity of all its clients. Such transactions include:

- *All cash transactions of the value of more than Rs. 10 lakh or its equivalent in foreign currency.*
- *All series of cash transactions integrally connected to each other which have been valued below Rs. 10 lakh or its equivalent in foreign currency where such series of transactions take place within one calendar month and the aggregate value of such transaction exceeds Rs. 10 lakh.*
- *All suspicious transactions whether or not made in cash and including inter alia credits or debits into from any non-monetary account such as demat account, security account maintained by the registered intermediary.*

Provided that where the principal officer of a banking company or financial institution or intermediary, as the case may be, has reason to believe that a single transaction or series of transactions integrally connected to each other have been valued below the prescribed value so as to defeat the provisions of this section, such officer shall furnish information in respect of such transactions to the Director within the prescribed time.⁷

These records which have been referred to in the above paragraphs shall be maintained for a period of ten years from the date of cessation of the transactions between the clients and the banking company or financial institution or intermediary, as the case may be.

Sections 16 and 17 lay down the powers of the authorities to carry out summon, searches and seizures.

Section 24 makes it clear that when a person is accused of having engaged in money-laundering, the burden of proving that the proceeds of the alleged crime are untainted shall be on the accused.

Sections 25 and 26 relate to the establishment of an Appellate Tribunal and the procedures for filing an appeal to the same.

Section 42 deals with appeals against any decision or order of the Appellate Tribunal.

Section 43 empowers the Central Government to designate one or more Courts of Session as Special Courts for the trial of the offence of money-laundering.

The offence of money laundering is punishable with rigorous imprisonment for a term which shall not be less than 3 years but which may extend to 7 years and shall also be liable to fine which may extend to Rs. 5 lakh.

SEBI has also issued guidelines and master circulars pertaining to PMLA.

⁷ Principal Officer's are designated officers of the intermediaries, who would be responsible for ensuring compliance of the provisions of the PMLA.

SEBI (Prohibition of Insider Trading) Regulations, 2015

Insider Trading is considered as an offence and is hence prohibited as per the SEBI (Prohibition of Insider Trading) Regulations, 2015. These regulations came into force w.e.f May 2015.

Any dealing/trading done by an insider based on information which is not available in public domain, gives an undue advantage to insiders and affects market integrity. This is not in line with the principle of fair and equitable markets. Thus, in order to protect integrity of the market, the SEBI (Prohibition of Insider Trading) Regulations have been put in place. The Regulations lay down the definition of 'Insiders'; restrictions on communication and trading by insiders; disclosures of trading by them; and the systemic provisions which need to be laid down and followed by listed company as well as intermediaries.

Regulation 2(g) of the SEBI Insider regulations, defines an 'insider' any person who is:

- i) a connected person; or
- ii) in possession of or having access to unpublished price sensitive information;

Regulation 2(n) defines unpublished price sensitive information as any information, relating to a company or its securities, directly or indirectly, that is not generally available which upon becoming generally available, is likely to materially affect the price of the securities and shall, ordinarily including but not restricted to, information relating to the following: –

- (i) financial results;
- (ii) dividends;
- (iii) change in capital structure;
- (iv) mergers, de-mergers, acquisitions, delistings, disposals and expansion of business and such other transactions;
- (v) changes in key managerial personnel; and
- (vi) material events in accordance with the listing agreement.

Code of Conduct

These regulations mention that (a) the board of directors of every listed company and market intermediary (b) every other person who is required to handle unpublished price sensitive information in the course of business operations shall formulate a code of conduct to regulate, monitor and report trading by its employees and other connected persons towards achieving compliance with these regulations, adopting the minimum standards set out in Schedule B to these regulations, without diluting the provisions of these regulations in any manner.

Also, the listed companies, market intermediary and other persons formulating a code of conduct shall identify and designate a compliance officer to administer the code of conduct and other requirements under these regulations.

Minimum Standards for Code of Conduct to Regulate, Monitor and Report Trading by Insiders

Some of these standards are mentioned below:

The compliance officer shall report to the board of directors and in particular, shall provide reports to the Chairman of the Audit Committee, if any, or to the Chairman of the board of directors at such frequency as may be stipulated by the board of directors.

Employees and connected persons designated on the basis of their functional role (“designated persons”) in the organisation shall be governed by an internal code of conduct governing dealing in securities. The board of directors shall in consultation with the compliance officer specify the designated persons to be covered by such code on the basis of their role and function in the organisation. Due regard shall be had to the access that such role and function would provide to unpublished price sensitive information in addition to seniority and professional designation.

Designated persons may execute trades subject to compliance with these regulations. Towards this end, a notional trading window shall be used as an instrument of monitoring trading by the designated persons. The trading window shall be closed when the compliance officer determines that a designated person or class of designated persons can reasonably be expected to have possession of unpublished price sensitive information. Such closure shall be imposed in relation to such securities to which such unpublished price sensitive information relates. Designated persons and their immediate relatives shall not trade in securities when the trading window is closed.

All information shall be handled within the organisation on a need-to-know basis and no unpublished price sensitive information shall be communicated to any person except in furtherance of the insider’s legitimate purposes, performance of duties or discharge of his legal obligations. The code of conduct shall contain norms for appropriate Chinese Walls procedures, and processes for permitting any designated person to “cross the wall”.

Prior to approving any trades, the compliance officer shall be entitled to seek declarations to the effect that the applicant for pre-clearance is not in possession of any unpublished price sensitive information. He shall also have regard to whether any such declaration is reasonably capable of being rendered inaccurate.

SEBI(Prohibition of Fraudulent and Unfair Trade Practices relating to the Securities Market) Regulations, 2003

The SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to the Securities Market) Regulations 2003 enable SEBI to investigate into cases of market manipulation and fraudulent and unfair trade practices. Regulation 2(1) (c) defines fraud as inclusive of any act, expression, omission or concealment committed to induce another person or his agent to deal in securities. There may or may not be wrongful gain or avoidance of any loss. However, that is inconsequential in determining if fraud has been committed. Some of the instances cited are as follows:

- a) A knowing misrepresentation of the truth or concealment of material fact in order that another person may act, to his detriment
- b) A suggestion as to a fact which is not true, by one who does not believe it to be true
- c) An active concealment of a fact by a person having knowledge or belief of the fact
- d) A promise made without any intention of performing it
- e) A representation, whether true or false, made in a reckless and careless manner

Under Section 3, no person shall buy or sell securities in a fraudulent manner, use any manipulative device or scheme to defraud or engage in any practice which would operate as a fraud upon any person dealing in listed securities or perform any act which is in contravention to these regulations.

Regulation 4(2) describes instances of what would be deemed as a manipulative, fraudulent or an unfair trade practice and includes the following:

- a) Indulging in an act which creates a false or misleading appearance of trading in the securities market
- b) Dealing in a security not intended to effect transfer of beneficial ownership but only to operate as a device to inflate, depress or cause fluctuations in the price of the security for wrongful gain or avoidance of loss
- c) Advancing or agreeing to advance any money to any person thereby inducing any other person to offer to buy any security in any issue only with the intention of securing the minimum subscription to such issue
- d) Paying, offering or agreeing to pay or offer, directly or indirectly to any person any money or money's worth for inducing such person for dealing in any security with the object of inflating, depressing, maintaining or causing fluctuation in the price of such security
- e) Any act or omission amounting to manipulation of the price of a security
- f) Publishing or causing to publish or reporting or causing to report by a person dealing in securities any information which is not true or which he does not believe to be true prior to or in the course of dealing in securities
- g) Entering into a transaction in securities without intention to perform it or without intention to change the ownership of such securities
- h) Selling, dealing or pledging of stolen or counterfeit security whether in physical or dematerialized form
- i) An intermediary promising a certain price in respect of buying or selling of a security to a client and waiting till a discrepancy arises in the price of such security and retaining the difference in prices as profit for himself
- j) An intermediary providing his clients with such information relating to a security as cannot be verified by the clients before their dealing in such security
- k) An advertisement that is misleading or that contains information in a distorted manner and which may influence the decision of the investors
- l) An intermediary reporting trading transactions to his clients entered into on their behalf in an inflated manner in order to increase his commission and brokerage
- m) An intermediary not disclosing to his client transactions entered into on his behalf including taking an option position

- n) Circular transactions in respect of a security entered into between intermediaries in order to increase commission to provide a false appearance of trading in such security or to inflate, depress or cause fluctuations in the price of such security
- o) Encouraging the clients by an intermediary to deal in securities solely with the object of enhancing his brokerage or commission
- p) An intermediary predating or otherwise falsifying records such as contract notes
- q) An intermediary buying or selling securities in advance of a substantial client order or whereby a futures or option position is taken about an impending transaction in the same or related futures or options contract
- r) Planting false or misleading news which may induce sale or purchase of securities
- s) Mis-selling of units of a mutual fund scheme.
- t) Illegal mobilization of funds by sponsoring or causing to be sponsored or carrying on or causing to be carried on any collective investment scheme by any person.

We here describe the act of front running as an example of unfair trade practices. Front – running can be described as an illegal act on part of a dealer/stock broker in which the broker places his own/firm's order ahead of client's order or when client's order is pending. This act of dealer/broker gives him/her an unfair advantage if price of a security is likely to be affected by client's order. Front running could be in the form of buying/selling ahead of client's purchase or sale order. Such act on part of dealer / broker amounts to violation of Section 12A (a), (b) and (e) of the SEBI Act, 1992 or Regulations 3 (a) to (d) and Regulation 4(q) of the SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 2003.

When SEBI has reasonable grounds to believe that the transaction in securities are being dealt with in a manner detrimental to the investor or the securities market in violation of these regulations and when any intermediary has violated the rules and regulations under the act then it can order to investigate the affairs of such intermediary or persons associated with the securities market. Based on the report of the investigating officer, SEBI can initiate action for suspension or cancellation of registration of an intermediary.

SEBI (Custodian of Securities) Regulation, 1996

The custodians are entities that hold securities or gold or gold-related instruments on behalf of mainly large investors, e.g., mutual funds and insurance companies. Custodians maintain and reconcile the records relating to the assets held and also monitor corporate actions such as dividend payments or rights issues on behalf of their clients. In short, custodians are mainly into trade settlement, safekeeping, benefit collection, reporting and accounting. One point of distinction is that a Depository has the right to effect transfer of beneficial ownership while a custodian does not.

The SEBI (Custodian of Securities) Regulation 1996, states that for the purpose of grant of a certificate for activities of a custodian of securities, the entity should have a net worth of a minimum Rs. 50 crores As per Chapter III, every custodian of securities shall enter into an agreement with each client on whose behalf it is acting as custodian of securities and every such agreement shall provide for the circumstances under which the custodian of securities

will accept or release securities from the custody account, will accept or release monies from the custody account; time circumstances under which the custodian of securities will receive rights or entitlements on the securities of the client.

Every custodian of securities shall have adequate internal controls to prevent any manipulation of records and documents including audits for securities and rights or entitlements arising from the securities held by it on behalf of its client.

Review Questions

1. American Depositary Receipts (ADRs) are _____.
- a) Negotiable instruments denominated in dollars and issued by US depository Banks.
 - b) Bonds issued by Indian companies abroad.
 - c) Depository receipts issued abroad by authorized overseas corporate bodies against shares of Indian companies held with nominated domestic custodian banks.

Ans: (a)

2. Which of the following statement is false?
- a) Custodians are registered with SEBI as professional clearing members
 - b) Self-clearing members can clear trades done by them only.
 - c) Trading cum clearing members can trade and clear trades done by him, but cannot trade and clear trades done by others.

Ans: (c)

3. Stock brokers need to get registered as stock brokers with SEBI as per which regulation?
- a) SEBI (Intermediaries) Regulations, 2008
 - b) SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992
 - c) SEBI Act, 1992

Ans: (b)

4. Securities Contracts (Regulation) Act, 1956 has regulatory jurisdiction over
- (a) Listing of securities on Stock Exchanges
 - (b) Recognition of intermediaries in the Securities Market
 - (c) Investor Protection

Ans: (a)

Chapter 3: Introduction to Securities Broking Operations

LEARNING OBJECTIVES

After studying this chapter you should know about:

- Concept of Trade life cycle
- Front Office, Middle Office and Back Office Operations of a stock broking firm
- Information Technology and Business Continuity Plan of a stock broking firm
- Regulatory Compliances

3.1 Introduction to the Trade Life Cycle

In financial market, “trade” means to buy and/or sell securities/financial products. To explain it further, *a trade is the conversion of an order placed on the Exchange into a pay-in and pay-out of funds and securities. Trade ends with the settlement of the order placed.*

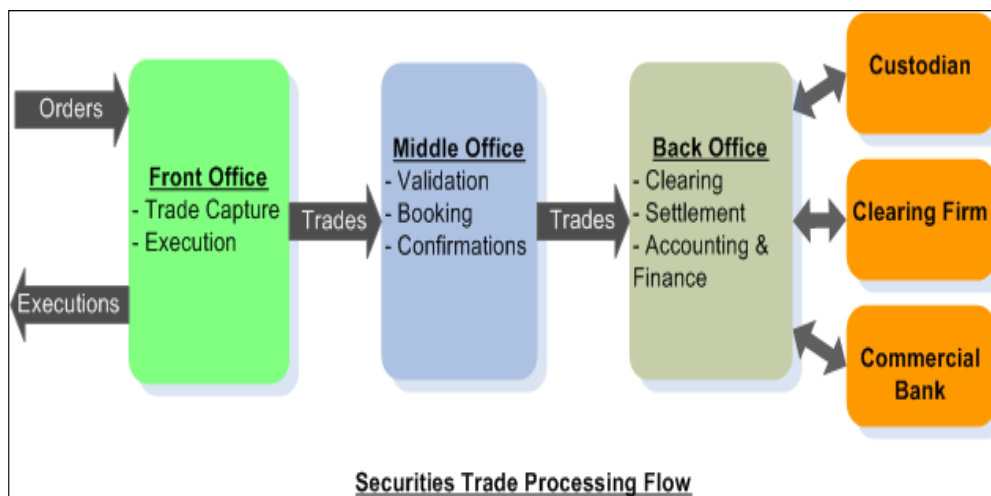
Every trade has its own cycle and can be broken down into pre-trade and post-trade events. Trading of securities also involves many participants like the investors, brokers, Exchange, clearing agency/corporation, clearing banks, depository participants, custodians etc.

The following steps are involved in a trade’s life cycle:

1. Placing an Order
2. Risk management and routing of order
3. Order matching and its conversion into trade
4. Affirmation and Confirmation (only for institutional deals)
5. Clearing and Settlement

The above mentioned steps can easily be categorized into front office, middle office and back office operations of broking firms. However, this categorization of the three different offices is mostly the set up with big broking houses. Points 1 and 3 are generally the front office functions; Risk management part of point 2 is the middle office function, whereas the order routing part of point 2 is again a front office function. Points 4 and 5 are the back office functions. In this chapter we discuss these various steps involved in a trade life cycle. Figure 3.1 gives a pictorial representation of the trade life cycle.

Figure 3.1: Securities Trade Life Cycle



3.1.1 Placing of order

The Broker accepts orders from the client and sends the same to the Exchange after performing the risk management checks. Clients have the option of placing their orders through various channels like internet, phone, direct market access (DMA) (for institutional clients) etc. Box 3.1 gives details of DMA.

Once the orders are received by the broker, it is confirmed with the client and then entered into the trading system of the Exchange. The Exchange gives confirmation of the order and time stamps it. An order generally comes with certain conditions which determine whether it is a market order, limit order etc (discussed in section 3.2.2). These specify the terms and conditions at which the client wants his/her order to get executed.

Box 3.1 Direct Market Access

In the year 2008, SEBI permitted the facility of Direct Market Access for institutional clients. DMA is a facility which allows brokers to offer its institutional clients the direct access to the Exchange trading system through the broker's infrastructure. This does not involve any manual intervention of the broker. This facility can be extended to the institutional clients provided the broker satisfies the operational specifications; risk management measure and other details as prescribed by SEBI.

3.1.2 Risk Management and Order Routing

A sound risk management is integral to an efficient system. A broker's risk management works on the following concepts:

- **Cash:** The broker normally ensures that there is enough balance in the clients' account to honour the trade.
- In case a buy order is entered by the client or on behalf of the client, the broker's system runs a query to find the available funds in the client's bank account and whether it is

sufficient to meet the stipulated margin requirements. This is as per the agreed upon terms and conditions of risk management with the client. If the available balance satisfies the risk management parameters then the order is routed to the Exchange. In cases where the balance is not sufficient the order gets rejected. A rejection message is shown in the system, which then is conveyed to the client.

In case there is no direct interface to a banking system, the client is asked to maintain cash and securities deposit in order to ensure adequacy of balance.

- In case a client gives a sell order, the broker ensures that the client's custody/demat account has sufficient balance of securities to honour the sale transaction; this is possible only if the client has his/her demat account with the same broker. In all other cases, wherever the client has his demat account with an outside / third party DP, it's the duty of the client to ensure that he has/ will have the required securities in the demat account, before selling the same.
- Depending upon the type of order and the actual prices prevailing in the market, the order gets executed immediately or remains pending in the order book of the Exchange.

3.1.3 Order Matching and Conversion into Trade

All orders which are entered into the trading system of the Exchange are matched with similar counter orders and are executed. The order matching in an Exchange is done on a price time priority basis. The best price orders are matched first. If more than one order is available at the same price then they are arranged in ascending time order. Best buy price is the highest buy price amongst all orders and the best sell price is the lowest price of all sell orders. This has been discussed in detail in section 3.2.2.3.

Once the order is matched, it results into a trade. As soon as the trade is executed, a trade confirmation message is sent to the broker who had entered the order. The broker in turn lets the client know about the trade confirmation through a contract note. (To understand about a contract note read Box 3.2)

All orders which have not been executed, partly or fully can be modified or cancelled during the trading hours. Trades done during the day can also be cancelled by mutual consent of both the parties subject to approval of the Exchange. These generally occur due to order entry errors and are not a common practice.

Box 3.2: What is a Contract Note?

A contract note is a confirmation of trade done on a particular day for and on behalf of a client. A contract note is issued in the format and manner prescribed by the Exchanges. It establishes a legally enforceable relationship between the stock broker and the client in respect of settlement of trades executed on the Exchange as stated in the contract note. Every trade executed by a stock broker on behalf of his client should be supported by a contract note.

Contract note should be issued within 24 hours and in the format prescribed by Exchanges/SEBI. These should be issued in physical form or electronic form depending on the mode chosen by client.

The contract notes should be acknowledged by the clients along with date in case of personal delivery. Stock brokers are required to maintain proof of dispatch of contract notes in the case of delivery of physical contract notes through post/courier. In the case of Electronic Contract Note (ECN), log of sending ECN to client's email id should be maintained.

The contract notes should be serially numbered starting from the beginning of the financial year. They should be issued with the client's name and client's code written on them. It should also contain the exact order number, order entry time, trade number, trade time, quantity of securities transacted, rates/price, etc. Contract notes with weighted average rates of trade should contain an annexure with the details thereon. Electronic contract notes should be issued only if the client has pre-authorized the stock broker. The contract note should be digitally signed, encrypted, non-tamperable, and in accordance with the Information Technology Act, 2000.

Stock brokers are required to maintain duplicate copy or counter foil of the contract notes. The contract notes should be signed by stock broker or by an authorised signatory of the stock broker. A contract note without consideration is null and void under Indian Contracts Act and hence all contracts should mention the consideration separately.

Contract should also mention all statutory charges like Securities Transaction Tax (STT), Service Tax (ST), Education Cess, SEBI and Exchange charges, etc. Contract notes should be affixed with the brokers note stamps, as a percentage of the total value of the contract, as per the respective state government stamp acts / rules. Contract note also should clearly specify the complete address, phone number, e-mail IDs, fax numbers, Depository Participant ID (DP-ID), Pool A/C details, etc. of the broker alongwith the PAN.

3.1.4 Affirmation and Confirmation (*For Institutional Clients*)

FIs trading in the Indian securities market use the services of a custodian to assist them in the clearing and settlement of executed trades. Custodians are clearing members of the Exchange and not brokers who trade on behalf of them. On behalf of their clients, they settle the trades that have been executed through other brokers. A broker assigns a particular trade to a custodian for settlement. The custodian needs to confirm to the broker whether he is going to settle that trade. Upon confirmation by the custodian the broker communicates the same to the clearing corporations who then assigns the obligation to the custodian. The overall risk that the custodian is bearing by accepting the trade is constantly measured against the collateral that the institution (who trades) submits to the custodian for providing this service.

This process gains more importance when while giving orders for purchase or sale of security, the fund manager of a mutual fund gives the order without having any specific fund in mind for allocating those shares for which order has been given. In such cases, the broker accepts the order. On the order being traded, the broker sends the trade confirmation to the MF. The fund manager before the end of day has to allocate the shares to the respective funds/schemes and send the details to the broker for him to issue the contract notes. Using the allocation details sent by the MF, the broker issues the contract note.

In 2004, SEBI had mandated that all the institutional trades executed on the Stock Exchanges should be processed through the Straight through Processing (STP) system.⁸ STP is a mechanism that automates the end-to-end processing of transactions of the financial instruments. It involves use of a single system to process or control all elements of the workflow of a financial transaction, including what is commonly known as the Front, Middle, and Back office, and General Ledger. In other words, STP can be defined as electronically capturing and processing transactions in one pass, from the point of first 'deal' to final settlement.

3.1.5 Clearing and Settlement

Once the trade is executed on the Exchange, the details are passed on to the clearing corporation, to initiate the clearing and settlement of those executed trades. Based on the trade details from the Exchange, the Clearing Corporation determines the obligations of the members. It then notifies the consummated trade details to the clearing members/custodians who affirm back. Based on the affirmation, the clearing corporation applies multilateral netting and determines obligations. The settlement process begins as soon as member's obligations are determined through the clearing process.

The settlement process is carried out by the clearing corporation with the help of clearing banks and the depositories. The clearing corporation provides a major link between the clearing banks and the depositories. This link ensures actual movement of funds as well as securities on the prescribed pay-in and pay-out day.

⁸ Vide SEBI Circular no. DNPD/Cir- 22 /04 dated April 1, 2004.

Instructions are given to the depositories and the clearing banks for pay-in of securities and funds and pay-out of securities and funds. The clearing members have to ensure that they make available the securities / funds to the clearing corporation before pay-in day and time. Once the pay-in activities are carried out the clearing corporation carries out the pay-out of funds and securities.

In India, we follow the T+2 Rolling Settlement, which means that the brokers settle the transactions on the second working day from the trade day. To give an example, a trade executed on Wednesday, has to be settled on Friday (provided Thursday and Friday are working days), with pay-in and pay-out of funds and securities being completed on that day.

3.2 Front Office Operations

The front office is responsible for trade capture and execution. This is where the trade originates and the client relationship is maintained. The front office makes/takes orders and executes them. Traders and sales staff are considered front office staff.

To better understand the subsequent sections we need to keep in mind the trade life cycle (figure 3.1) discussed earlier. It can be clearly seen from the Figure 3.1 that the main task of the front office staff is to generate orders and execute them. The dealers are the face of the brokers, who liaise with the clients and accept orders. Discussed below are the various front-office related activities.

3.2.1 Client On-Boarding and Registration

An important part of a broker's job is finding clients and building a customer base. Thus, securities sales agents spend time searching for clients. Some agents network by joining civic organizations or social groups, while others may rely on referrals from satisfied customers.

3.2.1.1 Sales

Traders buy and sell financial products with the goal of making an incremental amount of money on each trade. The sales force, whose primary job is to call on clients to suggest trading ideas and take orders and then communicate their clients' orders to the appropriate trading desks, who can price and execute trades. The job of the sales team also includes getting new clients to the brokerage firm.

3.2.1.2 Account opening

This refers only to the opening of accounts for new clients. There are certain procedures to be followed before the account can be opened and the broker can execute the orders of the client.

To simplify and rationalize the trading account opening procedure, SEBI has devised uniform documentation to be followed by all the stock brokers/trading members and providing a copy of those documents to the clients.⁹

By uniform documentation, it is meant that a list of six documents that are required for account opening process. (The sample of these documents are provided as annexure to this workbook). An index of documents listing the following documents required for client account opening process is provided to the clients.

- 1) **Client Account Opening Form** which is in two parts. a) Know Your Client (KYC) form capturing the basic information about the client and instruction/check list to fill up the form and b) Additional Document capturing additional information about the client related to trading account.
- 2) Document stating the **Rights & Obligations of stock broker**, sub-broker and client for trading on Exchanges (including additional rights & obligations in case of internet/wireless technology based trading).
- 3) **Uniform Risk Disclosure Documents (RDD)** for all segments/Exchanges.
- 4) **Guidance Note** detailing Do's and Don'ts for trading on Exchanges.
- 5) Document describing the **Policies and Procedures of the stock broker**
- 6) **A tariff sheet** specifying various charges, including brokerage, payable by the client to avoid any disputes at a later date.

In addition to the above documents, the clients should also be provided with the contact details of senior officials within the stock broking firm and investor grievance cell in the stock Exchange, so that the client can approach them in case of any grievance.

Details of certain documents to be submitted by the client are enumerated in the following section.

KYC and Other Documents

KYC is an acronym for “Know your Client”, a term commonly used for Customer Identification Process. SEBI has prescribed certain requirements relating to KYC norms for Financial Institutions and Financial Intermediaries including Mutual Funds and Stock Brokers to ‘know’ their clients. This entails verification of identity and address, financial status, occupation and such other personal information as may be prescribed by guidelines, rules and regulation.

SEBI in consultation with Unique Identification Authority of India (UIDAI) now allows brokers to accept e-KYC service provided by UIDAI as a valid process for KYC verification.

⁹ Vide SEBI Circular no. CIR/MIRSD/16/2011 dated August 22, 2011

The broker must ensure that the clients fill-up the KYC form and submit it to them. There are separate forms for individuals and non-individuals. Brokers must also ensure that the following documents are submitted along with the KYC forms by the clients.

- **PAN Card:** The PAN card along with its photocopy is required for identity verification of an individual. The original PAN card is for verification only and will be returned to the client immediately.

Certain entities or individuals (as mentioned below) are exempt by SEBI to produce their PAN provided they have sufficient documentary evidence in support of such claims are collected.

- In case of transactions undertaken on behalf of Central Government and / or State Government and by Officials appointed by Courts e.g. Official Liquidator, Court receiver etc.
 - Investors residing in the state of Sikkim.
 - UN entities / multilateral agencies exempt from paying taxes / filing tax returns in India.
 - SIP of Mutual Funds upto Rs. 50,000 per annum.
 - In case of institutional clients, namely, FIIs, MFs, VCFs, FVCIs, Scheduled Commercial Banks, Multilateral and Bilateral Development Financial Institutions, State Industrial Development Corporations, Insurance Companies registered with IRDA and Public Financial Institutions as defined under the Companies Act, 2013, Custodians shall verify the PAN card details with the original PAN card and provide duly certified copies of such verified PAN details to the intermediary.
- **Proof of Address Document:** List of documents admissible for Proof of Address are given below, however these documents having an expiry date should be valid on the date of submission:
 - Passport/Voters Identity Card/Ration Card/Registered Lease or Sale agreement of Residence /Driving license/Flat Maintenance Bill /Insurance Copy.
 - Aadhaar letter issued by UIDAI
 - Utility bills like Telephone bill (only landline), Electricity bill or Gas bill –Not more than 3 months old.
 - Bank account statement /Passbook –Not more than 3 months old.
 - Self Declaration by High Court and Supreme Court judges, giving the new address in respect of their own accounts.
 - Proof of address issued by any of the following: Bank managers of Scheduled commercial Banks/Scheduled Co-operative Bank/Multinational Foreign Banks/Gazetted Officer/Notary public/Elected representatives to the legislative assembly/Parliament/Documents issued by any Government or statutory Authority.

- Identity card /document with address. Issued by any of the following: Central/State Government and its departments, statutory/Regulatory authorities, Public Sector Undertakings, scheduled Commercial Banks, Public Financial Institutions, Colleges affiliated to universities and Professional Bodies such as ICAI, ICWAI, ICSI, Bar Council etc. to their members.
- For FII / Sub account, Power of attorney given by FII / Sub-account to the custodians (which are duly notarized and /or apostiled or consularised) that gives the registered address should be taken.
- The proof of address in the name of the spouse may also be accepted.
- **Proof of Identity:** The following documents are considered admissible as proof of Identity:
 - i. Unique Identification Number (UID) (Aadhaar)/Passport/Voter ID Card/Driving License.
 - ii. PAN card with photograph
 - iii. Identity card /documents with applicants photo, issued by any of the following: Central/State Government and its departments, Statutory/Regulatory Authorities, Public Sector Undertakings, Scheduled Commercial Banks, Public Financial Institutions, Colleges Affiliated to Universities, Professional Bodies such as ICAI, ICWAI, ICSI, Bar council etc., to their Members; and credit cards/debit cards issued by banks.

If the proof of identity or address is in a foreign language, then translation into English is required. In person verification is also required to be made by the broker or by the person authorised by him of each new client added on the books.
- **Bank account details:** The client must also have a valid bank account from which transactions can be made for pay-in/out of funds. The details are to be given with the KYC. A cancelled cheque leaflet with a copy of the bank account statement/ pass book should also be submitted at the time of opening the trading account. This bank account will be mapped to the client's trading account and thereafter, generally, payment will be accepted only from this account. A client can map more than one bank account also, but should provide the proof of the same.

The client must have also opened a demat account with a DP for pay-in or pay-out of securities. A copy of the client master given by the respective DP to the client should be submitted to broker at the time of opening the trading A/C.

Normally the client prefers to open both trading and demat account with the same broker. In that case the client is willing to give Power of Attorney (POA) in favour of broker for smooth functioning. SEBI has stipulated certain formats and stipulations with respect to POA to be followed by the broker.

- **Authority Letter for settle account:** The retail clients normally do not wish to exchange cheques to and fro for every contract. They prefer to settle the account with the broker at periodic interval. To facilitate this SEBI has approved brokers to collect running authority letter from the client. In spite of this letter the broker should settle the accounts at least once a quarter or earlier as per the client preference.

3.2.1.3 KRA Agency (Know Your Client Registration Agency)

SEBI simplified the account opening process for investors and made it uniform across intermediaries in the securities markets as already mentioned above. Further, to avoid duplication of the KYC process with every intermediary, in the year 2011 SEBI devised the KRA system for centralization of the KYC records in the securities markets. The KRA system was made applicable for those clients who opened accounts with the intermediaries from January 1, 2012 onwards.

The brokers or trading members, after completing the client account opening procedures, are required to upload the KYC details to the KRA agencies registered with SEBI.¹⁰ The members may upload the KYC data on the KRA system and send the relevant KYC documents to KRA within 10 working days.

3.2.1.4 Unique Client Code (UCC)

In 2001, SEBI made it mandatory for brokers to use unique client codes for all clients.¹¹ Once the formalities of KYC and other details thereon are complete, each client is assigned a unique client code (UCC) by the broker. This acts as an identity for the client with respect to the broker. SEBI has made it mandatory for all the brokers/sub-brokers to use unique client codes for all clients while entering orders on their behalf. It is also mandated by SEBI, that the unique client code be mapped with the PAN number of the client.

The broker has to provide the Stock Exchange(s) with the UCC and the PAN details of the client(s) before entering into any trade for the client. The Stock Exchanges provide an upload facility to the brokers through which the UCC and other client details are uploaded on the stock exchange platform on a periodic basis. If the broker fails to register the unique client code with the Exchange, he is liable to be penalized.

3.2.1.5 Brokerage

Brokerage firms have elaborate commission module (brokerage) to attract and retain clients. Given below are the rules for charging brokerage.

¹⁰SEBI Circular No. MIRSD/Cir-23/2011 dated December 2, 2011. The guidelines on KRA upload are provided in SEBI Circular No. MIRSD/Cir- 26 /2011 dated December 23, 2011.

¹¹ SEBI Circular no: SMDRP/Policy/CIR-39/2001 dated July 18, 2001

- Brokerage rule for equity segment:
 - Maximum brokerage that brokers can charge is 2.5% of the trade value.
 - If the value of share is Rs.10/- or less, a maximum brokerage of 25 paise per share can be collected.
 - There is no minimum brokerage requirement specified.
- Brokerage rule for F&O segment:
 - Brokerage rule for F&O segment is similar to the equity segment except for options contract
 - In the case of options contracts, maximum brokerage can be 2.5% of the option premium or Rs.100/- per contract whichever is higher.

Trading member can be a full service broker, discount broker or an online broker. Commission charged can be different for different types of brokers.

- Full service broker charges higher commission
- Discount brokers charge a much lower commission
 - They also don't offer any other facility other trading
- Online brokers cater to niche segment of retail clients.
 - Commission charged is lesser than what would be charged for a client placing orders through a broker.
- Brokers also use multiple commission schemes such as
 - Volume based commission
 - Slab wise commission or
 - Scrip wise commission.

Commission charges may differ for day trades versus delivery transactions.

3.2.2 Order Management

Order management consists of entering orders, order modification, order cancellation and order matching. The main components of an order are:

- Price
- Time
- Quantity
- Security (What to buy and what to sell)
- Action (Buy / Sell)
- Client identity (UCC)

3.2.2.1 Types of order

Price, time and quantity are three major components of an order. There are generally three types of orders that can be used when placing trades. These are market orders, stop orders

and limit orders. There are variations on each to which traders should be aware of. These variations are present for security and precision and there are occasions where more than one order is required. These variations are because of different conditions / preferences of price, time and quantity.

Market Order - Basic Trade

A market order is where a trader purchases or sells their security at the best market price available. In the market order there is no need to specify the price at which a trader wants to purchase or sell. There are two variations on the market order—market order without protection and Market with protection order.

The market order without protection means that the trades are executed at the best available price in the market at that point in time.

The second type of market order i.e. market with protection order is like a Limit Order. The risk of an order getting executed at any price is protected by using such order. The protection percentage is applied on the LTP (last traded price) to arrive at a price beyond which the order will not get executed.

Example 3.1: Illustration of a typical market order

Order is placed to buy 100 shares of ABC Industries Ltd. “at Market”. The order book snapshot looks like as below:

Buy Qty.	Buy Price	Sell Price	Sell Qty.
1,606	807.55	807.60	100
13	807.50	807.65	119
383	807.45	807.70	184
78	807.40	807.75	42
1	807.35	807.85	86
1,86,054	Total Quantity		1,30,050

In this current scenario, the incoming market order will get matched with the best sell order in the book which is 100 shares @ Rs.807.60 and a trade will take place for 100 shares at Rs.807.60.

Limit Order - Buying at a Lower Price/Selling at a Higher Price

Limit orders involve setting the entry or exit price and then aiming to buy at or below the market price or sell at or above it. Unlike market order, the trader here needs to specify at

least one price. They of course can be changed any time before execution. Reaching these limits/targets is not always possible and sometimes the orders do not go through. Limit orders are very common for online traders.

Example 3.2: Illustration of a typical limit order

Order is placed to buy 200 shares of ABC Industries Ltd at Rs. 807.65. The order book snapshot looks like as below:

Buy Qty.	Buy Price	Sell Price	Sell Qty.
1,606	807.55	807.60	100
13	807.50	807.75	119
383	807.45	807.80	184
78	807.40	807.85	42
1	807.35	807.90	86
1,86,054	Total Quantity		1,30,050

In this current scenario, the incoming limit order will get matched with the best sell order in the book which is 100 shares @ Rs.807.60 and a trade will take place for 100 shares at Rs.807.60. It should be noted that the order is always matched with the passive order price, in this case as the sell order is the passive order, matching takes place at Rs.807.60. The balance buy order for 100 shares @ Rs.807.65 will sit in the order book on the buy side as the best buy order. The revised order book snapshot after the trade match will look as follows:

Buy Qty.	Buy Price	Sell Price	Sell Qty.
100	807.65	807.75	119
1,606	807.55	807.80	184
13	807.50	807.85	42
383	807.45	807.90	86
78	807.40	807.95	12
1,86,153	Total Quantity		1,29,062

There is one more variation in Limit order called IOC (immediate or cancel). In this case the trader puts the current market rate as limit and the order gets executed to the extent of available quantity at that rate. The balance unexecuted quantity if any is cancelled instead of keeping pending at the order book.

Example 3.3: Illustration of a typical IOC order

Order is placed to buy 200 shares of ABC Industries Ltd. at Rs. 807.65 immediate or cancel. The order book snapshot looks like as below:

Buy Qty.	Buy Price	Sell Price	Sell Qty.
1,606	807.55	807.60	100
13	807.50	807.75	119
383	807.45	807.80	184
78	807.40	807.85	42
1	807.35	807.90	86
1,86,054	Total Quantity		1,30,050

In this current scenario, the incoming limit order will get matched with the best sell order in the book which is 100 shares @ Rs. 807.60 and a trade will take place for 100 shares at Rs. 807.60. It should be noted that the order is always matched with the passive order price, in this case as the sell order is the passive order, matching takes place at Rs. 807.60. The balance buy order for 100 shares @ Rs. 807.65 will be cancelled as it is an IOC order and there is no match for the remaining 100 shares.

Stop Orders (orders with stop loss triggers)

In stop order, the client enters two prices: one is trigger price and the other is limit price. A stop order can best be explained with an example. Suppose a trader has a short term (say, for a day), bullish view on a stock, he may buy the stock at say Rs. 100/- per share in the early hours of trading session. If the stock price moves upwards as per his expectation, he may sell the stock, say at Rs. 110/- and close his position.

The stock price can also move downwards much against expectations of the trader. It may so happen that the trader may have limited risk appetite and does not want to incur loss of more than Rs. 5/- per share. In such a scenario, trader can give stop loss order with trigger price of Rs. 96/- and limit price of Rs. 95/-. When the stock price starts moving downwards, as soon as it hits price of Rs. 96/- , the sell order of Rs.95/- will automatically get triggered. Any further downward movement in price will not affect the trader as he has already limited his loss on the position.

A stop order can also be used with similar logic if a trader has bearish view on a stock.

A typical sell stop loss order example:

- Original transaction-Bought 400 shares of ABC Industries Ltd. (ABC) at Rs.830.
- If the price falls below the purchase price, the investor will start clocking a loss.
- Investor may place a sell stop loss order at a trigger price of Rs.800. When the price of ABC drops to Rs.800, sell stop loss order will get triggered.
- Order is then placed in the market to sell 400 shares of ABC.
- It can be triggered as a market order, or as a limit order
- If the investor had specified a limit price, for example in this case, Rs.790
- In the case of stop loss limit order, once triggered, the order will be placed in the market for sell ABC 400 shares at Rs.790.
- It will match only if a corresponding buy order exists for Rs.790/- or better.
- If it is stop loss market order, once triggered it will match with the best counter order available.

A typical buy stop loss order example:

- Original transaction – Sell 400 shares of ABC Industries Ltd (ABC) at Rs.830.
- If the price goes above the selling price, the investor will start clocking a loss.
- Buy stop loss order is used to anticipate potential loss. Investor may place a buy stop loss order at a trigger price of say Rs.880.
- When ABC price reaches Rs.880, the buy stop loss order will get triggered.
- An order will be placed in the market to buy 400 shares of ABC.
- It can be triggered as a market order, or as a limit order.
- If the investor had specified a limit price, for example in this case, the limit price could be Rs.890.
- In the case of stop loss limit order, when the stop loss order is triggered, the order will be placed in the market for selling 400 ABC shares at Rs.890/-. It will match only if a corresponding buy order exists for Rs.890/- or better.
- If stop loss market order, it will be released to the market when the trigger price is reached. It could potentially trade at any price at which the best order in the market is available.

The variations in the three orders require traders to be well aware of the options when trading. Studying the stock and predicting the trend accurately is very important.

3.2.2.2 Placing of orders through the Internet / Phone

Placing of orders through the internet/phone means the facility provided by stock brokers, whereby the client can place order(s) over the phone/internet for transactions in securities, to be executed on behalf of clients by the broker.

Here, the dealer shall refer to the Dealing Desk Executive appointed by the call centre(s) for the purpose of providing this facility.

- For the purpose of availing of this service, the Client is required to call on the specific numbers intimated or notified from time to time by the stock broker for the said purpose by means of an email and/or by putting up such numbers on the website or otherwise.
- In case the Client opts for this service, he may be required to provide accurate answers to the questions asked by the Dealing Desk Executive, including the Client's user id and TPIN, for ascertaining the genuineness of the caller. Once this is done, the order can be placed and will be processed in the normal course.

3.2.2.3 Process of order routing through the Exchanges

Once the order is entered and confirmed by the client/dealer at his trading terminal and verified by the broker software, the order is routed to the Exchange for its execution. The Exchange system allots a unique order number for all orders received in the system. This is given as order confirmation along with the time stamp to the broker.

The order gets executed at the Exchange depending upon the type of order. If the order is a market order it gets executed immediately. If it is a limit order it is stored in the order book and matched against appropriate counter orders. Once the order is matched, a trade is said to be executed. As soon as a trade is executed the trade confirmation message will be automatically available on the trading terminal of broker and client which in turn informs the client through a message on the trading terminal (only if the client is trading on internet platform).

All orders can be modified or cancelled during the trading hours and pre-open market stage provided they are not fully executed. For the orders, which are partially executed, only the open or unexecuted part of the order can be cancelled/modified.

The order matching in an Exchange is done based on price-time priority. The best price orders are matched first. If more than one order arrives at the same price they are arranged in ascending time order. Best buy price is the highest buy price amongst all orders and similarly best sell price is the lowest price of all sell orders. Let us take an example here to better understand this. A sample of the order book is given below for understanding.

Buy Quantity	Buy Price	Sell quantity	Sell Price
50	121.20	50	121.50
100	121.10	200	121.80
25	120.90	3000	122.10
500	120.00	1000	122.20
5000	120.00	200	122.60

These quotes given in the table above are visible to clients. Now if a buy market order comes with an order quantity of 50 it gets executed for a price of Rs. 121.50 and the order book entries on the sell side moves up by one notch i.e. the Rs. 121.80 order comes

to top. On the other hand if a limit order with a sell price of Rs. 121.20 for a quantity of 500 comes 50 shares get executed and the order for remaining 450 stays at the top on the sell side.

All orders come as active orders into the order book. If they get a match they will be executed immediately, else they will be entered into the order book according to price and time as passive orders.

Trades done during the day can be cancelled with mutual consent of both the parties subject to approval of an Exchange. This is mostly due to the punching errors in the system. Trade cancellations, however are rare in an Exchange traded market.

3.2.3 Trade execution

Execution of trade occurs when a buyer and seller reach an agreement pertaining to the terms and price of a trade, and the order to buy or sell a security is completed after the same is matched on the Exchange platform.

3.3 Middle Office Operations

The middle office, as the name implies, is a hybrid function between the front and back office. The middle office handles validations, bookings and confirmations. Risk Management and Surveillance typically forms the main function of the middle office.

3.3.1 Risk Management & Surveillance

Any transaction or behaviour, whether it is buying, selling or instigating to willfully produce an abnormal effect on prices and/or volumes, goes against the fundamental objective of the protecting the interest of the investors of the securities markets. Here the risk management system plays a crucial role. An efficient risk management system is integral to an efficient settlement system.

The goal of a broking firm's risk management system is to measure and manage its own and its client's exposure to various risks identified as central to its operations. For each risk category, the broking firm must employ procedures to measure and manage firm-level exposure. These are:

a) Establishing Standards and Reports

Every broking firm is mandated to define a set of risk management standards. They themselves adhere to these standards and also measure the risk appetite of their clients (individuals and companies). These standards help the brokers in their client profiling and determining the risk monitoring strategy for safeguarding the interest of the clients (investors). These details are then developed in forms of reports and submitted to the management of the broking houses for their perusal and action.

b) Imposing Position Limits

A key element in financial risk management is identifying the type of risk(s) and the extent to which those risk(s) can be borne. For discussion on various types of risks, see Box 3.1. A broking firm imposes limits to cover exposures, and overall position concentrations relative to the potential systematic risks. From time to time, SEBI and Exchanges prescribe open position limits for various categories of investors in the equity and currency derivative segments.

c) Set Investment Guidelines and Strategies

The broking firm should outline investment guidelines and strategies for risk taking in the immediate future in terms of commitments to a particular market area, extent of asset-liability mismatching, or the need to hedge against systematic risk at a particular time. Risk management involves determining what risks the firm's financial activities generate and avoiding unprofitable risk positions. Guidelines can advise on the appropriate level of active management, given the state of the market and senior management's willingness to absorb the risks implied by the aggregate portfolio of the broking firm (comprising its own account and its client's account).

Box 3.3 Types of Risk

Operational risk is the risk of monetary loss resulting from inadequate or failed internal processes, manual and systems error or external events. For the stock broker, operations risks are essentially risks such as non-payment for buying or selling a scrip, non-delivery of scrip(s), denial of matched order by clients, trading errors, and sudden closure of banks where funds are deposited.

Market risk refers to the possibility of incurring large losses from adverse changes in financial asset prices such as stock prices or interest rates. This risk entails the erosion of value of marketable securities and assets, due to factors beyond an enterprise's control. Market risk is usually affected by economic developments and political destabilization such as a, rising fiscal gap, national debt, terrorism, energy price shocks, increase in interest rates, all resulting in a drop in equity prices.

Regulatory risk occurs when the rules governing the securities industry are changed, giving rise to a potential loss. For example, the '*customer first*' policy makes it difficult to trade house accounts (in other words proprietary accounts i.e. accounts of the trading member) and therefore a broker may not be able to liquidate its own trade position (buy or sell) immediately, leading to potential or actual loss.

A stock broking firm must identify factors that can trigger operational, market, credit and regulatory risks. It needs to establish procedures so that risk management begins at the point nearest to the assumption of risks. This means adapting trade-entry procedures, customer documentation, client engagement methods, trading limits, and other normal activities to maintain management control, generate consistent data, and eliminate needless exposure to risk.

3.4 Back Office Operations

The back office exists for three reasons: confirmation, payments, settlements and accounting. In other words, the back office monitors the post-market processing of transactions. The back office is where the trade ends.

3.4.1. Trade Enrichment

Trade Enrichment is performed automatically after each trade execution. In this step, all necessary details for the clearing of futures and option contracts, or the settlement of cash securities are added.

Trade enrichment is defined as process of including additional information in one instruction in a trade which is already being executed.

For the purpose of back office operations, the back office systems maintain masters relating to brokerage rate client wise, service tax, turnover tax, stamp duty and STT charge tables.

When the trade data is uploaded into the back office, the above information is appended to each and every trade. Post upload of data with all the relevant information, the back office process is carried out to arrive at:

- Client wise brokerage
- Client wise obligation for securities and funds
- All the relevant tax amounts to be collected and paid

Back office systems generate obligations towards exchange settlements as well as client wise contract notes, settlements and tax obligations.

3.4.2 Trade Allocation

In the case of institutional trades, the front office may enter a single order for a particular client and subsequently distribute it across various sub schemes of the client at the back office end.

For example, hedge fund makes a trade, and manages several portfolios. Often, they will choose to allocate their trade to various portfolios for a number of reasons. Trade allocation specifically refers to this process, or more specifically, how the trade is allocated (pro rata, all or nothing, etc).

Once the trade data is received at the back office, the user will also receive deal sheets from the front office team in terms of details of allocation to individual schemes. Based on these instructions, the back office user will then allocate the trade to individual schemes within the parent fund and generate appropriate contract note.

3.4.3 Order Modification/ Cancellation

Some times in a moving market, orders need to be changed in terms of the price and quantity as per the client's requirement. All the orders can be modified till the time they are not fully executed.

Due to some problems in the moving market or when one does not want to buy or sell shares, then orders need to be cancelled. In this case only those orders can be cancelled which have not been fully or partially executed and only during market hours.

3.4.4 Clearing and Settlement Process

Clearing and Settlement is a post trading activity that constitutes the core part of equity trade life cycles. After any security deal is confirmed (when securities are obliged to change hands) the broker who is involved in the transaction issues a contract note at the end of the trade day. The contract note issued by broker, informs the client of his obligations.

Clearing house/corporation is an entity through which settlement of securities takes place. The details of all transactions performed by the brokers are made available to the Clearing House/Corporation by the Stock Exchange. The Clearing House/Corporation gives an obligation report to the brokers and custodians who are required to settle their money/securities obligations within the stipulated time period, failing which they are required to pay penalties. This obligation report serves as statement of mutual contentment.

In India, the pay-in of securities and funds happens on T+ 2 day by 10.30 a.m., and pay-out of securities and funds happen on T+2 by 1.30 p.m. The pay-in and pay-out days for funds and securities are prescribed as per the settlement Cycle. A typical normal settlement cycle is given in Table 3.1:

Table 3.1 Normal Settlement Cycle:

	Activity	Day
Trading	Rolling Settlement Trading	T
Clearing	Custodial Confirmation	T +1 working days
	Delivery Generation	T +1 working days
Settlement	Securities and Funds pay in	T+2 working days
	Securities and Funds pay out	T+2 working days
Post Settlement	Valuation Debit	T+2 working days
	Auction on or by ¹²	T+2 working days
	Auction settlement on or by	T+3 working days
	Bad Delivery Reporting	T+4 working days

¹² SEBI Circular Ref. No. Cir/MRD/DRMNP/8/2015 Dated May 14, 2015.

	Rectified bad delivery pay-in and pay-out	T+6 working days
	Re-bad delivery reporting and pickup	T+8 working days
	Close out of re-bad delivery	T+9 working days

3.4.5 Accounting

The stock brokers are required to maintain books of account as prescribed by the Securities Contracts (Regulation) Rules, SEBI (Stock brokers and Sub-brokers) Regulations and requirements of Stock Exchanges. These are to be maintained for a minimum period of 5 years.

3.4.5.1 Different types of accounts

The broker has to maintain the required books of accounts as per Rule 15 of SC(R) Rules 1957 and Regulation 17 of SEBI (Stock Broker and Sub Brokers) Regulations, 1992. Stock brokers are required to maintain separate books for each Stock Exchange in which they operate. Further, for any Stock Exchange, a separate set of ledger accounts of clients has to be maintained for each particular segment of the Exchange in which the stock broker operates.

The books that shall be maintained by a broker include, register of transactions (sauda book), clients ledger, general ledger, journals, cash book, bank pass book, securities register, counterfoils or duplicates of contract notes, margin deposit book, register of accounts of sub-brokers, KYC, agreements with clients and tripartite agreements with client and sub-brokers, client account opening form. Some of these books/transaction records are briefly discussed below.

- The **register of transactions (sauda book)** is to include each transaction effected. This would show the name of the security, its value, rates gross and net of brokerage and names of the clients.
- The **client's ledger**, as the name suggests, has the details of all clients, and their transactions through the broker.
- The **general ledger** accounts for all general transactions including expenses, overheads salaries, petty cash, etc.
- The **journal** is the accounting book of the general ledger. Any adjustment entries for e.g., interest receivable, etc., are accounted here.
- The **cash and bank book** contain records of all cash and cheque transactions and are normally balanced daily.

- The **securities register** is required to be maintained client-wise and scrip-wise. The details provided would include date of receipt/delivery of the security, quantity received/delivered, party from whom delivered/to whom delivered, the purpose of receipt/delivery and the balance quantity.
- A **contract note** is a confirmation of trade done on a particular day for and on behalf of a client. A contract note issued in the format and manner prescribed by the Exchanges establishes a legally enforceable relationship between the stock broker and the client in respect of settlement of trades executed on the Exchange as stated in the contract note. The copies of the original contract notes issued to the client are to be maintained by the broker.
- The **margin deposit book** contains details of margins paid and collected and payable and collectable.

The broker has also to maintain separate accounts for each sub-broker and all transactions entered into by him. The broker also has to keep copies of KYC forms, agreement with clients and sub-brokers, as part of his records.

Stock brokers shall also maintain separate ledgers reflecting the customers' transactions which shall include, chronological and customer-wise record of money received and paid, chronological and customer-wise record of securities received and delivered specifically, chronological record of transactions made in a consolidated customers' account and record of the customer account information.

3.4.6 Information Technology (IT)

Any stock broking office needs to have a complete integrated system that optimizes current business processes and provides a single integrated solution that covers all the aspects of the stock brokering industry. The system should cover all areas of brokerage operations and management, including, but not limited to, back office management, order management, customer accounting, general accounting, branches management and control, accounts managers, on line trading system, commissions builder, archiving system, auditing system, invoicing, risk management and control. A summary of the operations is given below:

- Business Functions include customer database and document archiving including customer signature, customer accounting, portfolio management, risk management, auditing system, on-line trading system, general accounting system, etc.
- Technical Functions include, support and standby database function, disaster recovery, customer database, customer data, etc.
- Trades functions include, automatic entry of daily executions, automatic identification of new customers, automatic link of executions to orders, etc.
- The IT will also include an order management system with issue of sell orders, buy orders, order execution, log of orders, orders confirmation, etc.

SEBI has mandated that there should be comprehensive testing of software deployed by the brokers before release to market. These tests will include user acceptance testing on the test environment of the exchange and mock testing. Mock testing and UAT test reports are required to be verified and certified by system auditors appointed by the brokers.

SEBI has also advised the stock brokers to implement the following measures to protect against trading disruption due to any kind of failure on part of the software vendor: ¹³

- (a) explore the possibility of establishing a 'software escrow arrangement' with their existing software vendors. This arrangement would enable the brokers to transit to another software vendor in those circumstances when the existing vendor is unable to provide software and other services in a timely manner.
- (b) In case of large stock brokers, consider engaging more than one vendor to reduce dependency.
- (c) Certain conditions should be included in the agreement with the software vendor. These conditions relate to access to design documents; training of its staff with regard to software usage and maintenance; appropriate penalty clauses for cases of disruptions to the trading system of the broker and co-operation in case of software audit including forensic audit (when required).

3.4.6.1 Business Continuity Plan / Disaster Recovery Management

It is desirable that all stock brokers have business continuity plans. Ideally, the broker must create and maintain a written business continuity plan (BCP) identifying procedures relating to an emergency or significant business disruption. Such procedures must be reasonably designed to enable the broker to meet its existing obligations to customers. In addition, such procedures must address the member's existing relationships with other broker-dealers and counter-parties.

3.4.7 Securities Transaction Tax

Securities Transaction Tax (STT) was introduced in India to stop tax avoidance of capital gains tax. As per the Finance Act 2004, and modified by the Finance Act 2008, STT is levied on every purchase or sale of securities that are listed on the Indian Stock Exchanges. This includes shares, derivatives or equity-oriented mutual funds units. STT is deducted at source by the broker or AMC and it is collected and remitted by the Stock Exchanges.

The Following STT rates are applicable for trades executed in the Equity segment of the Stock Exchange:

¹³ Vide SEBI circular no: CIR/MRD/DP/07/2014 dated February 11, 2014.

Sr. No.	Taxable securities transaction	New rate from 01.06.2013	Payable by
1.	Purchase of an equity share in a company or a unit of a business trust, where the transaction of such purchase is entered into in a recognised stock exchange and the contract for the purchase of such share or unit is settled by the actual delivery or transfer of such share or unit.	0.100 per cent	Purchaser- on the value of taxable securities transaction based on the volume weighted average price.
2.	Sale of an equity share in a company or a unit of a business trust, where the transaction of such sale is entered into in recognised stock exchange and the contract for the sale of such share or unit is settled by the actual delivery or transfer of such share or unit.	0.100 per cent	Seller - on the value of taxable securities transaction based on the volume weighted average price.
	Sale of a unit of an equity oriented fund, where the transaction of such sale is entered into in recognised stock exchange and the contract for such unit is settled by the actual delivery or transfer of such share or unit	0.001 per cent	Seller - on the value of taxable securities transaction based on the volume weighted average price.
3	Sale of an equity share in a company or a unit of an equity oriented fund or a unit of a business trust, where the transaction of such sale is entered into in a recognised stock exchange and such contract is settled otherwise than by the actual delivery or transfer of such share or unit.	0.025 per cent	Seller - on the value of taxable securities transaction based on the volume weighted average price.

The following rates are applicable for transactions executed in the Derivatives Segment:

Sr.No.	Taxable securities transaction	New rate from 01.06.2013	Payable by
1	Sale of an option in securities	0.017 per cent	Seller

2	Sale of an option in securities, where option is exercised	0.125 per cent	Purchaser
3	Sale of a futures in securities	0.01 per cent	Seller

Stock Exchanges provide a report to the brokers/members at the end of each trading day. The report contains information on the total STT liability, trading member wise STT liability, client wise STT liability and also the detailed computations for determining the client wise STT liability.

3.4.8 Bulk Deals & Block Deals

Bulk Deals

With a view to imparting transparency in bulk deals and to prevent rumours/speculation about such deals causing volatility in the scrip price, it was decided by SEBI to bring about greater disclosure of such bulk deals.¹⁴

Bulk Deal is defined as “all transactions in a scrip (on an Exchange) where the total quantity of shares bought/sold is more than 0.5% of the number of equity shares of the company listed on the Exchange”. However, the quantitative limit of 0.5% could be reached through one or more transactions executed during the day in the normal market segment. These deals are subject to following conditions:

- The brokers shall disclose to the Stock Exchange the name of the scrip, name of the client, quantity of shares bought/sold and the traded price.
- The disclosure shall be made by the brokers immediately upon execution of the trade.
- The Stock Exchanges shall disseminate the aforesaid information on the same day after market hours to the general public.

Block Deals

In September 2005, SEBI permitted the Stock Exchanges to set up a separate trading window called block window.¹⁵ This window allows large value transactions to be executed as a single transaction without putting the buyer or seller at a disadvantageous position. A trade, with a minimum quantity of 5,00,000 shares or minimum value of Rs. 5 crore executed through a single transaction on this separate window of the stock Exchange constitutes a “**block deal**” as distinguished from “bulk” deal.

“Block Deals” are subject to the following conditions:

¹⁴ Vide SEBI Circular SEBI/MRD/SE/Cir-7/2004) dated January 14, 2004

¹⁵ Vide SEBI circular number: MRD/DoP/SE/Cir- 19 /05 dated September 2, 2005

- 'Block Deal' window is open for a period of 35 minutes from the beginning of trading hours i.e. the trading window remains open from 9.15 am to 9.50 am.
- The orders may be placed in this window at a price not exceeding $\pm 1\%$ from the ruling market price/previous day closing price, as applicable.
- An order may be placed for a minimum quantity of 5,00,000 shares or minimum value of Rs.5 crore.
- Every trade executed in this window must result in delivery and shall not be squared off or reversed.
- The stock Exchanges shall disseminate the information on block deals such as the name of the scrip, name of the client, quantity of shares bought/sold, traded price, etc. to the general public on the same day, after the market hours.

3.4.9 Regulatory Compliances

The stock broker has to follow certain regulatory compliances under the law, rules and bye laws of SEBI and the Exchanges. These are mandatory and non-compliance to these rules, laws attracts penal action. However, the main compliances include:

- Maintain or furnish documents as prescribed under the various sub-sections of section 15 of SEBI Act
- Maintenance of different types of Books as prescribed under SC(R)R 1957 (e.g Sauda book etc.)
- Sending account statements to clients
- Submission of various periodic reports to the stock Exchanges.

These are covered in detail in section 4.2 under Regulatory Compliances and Reporting.

Review Questions

Questions to assess your learning:

1. Direct Market Access facility is introduced for _____.
- a. Retail Investors.
- b. Institutional Clients only.
- c. Specific International Broking Firms.

Ans: (b)

2. Which of the statement is false?
- a. On receipt of the order at the Exchange system, an order confirmation is sent to the broker.
- b. Depending upon the order terms and conditions and the actual prevailing market prices, the order may get executed immediately, partially or fully.
- c. The order can be entered for buy or sell irrespective of whether the client has sufficient balance of funds or securities in his account.

Ans: (c)

3. A contract note is _____.
- a. A legal document which is entered upon by the client with his broker before entering into any transaction.
- b. Confirmation of trade done during the particular day with all details of which securities have been bought or sold, at price etc.
- c. A note which holds margin details.

Ans: (b)

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Chapter 4: Risk Management

LEARNING OBJECTIVES:

After studying this chapter you should know about:

- Risk management framework for cash and futures and options segment
- Compliances and Regulatory Reporting by the stock brokers
- Core Settlement Guarantee Fund

4.1 Risk Management

4.1.1 Risk Management Framework for Cash Segment

A comprehensive Risk Management framework is the backbone of the Clearing Agency/Corporation/house. A clearing corporation/house provides settlement guarantee i.e., the settlement of securities and funds will take place even if there is a failure by a broker to fulfill their obligation. In order to safeguard against such failures, the clearing agency is required to carry out the following risk management measures as specified by SEBI through its various circulars.

Risk Management framework consists of the following components:

- Margin
- Liquid Asset
- Base minimum capital
- Pre-trade risk control
- Risk Reduction mode

4.1.1.1 Margin

Margining is a process by which a clearing corporation computes the potential loss that can occur to the open positions (both buy and sell) held by the members. Based on the computation, the clearing agency will ensure that the liquid assets deposited by members is sufficient to cover the potential loss.

The clearing corporation computes and collects three kinds of margins namely:

- Value at Risk Margin (VaR) to cover potential losses for 99% of the days.
- Mark to Market Loss Margin: Mark to market losses on outstanding settlement obligations of the member.
- Extreme loss margin: Margins to cover the loss in situations that lie outside the computation of the VaR margin.

VaR Margin

The VaR Margin is a margin intended to cover the largest loss that can be encountered on 99% of the days (99% Value at Risk). For liquid stocks, the margin covers one-day losses while for illiquid stocks, it covers three-day losses so as to allow the clearing corporation to liquidate the position over three days.

For liquid stocks, the VaR margins are based only on the volatility of the stock while for other stocks, the volatility of the market index is also used in the computation. Computation of the VaR margin requires the following definitions:

Scrip sigma means the volatility of the security computed as at the end of the previous trading day. The computation uses the exponentially weighted moving average method applied to daily returns in the same manner as in the derivatives market.

Scrip VaR means the higher of 7.5 percent or 3.5 scrip sigmas.

Index sigma means the daily volatility of the market index (CNX Nifty or S&P BSE Sensex) computed as at the end of the previous trading day. The computation uses the exponentially weighted moving average method applied to daily returns. Index VaR means the higher of 5 percent or 3 index sigmas. The higher of the Sensex VaR or Nifty VaR would be used for this purpose. The VaR Margins are specified as follows for different groups of stocks:

Table 4.1: VaR Margins for different group of stocks

Liquidity Categorization	One-Day VaR	Scaling factor for illiquidity	VaR Margin
Liquid Securities (Group I)	Scrip VaR	1.0	Scrip VaR
Less Liquid Securities (Group II)	Higher of Scrip VaR and three times Index VaR	1.73 (square root of 3.00)	Higher of 1.73 times Scrip VaR and 5.20 times Index VaR
Illiquid Securities (Group III)	Five times Index VaR	1.73 (square root of 3.00)	8.66 times Index VaR

Collection

- VaR margin is collected on an upfront basis by adjusting against the total liquid assets of the member at the time of trade.
- VaR margin is collected on the gross open position of the member. The gross open position for this purpose would mean the gross of all net positions across all the clients of a member including his proprietary position. For this purpose, there would be no netting of positions across different settlements.

- The VaR margin so collected shall be released along with the pay-in, including early pay-in of securities.

The applicable VaR margin rates shall be updated at least 5 times in a day, which may be carried out by taking the closing price of the previous day at the start of trading and the prices at 11:00 a.m., 12:30 p.m., 2:00 p.m. and at the end of the trading session.

Mark to Market Margin

Mark to market loss is calculated by marking each transaction in security to the closing price of the security at the end of trading. In case the security has not been traded on a particular day, the latest available closing price is considered as the closing price. In case the net outstanding position in any security is nil, the difference between the buy and sell values is considered as notional loss for the purpose of calculating the mark to market margin payable.

Mark to Market margin is collected in the following manner:

- The clearing corporation collects mark to market margin (MTM) from the member/broker before the start of the trading of the next day.
- The MTM margin is collected or adjusted against the cash/cash equivalent component of the liquid net worth deposited with the Exchange.
- The MTM margin is collected on the gross open position of the member.
- The gross open position means gross of all net positions across all the clients of a member including his proprietary position.
- There would be no netting across two different settlements.
- MTM losses for the day can be set-off against MTM profits.
- The margin so collected shall be released along with the pay-in, including early pay-in of securities.

Extreme Loss Margin

Extreme loss margin covers the expected loss in situations that go beyond those envisaged in the 99% value at risk estimates used in the VaR margin.

- The Extreme Loss Margin for any stock shall be higher of:
 - 5%, and
 - 1.5 times the standard deviation of daily logarithmic returns of the stock price in the last six months.
- This computation is carried out at the end of each month by taking the price data on a rolling basis for the past six months and the resulting value shall be applicable for the next month.

- The Extreme Loss Margin is collected/ adjusted against the total liquid assets of the member on a real time basis.
- The Extreme Loss Margin shall be collected on the gross open position of the member. The gross open position for this purpose would mean the gross of all net positions across all the clients of a member including his proprietary position.
- The Extreme Loss Margin so collected shall be released along with the pay-in.

Margins not to exceed the purchase value of a buy transaction

In case of a buy transaction in cash market, VaR margins, extreme loss margins and mark to market losses together shall not exceed the purchase value of the transaction. Further, in case of a sale transaction in cash market, the existing practice shall continue viz., VaR margins and extreme loss margins together shall not exceed the sale value of the transaction and mark to market losses shall also be levied.

4.1.1.2 Liquid Assets

The acceptable liquid assets and the applicable haircuts are listed in Table 4.2.

Table 4.2: Acceptable Liquid assets along with haircuts and limits

Item	Haircut	Limits
<i>Cash Equivalents</i>		
Cash	--	No limit
Bank fixed deposits	--	No limit
Bank guarantees	0	Limit on Exchange's exposure to a single bank
Securities of the Central Government	10 percent	No limit
Units of liquid mutual funds or government securities mutual funds	10 percent	No limit
<i>Other liquid assets</i>		
Liquid (Group I) Equity Shares	Same as the VaR margin for the respective shares	Limit on Exchange's exposure to a single issuer
Mutual fund units other than those listed under cash equivalents	Same as the VaR margin for the units or else, using the NAV of the unit	

Card value of eligible Exchanges	50 percent if the last sale or auction of card in the Exchange took place during the last six months. 75 percent if the last sale or auction of card in the Exchange took place during the last twelve months but not within the last six months. 100 percent if no sale or auction of card in the Exchange has taken place during the last twelve months.	Eligible only for Extreme Loss Margin
Corporate Bonds	Fixed percentage based or VaR based Haircut. A higher haircut may be considered to cover the expected time frame for liquidation. To begin with the haircut shall be a minimum of 10 percent.	Not to exceed 10 percent of the total liquid assets of the clearing member.

Liquidity Categorization of Securities

The securities shall be classified into three groups based on their liquidity:

Group	Trading Frequency	Impact Cost
Liquid Securities (Group I)	At least 80 percent of the days	Less than or equal to 1 percent
Less Liquid Securities (Group II)	At least 80 percent of the days	More than 1 percent
Illiquid Securities (Group III)	Less than 80 percent of the days	N/A

For securities that have been listed for less than six months, the trading frequency and the impact cost shall be computed using the entire trading history of the scrip.

The trading frequency and impact cost shall be calculated on the 15th of each month on a rolling basis and the categorisation shall be revised based on the new value. For the first month, till the time of monthly review, a newly listed stock shall be categorised in that Group where the market capitalization of the newly listed stock exceeds or equals the market capitalization of 80 percent of the stocks in that particular group.

Calculation of mean impact cost

The mean impact cost shall be calculated in the following manner:

- a) Impact cost shall be calculated by taking four snapshots in a day from the order book in the past six months. These four snapshots shall be randomly chosen from within four fixed ten-minutes windows spread through the day.
- b) The impact cost shall be the percentage price movement caused by an order size of Rs.1 lakh from the average of the best bid and offer price in the order book snapshot. The impact cost shall be calculated for both, the buy and the sell side in each order book snapshot.

Margining of Institutional Trades in Cash Market

All Institutional trades in the cash market would be subject to payment of margins as applicable to transactions of other investors. Institutional trades shall be margined on a T+1 basis with the margin being collected from the custodian upon confirmation of trade.

4.1.1.3 Shortfall of Margins / Pay-in of funds

In case of any shortfall in margin, the terminals of the broker shall be immediately deactivated.

In case of pay-in shortfall, trading facility of the trading member shall be withdrawn and security pay-out would be withheld if:

- shortfall is in excess of the base minimum capital (BMC),
- If amount of shortage exceeds 20 percent of the BMC but less than the BMC on six occasions within a period of three months,

Upon recovery of the complete shortages, the member shall be permitted to trade subject to his providing a deposit equivalent to his cumulative funds shortage as the 'funds shortage collateral' for a period of ten rolling settlements which shall not be usable for margin liabilities.

The Exchange may levy a penal interest of not less than 0.07 percent per day on the pay-in shortage of the member.

4.1.1.4 Base Minimum Capital

The base minimum capital for trading members in cash and derivatives segment (based on their risk profiles) is shown in Table 4.3 below.

Table 4.3: Base Minimum Capital Requirement of Members

Categories	BMC Deposit
Only Proprietary trading without Algorithmic trading (Algo)	Rs 10 Lacs
Trading only on behalf of Client (without proprietary trading) and without Algo	Rs 15 Lacs
Proprietary trading and trading on behalf of Client without Algo	Rs 25 Lacs
All Trading Members/Brokers with Algo	Rs 50 Lacs

- For stock brokers/trading members of Exchanges not having nation-wide trading terminals, the deposit requirement shall be 40 percent of the above stated BMC deposit requirements.
- The BMC deposit is meant to meet contingencies in any segment of the Exchange.
- For members who are registered on more than one segment of the same Exchange, the highest BMC deposit across various segments is applicable.
- No exposure is granted against BMC deposit.
- The Stock Exchanges shall be permitted to prescribe suitable deposit requirements, over and above the SEBI prescribed norms, based on their perception and evaluation of risks involved.
- Minimum 50 percent of the deposit shall be in the form of cash and cash equivalents.

4.1.1.5 Additional Margins

Exchanges/clearing corporations have the right to impose additional risk containment measures over and above the risk containment system mandated by SEBI. However, those additional risk containment measures should be based on objective criteria and should not discriminate between members.

4.1.1.6 Margins from the Client

Brokers/Trading Members should have a prudent risk management system to protect themselves against the default made by their clients. Margins constitute an important element of risk management systems and are required to be well documented and made accessible to the clients and the Stock Exchanges. However, the quantum of these margins, the form and mode of collection are left to the discretion of the members.

4.1.1.7 Provision of early pay-in

Necessary systems are required to be put in place by clearing corporations to enable early pay-in of funds by the trading members. In cases where early pay-in of funds is made by the members, the outstanding position to that extent of early pay-in shall not be considered for computing the margin obligations. In cases where early pay-in of securities is made prior to

the securities pay-in, such positions for which early pay-in (EPI) of securities is made are exempt from margins.

4.1.1.8 Pre-trade Risk Controls

Pre-trade risk control helps to prevent aberrant orders or uncontrolled trades.

Order-level checks

Value/Quantity Limit per order:

Any order with value exceeding Rs. 10 crore per order cannot be accepted by the Stock Exchange for execution in the normal market. The Stock Exchange(s) are also required to ensure that appropriate checks for value and/or quantity are implemented by the stock brokers based on the respective risk profile of their clients.

Cumulative limit on value of unexecuted orders of a stock broker

Stock Exchanges have been directed to ensure that the trading algorithms of the stock brokers have a 'client level cumulative open order value check'.¹⁶ This means that the stock brokers should put-in place a mechanism to limit the cumulative value of all unexecuted orders placed from their terminals to below a threshold limit set by the stock brokers.

Dynamic Price Bands

In 2001, SEBI had advised the Stock Exchanges to implement appropriate individual scrip wise price bands (in either direction—upward or downward), for all scrips in the compulsory rolling settlement. The concept of price band was not applicable to (a) scrips on which derivatives products are available and (b) scrips which were part of those indices on which derivatives products are available.¹⁷

However, for scrips on which no price bands are applicable, Stock Exchanges have implemented a mechanism of dynamic price bands. This mechanism prevents the acceptance of orders for execution that are placed beyond the price limits set by the Stock Exchanges.

Stock Exchange shall set the dynamic price bands at 10 percent of the previous closing price for the following securities:

- Stocks on which derivatives products are available
- Stocks included in indices on which derivatives products are available
- Index futures
- Stock futures

¹⁶ Vide SEBI circular CIR/MRD/DP/09/2012 dated March 30, 2012

¹⁷ Vide circular no. SMDRPD/Policy/Cir-37/2001 dated June 28, 2001.

In the event of a market trend in either direction, the dynamic price bands shall be relaxed by the Stock Exchanges in increments of 5 percent.

4.1.1.9 Risk Reduction Mode

Stock Exchanges shall ensure that the stock brokers are mandatorily put in risk-reduction mode when 90 percent of the stock broker's collateral available for adjustment against margins gets utilized on account of trades that fall under a margin system. Such risk reduction mode shall include the following:

- All unexecuted orders shall be cancelled once stock broker breaches 90 percent collateral utilization level.
- Only orders with Immediate or Cancel attribute shall be permitted in this mode.
- All new orders shall be checked for sufficiency of margins.
- Non-margined orders shall not be accepted from the stock broker in risk reduction mode.
- The stock broker shall be moved back to the normal risk management mode as and when the collateral of the stock broker is lower than 90 percent utilization level.

4.1.2 Risk Management Framework for F&O Segment

Risk Management framework for F&O will consist of the following:

- Margins
- Liquid Networkth
- Liquid assets

4.1.2.1 Types of Margins

In the futures and options segment, the following types of margins are levied:

- Initial margin
- Exposure margin
- Premium margin
- Assignment margin

Initial Margin Computation

Initial margin is payable on all open positions of clearing members, up to client level. Initial margin for F&O segment is calculated on the basis of a portfolio (a collection of futures and option positions) based approach. The margin calculation is carried out using software called - SPAN® (Standard Portfolio Analysis of Risk).¹⁸

¹⁸ It is a product developed by Chicago Mercantile Exchange (CME) and is extensively used by leading stock Exchanges of the world. SPAN® uses scenario based approach to arrive at margins. It generates a range of scenarios and highest loss scenario is used to calculate the initial margin. The margin is monitored and collected at the time of placing the buy / sell order. The SPAN®

Initial margin requirements shall be based on 99% Value at Risk (VaR) over a one day time horizon. However, in the case of futures contracts, where it may not be possible to collect mark to market settlement, before the commencement of trading on the next day, the initial margin may be computed over a two day time horizon by applying an appropriate statistical formula. In case of members who have opted for payment of MTM settlement on a T+0 basis, the initial margin may be computed over a one day time horizon.

Calendar Spread Charge: In the case of futures and options contracts on index and individual securities, the margin on calendar spread positions shall be calculated on the basis of delta of the portfolio consisting of futures and options contracts in each month. A calendar spread position shall be granted calendar spread treatment till the expiry of the near month contract.

The calendar-spread margin shall be charged in addition to worst-scenario loss of the portfolio. The spread charge shall be 0.5 percent per month of spread on the far month contract subject to a minimum margin of 1 percent and a maximum margin of 3 percent on the far side of the spread with legs upto 1 year apart.

Exposure margins

Members shall be subject to exposure margins in addition to initial margins. The applicable exposure margin shall be:

Index Futures contracts: The exposure margin shall be 3 percent of the notional value of the futures positions, based on the last available trading price.

Short Index Options contracts: The exposure margin shall be 3 percent of the notional value of the short open positions in options on index, based on the last available closing price of the underlying index.

Futures contracts on individual Securities: The exposure margins shall be higher of 5 percent or 1.5 standard deviation of the notional value of gross open position in futures on individual securities in a particular underlying.

Short Option contracts on individual Securities: The exposure margins shall be higher of 5 percent or 1.5 standard deviation of the notional value of short open positions in options on individual securities based on the last available closing price of the underlying security.

margins are revised 6 times in a day - once at the beginning of the day, 4 times during market hours and finally at the end of the day.

For this purpose, the standard deviation of daily logarithmic returns of prices of the underlying security in the normal market of capital market segment of the Exchange in the last six months shall be computed on a rolling and monthly basis at the end of each month.

Calendar Spread: In case of calendar spread positions in futures contracts, exposure margin shall be levied on one third of the value of the open position of the far month futures contract. A calendar spread position shall be granted calendar spread treatment till the expiry of the near month contract

Short Option Minimum Charge

Index Options: Short option minimum charge shall be equal to 3 percent of the notional value of all short positions in index options. Notional value, with respect to an option contract, shall be computed as the product of the short open position in that option contract multiplied by the previous day's closing price of the index futures contract, or such other price as may be specified by the Clearing Corporation from time to time.

Options on individual securities: Short option minimum charge shall be equal to 7.5 percent of the notional value of all short positions in options on individual stocks. Notional value, with respect to an option contract, shall be computed as the product of the short open position in that option contract multiplied by the previous day's closing price of the underlying security in the normal market of Capital Market Segment of the Exchange, or such other price as may be specified by the Clearing Corporation from time to time.

Minimum Percentage for Margins on Futures Contracts:

The minimum margin percentage on index futures shall be 5 percent which shall be scaled up by look ahead period. The minimum margin percentage on stock futures shall be 7.5 percent which shall be scaled up by look ahead period. Additionally, if the mean impact cost of a security exceeds 1 percent, the minimum margin percentage in such underlying shall be scaled by square root of three.

Premium Margin

In addition to initial margin, premium margin is charged in the case of options contracts. Premium Margin shall mean and include premium amount due to be paid to the Clearing Corporation towards premium settlement, at the client level. Premium margin shall be levied till the completion of pay-in towards the premium settlement. The premium margin is paid by the buyers of the Options contracts and is equal to the value of the options premium multiplied by the quantity of Options purchased.

Assignment Margin

Assignment Margin shall be levied on assigned positions of the members (sellers) towards final exercise settlement obligations for option contracts on index and individual securities. Assignment margin shall be the net exercise settlement value payable by a member towards

final exercise settlement. Assignment margin shall be levied till the completion of pay-in towards the exercise settlement.

4.1.2.2 Liquid Net Worth and Exposure Limits of a Clearing Member

The Liquid Net Worth is defined as under:

Total liquid assets deposited with the Exchange/clearing corporation/clearing house towards initial margin and capital adequacy, LESS initial margin applicable to the total gross open positions at any given point of time on all trades to be cleared through the clearing member.

The clearing member's liquid net worth must satisfy both the conditions given below on a real time basis:

Condition 1: Liquid Net Worth shall not be less than Rs 50 lacs at any point of time.

Condition 2: The mark to market value of gross open positions at any point of time of all trades cleared through the clearing member shall not exceed $33 \frac{1}{3}$ (thirty three one by three) times his liquid networkth.

The notional value of gross open positions at any point in time in the case of Index Futures shall not exceed $33 \frac{1}{3}$ (thirty three one by three) times the liquid net worth of a member. Exposure limits are in addition to the initial margin requirements.

Liquid Assets

At least 50 percent of the total liquid assets shall be in the form of cash equivalents viz. cash, bank guarantee, fixed deposits, T-bills and dated government securities. Liquid Assets for the purposes of initial margins as well as liquid net worth would include cash, fixed deposits, bank guarantees, treasury bills, government securities or dematerialized securities (with prescribed haircuts) pledged in favour of the Exchange/clearing corporation or bank guarantees as defined hereunder. Units of money market mutual funds and units of gilt funds may be accepted towards cash equivalent component of the liquid assets of a clearing member. The unit shall be valued on the basis of its Net Asset Value after applying a hair cut of 10 percent on the NAV and any exit load charged by the mutual fund. The valuation or the marking to market of such units shall be carried out on a daily basis.

Bank Guarantees

The clearing corporation/house would set an exposure limit for each bank, taking into account all relevant factors including the following:

The Governing Council or other equivalent body of the clearing corporation / house shall lay down exposure limits either in rupee terms or as percentage of the trade guarantee fund that can be exposed to a single bank directly or indirectly. The total exposure would include guarantees provided by the bank for itself or for others as well as debt or equity securities

of the bank which have been deposited by members as liquid assets for margins or net worth requirement.

Not more than 5 percent of the trade guarantee fund or 1 percent of the total liquid assets deposited with the clearing house, whichever is lower, shall be exposed to any single bank which is not rated P1 (or P1+) or equivalent, by a RBI recognised credit rating agency or by a reputed foreign credit rating agency, and not more than 50 percent of the trade guarantee fund or 10 percent of the total liquid assets deposited with the clearing house, whichever is lower, shall be exposed to all such banks put together.

The exposure limits and any changes thereto shall be promptly communicated to SEBI. The clearing corporation shall also periodically disclose to SEBI its actual exposure to various banks.

Securities

Equity securities classified under Group I in the underlying cash market may be accepted towards liquid assets in the derivative markets. Securities classified under Group I shall be those as defined by SEBI from time to time. The equity securities shall be valued/marked to market on a daily basis after applying a haircut equivalent to the respective VaR of the equity security. The list of acceptable equity securities shall be updated on the basis of trading and mean impact cost on the 15th of each month. Debt securities shall be acceptable only if they are investment grade. Haircuts shall be at least 10 percent with daily mark to market.

The total exposure of the clearing corporation to the debt or equity securities of any company shall not exceed 75 percent of the trade guarantee fund or 15 percent of the total liquid assets of the clearing corporation / house whichever is lower. Exposure for this purpose means the mark to market value of the securities less the applicable haircuts. All securities deposited for liquid assets shall be pledged in favour of the clearing corporation.

4.2 Compliances and Regulatory Reporting

SEBI and the Stock Exchanges issued directives to be followed by stock brokers. These include directives on margin requirements, smooth functioning of pay-in/pay-out, trading restrictions, base minimum capital, etc. Other requirements include submission of audit reports along with the annual reports to the Exchanges and payments of turnover fees to SEBI.

It is the duty of the stock brokers to inform the Exchanges of any defaulting clients or defaulting sub-brokers. The stock broker has also to inform the public/clients that his sub-broker's registration has been cancelled and no dealing should be done with him.

The stock broker shall obtain SEBI's permission to continue dealing in securities in case there has been any change in his firm's constitution or status. The stock brokers shall not enter orders into the systems of the Exchange in order to lower or raise prices or manipulate markets.

4.2.1 Failure to maintain or furnish documents as prescribed under the various sub-sections of Section 15

Section 15A of the SEBI Act, 1992, prescribes penalty for failure to furnish information, return, etc. It reads as under:

“If any person, who is required under this Act or any rules or regulations made thereunder,-

- (a) to furnish any document, return or report to the Board, fails to furnish the same, he shall be liable to a penalty of one lakh rupees for each such day during which such failure continues or one crore rupees, whichever is less;
- (b) to file any return or furnish any information, books or other documents within the time specified therefore in the regulations, fails to file return or furnish the same within the time specified therefore in the regulations, he shall be liable to “a penalty of one lakh rupees for each day during which such failure continues or one crore rupees, whichever is less;
- (c) to maintain books of accounts or records, fails to maintain the same, he shall be liable to a “a penalty of one lakh rupees for each day during which such failure continues or one crore rupees whichever is less.

4.2.2 Maintenance of different types of Books as prescribed under SC(R)R 1957

Rule 15 of the SC(R)R states that every member of a recognised stock Exchange should maintain and preserve the following books of account and documents for a period of five years:

- (a) Register of transactions (Sauda book).
- (b) Clients' ledger.
- (c) General ledger.
- (d) Journals.
- (e) Cash book.
- (f) Bank pass-book.
- (g) Documents register showing full particulars of shares and securities received and delivered.

Rule 15 of the said Rules also states that every member of a recognised Stock Exchange should maintain and preserve the following documents for a period of two years:

- (a) Members' contract books showing details of all contracts entered into by him with other members of the same Exchange or counter-foils or duplicates of memos of confirmation issued to such other members.
- (b) Counter-foils or duplicates of contract notes issued to clients.
- (c) Written consent of clients in respect of contracts entered into as principals.

4.2.3 Submission of various periodic reports

The stock Exchanges have prescribed certain periodic reports to be submitted by the brokers in their compliance calendars. These include:

Sr. No.	Reports	National Stock Exchange	Metropolitan Stock Exchange of India Ltd.	Bombay Stock Exchange
1	System Audit Report – Half yearly, annual or once in 2 years depending on the nature of business carried out by the broker	Preliminary report : 1 month from the end of audit period Corrective action report: 1 month from the due date for preliminary report Follow on report: 1 month from the due date for corrective action report	Once a Year, Or once in six months depending upon the technology that the trading member uses	Preliminary report: 2 months from the end of audit period Corrective action report: 3 months from due date for preliminary report Follow on report: 3 months from due date for corrective action report
2	Annual Returns	Within 6 months from the end of accounting year	Within 6 months from the end of accounting year	Within 6 months from the end of accounting year
3	Client wise Funding Report	Within seven days from the end of the month	Within fifteen days from the end of the month	Within eight days from the end of the month
4	Internal Audit Report Half yearly basis	Within 3 months from half year ended March and September	Within 3 months from half year ended March and September	Within 3 months from half year ended March and September
5	Net worth certificate Half yearly basis	Within 3 months from half year ending	Within 3 months from half year ended March and September	Within 3 months from half year ending
6	Networth certificate in Margin Trading for CM Segment	Within one month from the end of half year	-	Within 1 month from the end of half year
7	Proof of Insurance cover	By July 31 yearly	Yearly basis	By July 31 st yearly

8	Client details for Margin Trading facility	Before 9:00 pm on the trade day ¹⁹	-	Before 12 noon following day
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4.2.4 Settlement of accounts (funds and securities) & Statement of accounts²⁰

It is mandatory for stock brokers to do the actual settlement of funds and securities of clients, at least once in a calendar quarter or month, depending on the preference of the client.

While settling the account, the member should send to the client a 'statement of accounts' containing an extract from the client ledger for funds and an extract from the register of securities displaying all receipts/deliveries of funds/securities. The statement should also explain the retention of funds/securities and the details of the pledge, if any. For the purpose of quarterly/monthly settlement trading member may settle across segments of the same Exchange for a particular client.

4.2.5 Sending account statements to clients

Each stock broker is required to send a statement of account for both funds and securities at least on a quarterly basis, within a month from the end of the period, to each client. However, this is applicable to only those members who do not maintain client account on a running basis and settle bills on a day to day basis.

The stock broker is also required to send daily margin information to all the clients. The said information shall contain Client Code and Name, Scrip wise Details of collaterals received /returned from/to clients, Status of Collaterals held, Breakup of Margins held by the member viz. value of Collaterals, Bank Guarantees, Fixed Deposit Receipts (FDRs) held and Cash balance available, Details of amount utilized towards margins etc.

¹⁹ Calendar for Compliance Reporting, NSE website (www.nse-india.com/content/members/mem_tmcc.xls).

²⁰ Refer SEBI circular no. MIRSD/SE/Cir-19/2009 dated December 03, 2009.

4.3 Core Settlement Guarantee Fund

The Clearing Corporation (CC) of the Stock Exchange should create a fund called Core Settlement Guarantee Fund (SGF) for each segment of the Exchange. This fund is set up to provide settlement guarantee in the event of a clearing member failing to fulfill their settlement commitments. The core SGF should be used to fulfill obligations of that failing member and complete settlement without disrupting the normal settlement process.

4.3.1 Corpus

While deciding on the fair quantum of the corpus of the SGF, the CC should consider the following factors:

- Risk management system in force
- Current and projected volume/turnover to be cleared and settled by the CC on a guaranteed basis.
- Track record of defaults of members (number of defaults, amount in default)

A Minimum Required Corpus (MRC) of the core SGF should be created subject to the following conditions:

- The MRC shall be fixed for a month.
- By 15th of every month, CC shall review and determine the MRC for next month based on the results of daily stress tests of the preceding month.
- CC shall also review and determine by 15th of every month the adequacy of contributions made by various contributors and any further contributions to the Core SGF required to be made by various contributors for the next month.
- For every day of the preceding month, uncovered loss numbers shall be estimated by the various stress tests for credit risk conducted by the CC for the segment and the highest of such numbers shall be taken as worst case loss number for the day.
- Average of all the daily worst case loss numbers determined shall be calculated.
- The MRC for next month shall be *higher of* the average arrived at as above and the segment MRC as per previous review

4.3.2 Contribution to Core SGF

Contributions of various contributors to Core SGF of any segment shall be as follows:

- a) *Clearing Corporation Contribution:* CC contribution to Core SGF shall be at least 50 percent of the MRC which should be from its own funds. CC contribution to core SGF shall be considered as part of its net worth.
- b) *Stock Exchange Contribution:* Stock Exchange contribution to Core SGF shall be at least 25 percent of the MRC
- c) *Clearing Member Primary Contribution:* If the CC wishes, it can seek risk based contribution from Clearing Members (CMs) of the segment (including custodial clearing members) to the Core SGF subject to the following conditions that:
 - total contribution from CMs shall not be more than 25% of the MRC,

- no exposure shall be available on Core SGF contribution of any CM (exposure-free collateral of CM available with CC can be considered towards Core SGF contribution of CM), and
- required contributions of individual CMs shall be pro-rata based on the risk they bring to the system.

CC shall have the flexibility to collect CM primary contribution either upfront or staggered over a period of time. In case of staggered contribution, the remaining balance shall be met by CC to ensure adequacy of total Core SGF corpus at all times. Such CC contribution shall be available to CC for withdrawal as and when further contributions from CMs are received.

- d) Any penalties levied by CC shall be credited to Core SGF corpus.
- e) Interest on cash contribution to Core SGF shall also accrue to the Core SGF and pro-rata attributed to the contributors in proportion to their cash contribution
- f) CC shall ordinarily accept cash collateral for Core SGF contribution. However, CC may accept CM contribution in the form of bank FDs too. CC shall adhere to specific guidance which may be issued by SEBI from time to time in this regard.

CC may utilise the Core SGF in the event of a failure of member(s) to honour settlement commitment.

4.3.2 Default waterfall

In the event of a default, the utilisation of the Settlement Guarantee Fund shall be as per the following order:

- a) Monies of defaulting member (including defaulting member's primary contribution to Core SGF(s) and excess monies of defaulter in other segments).
- b) Insurance, if any.
- c) CC resources (equal to 5% of the segment MRC).
- d) Core SGF of the segment in the following order:
 - I. Penalties
 - II. CC contribution to the extent of at least 25% of the segment MRC
 - III. Remaining Core SGF: CC contribution, Stock Exchange contribution and non-defaulting members' primary contribution to Core SGF on pro-rata basis.
 - IV. Proportion of remaining CC resources (excluding CC contribution to core SGFs of other segments and INR 100 Crore) equal to ratio of segment MRC to sum of MRCs of all segments. INR 100 Crore to be excluded only when remaining CC resources (excluding CC contribution to core SGFs of other segments) are more than INR 100 Crore.
 - V. CC/SE contribution to Core SGFs of other segments (after meeting obligations of those segments) and remaining CC resources to that extent as approved by SEBI.
 - VI. Capped additional contribution by non-defaulting members of the segment. The additional contribution by non-defaulting members shall be limited to a multiple of their primary contribution to the SGF.
 - VII. Any remaining loss to be covered by way of pro-rata haircut to payouts.

4.3.3 Stress testing and back testing

CC should effectively measure, monitor, and manage its credit exposures to its participants and those arising from its payment, clearing, and settlement processes by stress testing and back testing.

CC should carry out daily stress testing for credit risk using at least the standardized stress testing methodology prescribed for each segment by SEBI. CCs shall also develop own scenarios for a variety of 'extreme but plausible market conditions' (in terms of both defaulters' positions and possible price changes in liquidation periods, including the risk that liquidating such positions could have an impact on the market) and carry out stress testing using self-developed scenarios.

Review Questions

Questions to assess your learning:

1. Risk containment measures includes which of the following:

- (a) Checking Margin requirements
- (b) Checking networth of the client /investor
- (c) Checking whether the order placed is genuine

Ans: (a)

2. SPAN method of calculating margin requirement is for trades done _____.

- (a) On the Equities Segment
- (b) On the Futures and Options Segment
- (c) On Government Securities

Ans: (b)

3. State which of the following is true.

- (a) Failure to maintain and furnish documents as prescribed under various rules and regulation may attract penalty upto Rs. 1 crore.
- (b) The sauda book of the register of transactions needs to be maintained by the broker for a period of 2 years.
- (c) Members Contract books showing details of all contracts entered by the broker needs to be maintained for 10 years as per the Rule 15 of SCRR

Ans: (a)

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Chapter 5: Clearing Process

LEARNING OBJECTIVES:

After studying this chapter you should know about:

- Role of Clearing Corporation
- Role of Clearing Members and Custodians
- Role of Depositories and Depository Participant
- Clearing Process

5.1 Introduction

The clearing process follows the trading process.

1. At the end of the day's trade, all details about the trades are sent by the stock Exchanges to the clearing house/corporation.
2. The clearing corporation/house then groups the trades under the various clearing members and informs them about the transactions of their respective clients.
3. The clearing members/custodians then confirm back institutional trades by 1.00 p.m. the next day.
4. The clearing house/corporation then performs multilateral netting and determines the final obligations of all clearing members. These details are then sent to the clearing members by 2.30 p.m.

5.2 Role of the Clearing Agency / Corporation/House

When a trade occurs on the Stock Exchange it is a legal contract between the buyer and seller. If there is a default by either the buyer or the seller the counter party to the trade will have to bear the loss. In a multi-lateral netting scenario, when a default occurs, it is difficult to unwind the trade to find the original counter party who will have to bear the loss. The process of "novation²¹" addresses this risk.

Clearing Corporation/ House ensure that members meet their fund/security obligations. It acts as a legal counterparty to all trades through the process called novation. Thus Clearing Corporation / Clearing House becomes the buyer to every seller and seller to every buyer. If there is a default in this scenario, Clearing Corporation / Clearing House being counter party, is responsible for ensuring the settlement, thus managing risk and guaranteeing settlement to both the parties.

²¹ As per the definition given in the SEBI Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2012 "novation" means the act of a clearing corporation interposing itself between both parties of every trade, being the legal counterparty to both.

To provide such a guarantee, robust risk management practices are put in place including efficient margining system so that in the event of default, Clearing Corporation/ Clearing House has sufficient funds from the defaulter to cover the loss.

The Clearing Corporation / Clearing House also provides core settlement services apart from settlement guarantee. It determines fund/security obligations and arranges for pay-in of the same. It collects and maintains margins, processes for shortages in funds and securities. It takes help of clearing members, clearing banks, custodians and depositories to settle the trades.

The settlement cycle in India is T+2 days (i.e. trade day + 2 days). T+2 means the transactions done (for money and securities) on the trade day will be settled by the Stock Exchange on the second business day (excluding Saturday, Sundays, Bank and Exchange Trading Holidays). Pay-in and Pay-out for securities settlement is done on T+2 basis.

Thus, the clearing agency is the main entity managing the clearing and settlements of transactions done on a Stock Exchange. It interacts with the Stock Exchange, clearing banks, clearing members and depositories through an electronic connection.

The National Securities Clearing Corporation Limited (NSCCL) takes care of the clearing and settlement on NSE. It is a fully owned subsidiary of NSE and is called the clearing corporation.

The Bank of India Share Holding Limited (BOISL) takes care of the clearing and settlement on BSE. It is a subsidiary of BSE and Bank of India and is called the clearing house. MCX-SX Clearing Corporation Ltd. (MCX-SXCCL) is the clearing corporation for all the trades executed on the Metropolitan Stock Exchange of India Limited (MSXI) formerly known as MCX-SX Stock Exchange.

As a central counterparty, the clearing agency:

- Participates as counterparty in every transaction, which is commonly referred to as a 'counterparty undertaking'.
- Monitors the market and market participants.
- Provides structured procedures, as well as resources for dispute resolution. Buyers and sellers are not forced to take legal action against one another, as the clearing organization offers independent legal enforcement of contracts.
- Reduces the number of payments due to netting and handles all payments not relating to deliveries on behalf of members.
- Provides possibilities to net deliveries of underlying stocks on a member level compared with netting of payments, which are always netted.
- Provides secure and standardized transaction processing.
- Enables a clearing member to replace the counterparty risk between different market participants with the counterparty risk towards the clearing organization – even for instruments traded outside the Exchange.
- Calculates and controls pledged collateral

5.3 Clearing Banks and their function

Clearing Bank(s) acts as an important intermediary between a clearing member(s) and the clearing corporation. Every clearing member needs to maintain an account with a clearing bank. It's the function of the clearing members to ensure that the funds are available in his account with clearing bank on the day of pay-in to meet the obligations. In case of a pay-out clearing member receives the amount on pay-out day.

All transactions of pay-in/pay-out of funds are carried out by these clearing banks. The obligation details are passed on to the clearing banks, who then carry out the pay-in/pay-out of funds based on the net obligations. This happens on T+2 day. Normally, the demat accounts of clients have to be linked to their bank accounts to facilitate funds transfer.

5.4 Clearing members /Custodians

As already discussed in chapter 2 of this workbook, there are three types of clearing members who help in clearing of trades—professional clearing member (PCM), trading cum clearing member (TCM) and self-clearing member (SCM). The clearing members need to take membership of the clearing agencies. They then get a unique member ID number from the agency.

To perform its clearing and settlement functions, it is mandatory for clearing members to open demat accounts with both the depositories, i.e., the Central Depository Services Limited (CDSL) and the National Securities Depositories Limited (NSDL). These accounts are known as clearing member account. Clearing members need to open separate accounts for different Stock Exchanges. It should be noted that unlike the usual demat accounts, the clearing member does not get any ownership or beneficiary rights over the shares held in these accounts. There are three kinds of clearing member accounts—pool account, delivery account and receipt accounts. For details see Box 5.1

Box 5.1: Different types of clearing member accounts

Pool account is used to receive shares from selling clients and to send shares to buying clients.

Delivery account is used to transfer securities from pool accounts to clearing agency's account.

Receipt account is used to transfer securities from clearing agency's account to the pool account.

The clearing agency gives a list of the trading transactions made by the respective members, which have to be confirmed by the clearing members (about the genuineness of the

transactions). Once this is done, the clearing agency then determines the net obligations of the clearing members through multilateral netting. An example of multilateral netting is given below for better understanding.

Say trade takes place between 3 parties on Security ABC on a particular trade day called T. The parties involved are Broker 'X', Broker 'Y' and Broker 'Z'. The following are the trades that took place on the security ABC:

Trade	Buyer	Seller	Quantity of Shares	Price	Trade Value
1	X	Y	200	10	2000
2	Y	Z	50	10.50	525
3	X	Z	100	10.50	1050
4	Y	X	300	11	3300

Broker X

Buy	Sell	Price	Traded Value
200		-10	-2000
100		-10.5	-1050
	300	11	3300
300	300		250

Net Quantity to deliver / receive = $300 - 300 = 0$

Net Value to receive pay = 250 (to receive)

Broker Y

Buy	Sell	Price	Traded Value
	200	10	2000
50		-10.5	-525
300		11	-3300
350	200		-1825

Net Quantity to deliver / receive = $350 - 200 = 150$ (to receive)

Net Value to receive pay = -1825 (to pay)

Broker Z

Buy	Sell	Price	Traded Value
	50	10.5	525
	100	10.5	1050
0	150		1575

Net Quantity to deliver / receive = $0 - 150 = -150$ (to deliver)

Net Value to receive pay =1575 (to receive)

	Qty to Deliver	Qty to receive	Funds to Pay	Funds to receive
Broker X	0	0	0	250
Broker Y	0	150	1825	0
Broker Z	150	0	0	1575
Total	150	150	1825	1825

5.5 Depositories & Depository Participants

A depository can be defined as an institution where the clients/investors can keep their financial assets such as equities, bonds, mutual fund units etc. in the dematerialised form and transactions could be effected on it. In clearing and settlement process, the depositories facilitate transfer of securities from one account to another at the instruction of the account holder.

In the depository system both transferor and transferee have to give instructions to its depository participants (DPs) for delivering (transferring out) and receiving of securities. However, transferee can give 'Standing Instructions' (SI) to its DP for receiving in securities. If 'SI' is not given then the transferee has to give separate instructions each time for receiving the securities.

Transfer of securities from one account to another may be done for any of the following purposes:

- Transfer due to a transaction done on a person to person basis i.e. 'off-market' transaction.
- Transfer arising out of a transaction done on a Stock Exchange.
- Transfer arising out of transmission of securities and account closure.

A beneficiary account can be debited only if the beneficial owner has given 'Delivery Instruction' (DI) in the prescribed form.

The DI for an off-market trade or for a market trade has to be clearly indicated in the form by marking appropriately. The form should be complete in all respects. All the holder(s) of the account have to sign the form. If the debit has to be effected on a particular date in future, account holder may mention such date in the space provided for 'execution date' in the form.

Any trade that is cleared and settled without the participation of a clearing corporation is called off-market trade, i.e., transfer from one beneficiary account to another due to a trade between them. Large deals between institution, trades among private parties, transfer of securities between a client and a sub-broker, large trades in debt instruments are normally settled through off-market route. The transferor will submit a DI with 'off-market trade' ticked off to initiate an off-market debit. The account holder is required to specify the date on which instruction should be executed by mentioning the execution date

on the instruction. The debit will be effected on the execution date. DP will enter the instruction in the system of the depository participant (which links the DP with its depository) if the instruction form is complete in all respects and is found to be in order. This system will generate an 'instruction number' for each instruction entered. DP will write the instruction number on the instruction slip for future reference. The instruction will be triggered on the execution date. If there is adequate balance in the account, such quantity will be debited on the execution date. If adequate balances do not exist in the account, then instruction will wait for adequate balances till the end of the execution day. The account will be debited immediately on receipt of adequate balances in the account. If adequate balances are not received till the end of the day of the execution date, the instruction will fail. Transferee will receive securities into the account automatically if SI were given to the DP at the time of account opening. If SI is not given, transferee has to submit duly filled in 'Receipt-Instruction' [RI] form for every expected receipt. Exchange of money for the off-market transactions are handled outside the depository system.

A market trade is one that is settled through participation of a Clearing Agency. In the depository environment, the securities move through an account transfer. It is explained below:

- After the trade is executed by the broker on the stock exchange, the seller gives delivery instructions to his DP to move securities from his account to his broker's account.
- Securities are transferred from broker's account to Clearing Agency on the basis of a delivery out instruction.
- On pay-out, securities are moved from Clearing Corporation to the buying broker's account.
- Buying broker gives instructions and securities move to the buyer's account.

5.5 Clearing Process

As explained before, at the end of the trading day, the transactions entered into by the brokers are tallied to determine the total amount of funds and/or securities that the stock broker needs either to receive or to pay. This process is called clearing.

In the stock exchanges this is done by a process called multilateral netting. This process is performed by the clearing agency (clearing corporation/clearing house). The clearing agency guarantees that all contracts which are traded will be honoured.

Generally, the clearing and settlement process can be classified into: matching, central counterparty clearing, cash settlement and delivery.

Matching means that the parties agree upon the conditions of the transaction, i.e. what has been bought or sold, price, quantity, etc.

'Central counterparty clearing' is when the clearing organization becomes the legal counterparty in a transaction.

Cash settlement refers to settlement of premiums, fees, mark-to-market and other cash settlements.

Delivery of the underlying instrument or cash settlement occurs after expiration or premature exercise.

The following is the summary Clearing and Settlement process in India for equities:

- Trade details are available to Clearing Corporation from the Exchange.
- After the custodial confirmation, Clearing Corporation determines obligations.
- Download of obligation and pay-in advice of funds/securities by Clearing Corporation.
- Clearing Corporation gives instructions to clearing banks to make funds available by pay-in time.
- Clearing Corporation gives instructions to depositories to make securities available by pay-in-time.
- Pay-in of securities: Clearing Corporation advises depository to debit pool account of custodians/Clearing members and credit its (Clearing Corporation's) account and depository does the same.
- Pay-in of funds: Clearing Corporation advises Clearing Banks to debit account of Custodians/Clearing members and credit its account and clearing bank does the same.
- Pay-out of securities: Clearing Corporation advises depository to credit pool accounts of custodians/Clearing members and debit its account and depository does the same.
- Pay-out of funds: Clearing Corporation advises Clearing Banks to credit account of custodians/ Clearing members and debit its account and clearing bank does the same.

Note: Clearing members for buy order and sell order are different and Clearing Corporation acts as a link here.

The time line followed for the custodian settled trade for institutional clients is as follows:

- T is trade date by broker
- By T+1 morning trade confirmation to broker (Exchange obligations move from broker to custodian)
- On T+1 evening payment of margins or early pay-in of securities and/ or funds.
- On T+2/T+3 credit of shares /funds to client account

In case of trades by mutual funds the custodians act as clearing members.

Please note that a clearing member is the brokerage firm which acts as a trading member and clearing member of clearing agency whereas custodians are only clearing members. Even if the clients don't meet their obligations clearing members are required to meet their obligations to the clearing corporations.

Clearing Process for Derivatives

The clearing mechanism essentially involves working out open positions and obligations of clearing members. This position is considered for exposure and daily margin purposes. The open positions of clearing members are arrived at by aggregating the open positions of all the brokers/trading members and all custodial participants clearing through them. A trading member's open position is arrived at by summing up his proprietary and client's open positions.²² All derivatives contracts irrespective of whether it is index futures, stock futures, index options, stock options or currency futures and options are cash settled. The settlement amount for a clearing member is netted across all their TMs/Clients with respect to their obligations on Mark-to-Market settlement. The settlement process would be discussed in detail in chapter 6 of this workbook.

5.5.2 Determination of Obligation of Clients

An important step is determination of what counter-parties owe, and what counterparties are due to receive on the settlement date. The settlement process begins as soon as client's obligations are determined through the clearing process. The settlement process is carried out by the Clearing Agency with the help of clearing banks and depositories.

5.5.3 Balancing / Netting of Clients accounts within the brokers firm

The stock brokers are allowed to net the client account within the firm. At the end of the day, the position of each client is netted against all his transactions and the final pay-in/pay-out of securities/funds is carried out through clearing banks and depository participants.

5.5.4 Broker netting within the Exchange

Every day, the clearing corporation sends the clearing member a list of all trading transactions made by him and his clients for the day. After this, clearing is performed by multilateral netting. Then the members are informed by the clearing corporation of the amount/securities to be received/paid by them to the other members.

²² While entering orders on the trading system, TMs are required to identify the orders, whether proprietary or client through the pro /cli indicator in the order entry screen.

Review Questions

Questions to assess your learning:

1. The process of original trade being cancelled and the clearing agency taking over as counterparty to all trades is called _____
 - (a) Execution
 - (b) Novation
 - (c) Determination
 - (d) Guaranteeing

Ans: (b)

2. Clearing members need to take membership with the _____.
 - (a) Clearing Agencies
 - (b) Exchanges
 - (c) Brokers
 - (d) Depositories

Ans: (a)

3. What kind of accounts is used to receive shares from selling clients and to send shares to buying clients?
 - (a) Delivery
 - (b) Pool
 - (c) Receipt
 - (d) Common

Ans: (b)

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Chapter 6: Settlement Process

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Determining of Settlement of obligations for settlement in equity segment
- Settlement of Funds
- Settlement of Securities
- Corporate Actions adjustment
- Methodology for adjustment in Equity F&O
- Auction of securities

6.1 Introduction

Rolling Settlement is a mechanism of settling trades done on a stock exchange on T i.e. trade day plus "X" trading days, where "X" could be 1,2,3,4 or 5 days. For example, in T+5 environment, a trade done on T day is settled on the 5th working day excluding the T day. Hence the entire transaction, where the buyer has to make payments for securities purchased and seller has to deliver the securities sold, have to be completed with that "X" day.

T+2 settlement cycle is followed in the Indian equities market, i.e. which means that a transaction entered into on Day 1 has to be settled on the Day T + 2 working days, when funds pay in or securities pay out takes place. T+2 here, refers to Trade day + 2 working days.

For instance, trades taking place on Monday are settled on Wednesday, Tuesday's trades settled on Thursday and so on. Hence, a settlement cycle is the period within which the settlement is made. For arriving at the settlement day, all intervening holidays -- bank holidays, Exchange holidays, Saturdays and Sundays are excluded. From a settlement cycle taking a week, the Exchanges have now moved to a faster and efficient mode of settling trades within T+2 Days.

The settlement of derivative trades is done either on T+0 or on T+1 working day basis except final settlement in currency derivatives segment which takes place on a T+2 basis. The Clearing Corporations announces the settlement schedule for various segments/products on a periodic basis.

Settlement Price for derivatives is given in the following table:

Product	Settlement	Price
Futures Contracts on Index or Individual Security	Daily Settlement	Closing price of the futures contracts on the trading day (closing price for a futures contract shall be calculated on the basis of the last half an hour weighted average price of such contract).
Un-expired illiquid futures contracts	Daily Settlement	Theoretical Price computed as per formula $F = S + e^{rt}$
Futures Contracts on Index or Individual Securities	Final Settlement	Closing price of the relevant underlying index / security in the Capital Market segment, on the last trading day of the futures contracts.
Options Contracts on Individual Securities	Interim Exercise Settlement	Closing price of such underlying security on the day of exercise of the options contract.
Options Contracts on Index and Individual Securities	Final Exercise Settlement	Closing price of such underlying security (or index) on the last trading day of the options contract.
Currency Derivatives	Daily Settlement	Closing price of the futures contracts for the trading day.
	Final Settlement Price	The reference rate fixed by RBI.

6.2 Determination of settlement obligations- Equity segment

Clearing Corporation receives the details of trades and prices from the Exchange. Settlement obligations are computed using predefined methodology specified for the segment/product. Some of the methods of determining obligations are listed below:

- Netted obligation:** All purchase and sell transactions will be netted to determine the obligations. Member will have the obligation to deliver a security in a settlement only if the sell quantity is more than buy quantity. Similarly, in case the buy quantity is more than sell quantity, the member will receive a pay-out of the security. Fund obligations will also be computed on a netted basis across all securities under netted settlement.
- Trade to trade or Gross obligations:** Transactions will not be netted to determine obligations. Member's security pay-in obligation will be equivalent to cumulative sell quantity and security pay-out will be equivalent to cumulative buy quantity. Funds

pay-in will be equivalent to cumulative value of buy transactions and funds pay-out will be equivalent to cumulative sell value.

- c) ***Daily mark to market settlement of futures contract:*** Daily settlement prices will be computed for futures contracts based on specified methodology. All open positions will be marked to market at the settlement prices to determine mark to market obligations to be settled in cash. All open positions will be carried forward at the latest daily settlement prices.

6.3 Settlement of Funds

The Clearing Bank debits the settlement accounts of the trading members maintained with the bank by 10.30 a.m. on the last date of settlement period. This appears in the trading member's balance sheet.

The Clearing Bank credits the settlement accounts of the members maintained with the bank by 1:30 p.m. on the last date of the settlement period. This appears as net receivable in the trading member's balance sheet.

6.3.1 Informing obligations to Clients and custodians

Unless otherwise specifically agreed to by a client, the settlement of funds/securities shall be done within 24 hours of the pay-out. However, a client may specifically authorize the stock broker to maintain a running account subject to the following conditions:

- a. The authorization shall be renewed at least once a year and shall be dated.
- b. The authorization shall be signed by the client only and not by any authorised person on his behalf or any holder of the Power of Attorney.
- c. The authorization shall contain a clause that the client may revoke the authorization at any time.
- d. For the clients having an outstanding obligations on the settlement date, the stock broker may retain the requisite securities/funds towards such obligations and may also retain the funds expected to be required to meet margin obligations for next 5 trading days, calculated in the manner specified by the Exchanges.
- e. The actual settlement of funds and securities shall be done by the broker, at least once in a calendar quarter or month, depending on the preference of the client. While settling the account, the broker shall send to the client a 'statement of accounts' containing an extract from the client ledger for funds and an extract from the register of securities displaying all receipts/deliveries of funds/securities. The statement shall also explain the retention of funds/securities and the details of the pledge, if any.
- f. The client shall bring any dispute arising from the statement of account or settlement so made to the notice of the broker preferably within 7 working days from the date of receipt of funds/securities or statement, as the case may be.

- g. Such periodic settlement of running account may not be necessary:
 - i. for clients availing margin trading facility as per SEBI circular
 - ii. for funds received from the clients towards collaterals/margin in the form of bank guarantee (BG)/fixed deposit receipts (FDR).
- h. The stock broker shall transfer the funds / securities lying in the credit of the client within one working day of the request if the same are lying with him and within three working days from the request if the same are lying with the Clearing Member/Clearing Corporation.
- i. There shall be no inter-client adjustments for the purpose of settlement of the 'running account'.
- j. These conditions shall not apply to institutional clients settling trades through custodians. The existing practice may continue for them.

6.3.2 Margin Payment

The initial and exposure margin is payable upfront by clearing members. Initial margins can be paid by members in the form of cash, bank guarantee, fixed deposit receipts and approved securities.

Clearing members who are clearing and settling for other trading members can specify the maximum collateral limit towards initial margins, for each trading member and custodial participant clearing and settling through them.

Such limits can be set up by the clearing member, through the facility provided on the trading system upto the time specified in this regard. Such collateral limits once set are applicable to the trading members/custodial participants for that day, unless otherwise modified by clearing member.

Non-fulfillment of either whole or part of the margin obligations will be treated as a violation of the rules, bye-laws and regulations of the clearing agency and will attract penalty.

In addition, the clearing agency may at its discretion and without any further notice to the clearing member, initiate other disciplinary action, inter-alia including, withdrawal of trading facilities and/or clearing facility, close out of outstanding positions, imposing penalties, collecting appropriate deposits, invoking bank guarantees/ fixed deposit receipts, etc.

The clearing members and custodians, if required, shall pay to the Clearing Agency the margin moneys payable by them and the Clearing Agency shall release the margin moneys due to the clearing members and custodians based on the information provided by the stock

exchange or clearing agency, as may be specified by the clearing agency in the relevant regulations from time to time.

6.3.3 Settlement dues

The clearing members and custodians shall pay to the clearing agency whatever is due to them for settlement of their cleared positions. In turn, the clearing agency shall pay to the clearing members and custodians moneys payable to them for every settlement for their cleared positions. This is based on the information provided by the Exchange or Clearing Agency.

A clearing member, failing to discharge his funds obligations relating to settlement dues, margin money or non-settlement dues at the notified time, shall render him liable for withdrawal of trading facility or such other actions including disciplinary actions, as may be decided by the Relevant Authority.

6.4 Settlement of Securities

In case of sale of securities, immediately on receipt of intimation of execution of trade from broker, the seller should issue debit instructions to the DP with whom he maintains his demat account. Securities can be transferred either directly to the Clearing Corporation/Clearing House or to the broker's clearing account, as advised by his broker.

A purchaser of securities can give one-time standing instruction to his DP for receiving securities in his account. This standing instruction can be given at the time of opening of account or later. Alternatively, he may choose to issue separate receipt instruction to his DP every time he makes any purchase of securities.

The securities which the client has purchased will be first delivered in his brokers demat account by the Clearing Corporation / Clearing house. The broker will subsequently transfer the securities in his demat account. The broker may give request to the Clearing Corporation / Clearing house to deliver the securities directly in the purchaser's account.

6.4.1 Settlement through the Depository Clearing System

The securities pay-in takes place on the T+2 day after the trade date (T). Trading members have to deliver the shares by 10.30 a.m. on the pay-in date through their depository participant. The securities pay-in takes place through both depositories simultaneously.

The securities pay out takes place on the same date as the securities pay in date i.e. in the T+2 working days after the trade date. The securities pay-out is done simultaneously through both depositories and the process is usually completed by 1.30 p.m.

6.5. Corporate Actions Adjustment

Settlements also involve adjustments for corporate actions. Adjustments are called for actions like splitting of shares, or declaring of dividends etc. Clearing and settlement should capture all these actions and provide for adjustments accordingly. The following section enumerates some of this.

The basis for any adjustment for corporate actions in the equity F&O segment shall be such that the value of the position of the market participants, on the cum and ex-dates for the corporate action, shall continue to remain the same as far as possible. This will facilitate in retaining the relative status of positions viz. in-the-money, at-the-money and out-of-money. This will also address issues related to exercise and assignments.

6.5.1 Corporate Actions to be adjusted

The corporate actions may be broadly classified under stock benefits and cash benefits. The various stock benefits declared by the issuer of capital are:

- Bonus
- Rights
- Merger / De-merger
- Amalgamation
- Splits
- Consolidations
- Hive-off
- Warrants, and
- Secured Premium Notes (SPNs) among others.

The cash benefit declared by the issuer of capital is cash dividend.

6.5.2 Time of Adjustment

Any adjustment for corporate actions would be carried out on the last day on which a security is traded on a cum basis in the underlying equities market after the close of trading hours.

6.5.3 Adjustment in Equity F&O segment

Adjustments may entail modifications to positions and/or contract specifications as listed below, such that the basic premise of adjustment laid down above is satisfied:

- a) Strike Price
- b) Position
- c) Market Lot /Multiplier

The adjustments would be carried out on any or all of the above, based on the nature of the corporate action. The adjustments for corporate actions would be carried out on all open positions.

6.5.4 Methodology for adjustment in Equity F&O

The methodology to be followed for adjustment of various corporate actions to be carried out are as follows:

6.5.4.1 Bonus, Stock Splits and Consolidations

Strike Price:

The new strike price shall be arrived at by dividing the old strike price by the adjustment factor as under.

Market Lot / Multiplier:

The new market lot/multiplier shall be arrived at by multiplying the old market lot by the adjustment factor as under.

Position:

The new position shall be arrived at by multiplying the old position by the adjustment factor as under.

Adjustment factor:

Bonus - Ratio A:B	Adjustment factor : $(A+B)/B$
Stock Splits and Consolidations Ratio - A : B	Adjustment factor : A/B

The above methodology may result in fractions due to the corporate action e.g. a bonus ratio of 3:7. With a view to minimising fraction settlements, the following methodology is adopted:

1. Compute value of the position before adjustment
2. Compute value of the position taking into account the exact adjustment factor
3. Carry out rounding off for the Strike Price and Market Lot
4. Compute value of the position based on the revised strike price and market lot

The difference between 1 and 4 above, if any, is decided in the manner laid down by the relevant authority by adjusting Strike Price or Market lot, so that no forced closure of open position is mandated.

6.5.4.2 Dividends

Dividends which are below 10 percent of the market value of the underlying stock, would be deemed to be ordinary dividends and no adjustment in Equity F&O for the Strike Price would be made for ordinary dividends. For extra-ordinary dividends, above 10 percent of the market value of the underlying security, the Strike Price would be adjusted.

To decide whether the dividend is "extra-ordinary" (i.e. over 10 percent of the market price of the underlying stock.), the market price would mean the closing price of the scrip on the day previous to the date on which the announcement of the dividend is made by the Company after the meeting of the Board of Directors. However, in cases where the announcement of dividend is made after the close of market hours, the same day's closing price would be taken as the market price. Further, if the shareholders of the company in the AGM change the rate of dividend declared by the Board of Directors, then to decide whether the dividend is extra-ordinary or not would be based on the rate of dividend communicated to the Exchange after AGM and the closing price of the scrip on the day previous to the date of the AGM.

In case of declaration of "extra-ordinary" dividend by any company, the total dividend amount (special and/or ordinary) would be reduced from all the strike prices of the option contracts on that stock.

The revised strike prices would be applicable from the ex-dividend date specified by the Exchange.

6.5.4.3 Mergers

On the announcement of the record date for the merger, the exact date of expiration (last cum-date) would be informed to members.

After the announcement of the Record Date, no fresh contracts on futures and options in equity derivatives (futures and options) would be introduced on the underlying, that will cease to exist subsequent to the merger.

Un-expired contracts outstanding as on the last cum-date would be compulsorily settled at the settlement price. The settlement price shall be the closing price of the underlying on the last cum-date.

6.5.4.4 Rights

Rights Benefit per right entitlement (A) Benefit per share (E) Underlying close price on the last cum date (P) Issue price of the rights (S)	Ratio A : B, (C) : P - S (E) : (P - S) / A+B /	Adjustment factor = (P-E)/P To be multiplied by old strike price & divided into old lot size to arrive at the new strike price and lot size
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The relevant authority may, on a case by case basis, carry out adjustments for other corporate actions in conformity with the above guidelines, including compulsory closing out, where it deems necessary.

6.6 Auction of Securities

An auction is resorted to when there is a default in delivery by a broker. An auction is the stock exchange's mechanism through which, in a settlement, a buyer broker gets shares in the eventuality of default by the selling broker. This default occurs when a short seller fails to square up the position, or a seller fails to deliver shares on time, or a seller delivers bad/wrong shares.

The whole process of this auction event can be illustrated as under:

An auction is a mechanism utilised by the Exchange to fulfill its obligation towards the buying trading members. Thus, when the selling broker fails to deliver the shares, the stock exchange conducts an open market purchase by way of an open auction and the shares so bought through the auction are delivered to the buying broker.

6.6.1 Auction of securities on the BSE

An auction tender notice is issued by BSE to the trading members informing them about the a) names of the scrips which are short or have not been delivered, b) quantity slated for auction and c) the date and time of the auction session on the BOLT.

The auction for the undelivered quantities is conducted by T+2 day (i.e. auction can be conducted on or before T+2) between 2:00 p.m. and 2.45 p.m for all the scrips under compulsory rolling settlements except those in "Z" group²³ and scrips on "trade for trade" basis which are directly closed-out.

A trading member who has failed to deliver the securities of a particular company on the pay-in day is not allowed to offer the securities (of that company) in an auction. The members participating in the auction session, can download the delivery orders in respect of the auction obligations on the same day, if their offers are accepted. The members are required to deliver the shares to the clearing corporation on or before the auction pay-in day, i.e., T+3. Pay-out of auction shares and funds is also done on the same day, i.e., T+3.

6.6.1.1 Self Auction

²³ The 'Z' group was introduced by BSE in July 1999 and includes companies which have failed to comply with its listing requirements and/or have failed to resolve investor complaints and/or have not made the required arrangements with both the depositories, viz., Central Depository Services (I) Ltd. (CDSL) and National Securities Depository Ltd. (NSDL) for dematerialization of their securities.

The delivery and receive orders (i.e. the shares to be delivered and to be received by the clearing house) are issued by the BSE to its trading members after netting off their buy and sell transactions in scrips (where such netting is permitted).

To understand this better, assume that a client has sold the shares of a Company 'X' but fails to deliver those shares to its trading member. This does not necessarily result in the failure of the trading member to deliver the shares of that company to the clearing house/clearing corporation. This is because the trading member can net off those shares against the shares of the same company bought by his other client resulting in no delivery obligation to the Clearing Corporation / Clearing House. This is called internal netting.

In such a case, the trading member would require shares so that he can deliver the same to his buying client, which otherwise would have taken place from the delivery of shares by his selling client. To provide shares to the trading members in such cases, they have been given an option to submit the details of such internal shortages on floppies on pay-in day for conducting self-auction (i.e., as if they have defaulted in delivery of shares to the Clearing House). These shortages are clubbed with the normal shortages in a settlement arrived at by the clearing house/clearing corporation and the auction is conducted by the clearing corporation/clearing house for the combined shortages.

6.6.2 Auction of Securities on the NSE

The auction process at NSE is similar to BSE. However for internal shortages instead of resorting to self auction, members are required to have a consistent upfront declared policy on settlement of these trades.

6.6.3 Close Out of Securities

Whenever there is short delivery of securities, Clearing Corporation/ Clearing House will conduct auction to buy the shares from the market participants. If on the auction day, there are no sellers for a particular short delivery, the Clearing Corporation / Clearing House will then carry out a process called "Close out". In this process, the buyer is compensated by paying the value of the short delivered security at the highest price prevailing in the stock exchange from the day of trading till the auction day or 20% above the official closing price on the auction day, whichever is higher.

For all short deliveries for a) companies listed in the 'Z group' of BSE and b) trade for trade securities at both Exchanges, the trades are compulsorily closed out. During the auction process if there are no bids received from the trading members then also close out is resorted to.

When the auction seller fails to deliver the securities (partly or fully) on the auction pay-in day, the deal will be closed out at the highest price prevailing on the Exchange from the day on which the trade was originally executed till the day of closing out or 20 percent over the

official closing price on the close out day whichever is higher and will be charged to the auction seller unless otherwise specified.

Review Questions

Questions to assess your learning:

1. In case of sale of securities, what instruction should be given to the DP, upon receipt of intimation of execution of trade from broker with whom he maintains the demat account.
 - (a) Credit
 - (b) Debit
 - (c) Hold
 - (d) No action to be taken.

Ans: (b)

2. Corporate action adjustments are done on all _____ positions.
 - (a) Open
 - (b) Closed
 - (c) Past
 - (d) Executed

Ans: (a)

3. What is the action taken when there is a failure on part of the broker to deliver the securities?
 - (a) Sale
 - (b) Auction
 - (c) Trade Cancelled

Ans: (b)

Chapter 7: Investor Grievances and Arbitration

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Investor Grievance Redress procedures at trading members, stock exchange and the regulatory level.
- Arbitration process

7.1 Introduction

Investors are the backbone of the securities market. Protection of the interests of investors is of paramount importance for the intermediaries, stock exchanges and the regulators associated with the markets. Regulations and compliance efforts have been put in place to protect the investors against any intentional or unintentional wrong doing or activities of any of the participants in the market.

However, there may be occasions when the investors have grievances against (a) the intermediary/broking firm through which it is carrying out the transactions or/and (b) against the company of which it is a shareholder.

In the event of any grievance(s), the investor is first required to approach the concerned intermediary/trading firm/company for settling his/her grievance. If the investor is not satisfied then he/she can approach the stock exchange(s) of which the broking firm is a member and/or the investor can approach the securities market regulator--SEBI. The stock exchange(s) and SEBI then independently takes up the grievances against its registered intermediaries and advises the registered trading member to redress the investor grievance.

7.2 Investor Grievance

In the following sections of this chapter, we would explain the procedures followed in the Indian market for redress of investor grievances. Investor grievance is handled at the trading member level, stock exchange level and the regulator level, each of which have been explained below.

7.2.1 Investor Grievance handling at the trading member level

Generally all the trading firms have a designated cell/person for redressing investor grievances. When a complaint is filed by the investor, efforts are taken to resolve the matter at the branch level or the firm level depending upon the nature of the complaint.

SEBI has also mandated the stock brokers to let their investors know that in case of any grievance, the investor should contact the compliance officer of the stock broker, depository participant, CEO/Partner/Proprietor. The trading members are mandated to prominently display this information at their offices and also provide the telephone numbers and email id's of the concerned officers (compliance officer of the stock broker, depository participant, CEO/Partner/Proprietor).

Investor Grievance handling at the Stock Exchanges and SEBI

In case the complainant or the aggrieved investor is unsatisfied with the redress process of the trading member then the investor can take his grievance to the stock exchange or SEBI.

SEBI Complaints Redressal System (SCORES)

SEBI handles the investor grievances through a system called SEBI Complaints Redressal System (SCORES). SCORES is a web based centralised system to capture investor complaints and is available 24x7. It allows the investors to lodge their complaints and track the status online. When a complaint is lodged on SCORES, an email acknowledgement is generated for reference and tracking. The system also allows market intermediaries and listed companies to receive complaints lodged against them electronically. If an investor submits a manual complaint, the same is scanned and captured on SCORES.

Stock Exchanges and Depositories designate a person to resolve the complaints reported through SCORES within fifteen days from the date of receipt on SCORES. If additional information is required, then it is mandated to be sought within seven days of receipt of complaint. If additional information is sought, then fifteen days will be counted from the date of receipt of information. The stock exchanges are required to maintain a record of complaints which are not addressed within fifteen days from the date of receipt of the complaint along with reason for such delay.

An investor who has lodged the complaint can verify the status by logging in using unique complaint registration number. Every complaint has an audit trail and saved in a central database. If the complaint is successfully resolved the entity is advised to send reply to complainant.

Investor Redress at Stock Exchanges

Stock exchanges have an investor grievance department which looks into all the complaints/matters against the trading members registered with the Exchange.

The exchange usually has an investor grievance redress committee which is generally manned by a team of industry professionals possessing relevant experience in the area of securities markets, company and legal affairs and specially trained to identify problems faced by the investor and to find and effect a solution.

An issue generally arises, when the complainant puts a claim for the losses incurred by any act of the trading member. In that case, the committee generally tries to seek a consensus or a mid-path on hearing both the parties i.e. the complainant and the trading member. Both the parties can also seek to settle the matter outside the purview of the Exchange and then report it to the Exchange. The trading member has to take a *satisfaction letter* from the investor stating that the grievance has been redressed and submit the same to the Exchange. The matter is then supposed to be closed.

In certain cases, however the matter does not gets resolved by the committee and the case goes to arbitration.

Investor complaints should be resolved by the trading members within fifteen days. If it is not resolved, the Exchange's Investor Grievance Redressal Committee (IGRC) will try to resolve the matter amicably within 15 days. If not resolved, IGRC will determine the claim value and the Exchange will block the amount from the member's deposit. If the trading member doesn't inform the intention to pursue arbitration within seven days, the blocked amount will be released to the investor.

In case, the member decides to pursue arbitration and the claim amount is less than Rs.10 lakhs, the Exchange will be required to release the staggered amount to the investor from Investor Protection fund till completion of the arbitration. Appropriate indemnity will be obtained from investor to return the amount dispersed if the award is not in favour of the investor. If the investor fails to return the amount, investor will not be allowed to trade further and their demat account will be frozen.

7.3 Arbitration

Arbitration, which is a quasi-judicial process, is an alternate dispute resolution mechanism prescribed under the Arbitration and Conciliation Act, 1996. The Exchanges prescribe the provisions in respect of arbitration and the procedure therein has been prescribed in the Regulations. Arbitration aims at quicker legal resolution for the disputes. When one of the parties feels that the complaint has not been resolved satisfactorily either by the other party or through the complaint resolution process of the Exchange at the Investor Services Cell or the IGRC, the parties may choose the route of arbitration. Arbitration facility is provided at all centers which are specified by SEBI from time to time. SEBI has now identified 16 such centers where investor services as well arbitration facility are to be provided by stock Exchanges.

The Exchanges have a panel of arbitrators who are typically retired judges from High-Courts, Chartered Accountants, Advocates and other Professionals having knowledge related to the capital markets.

The list of arbitrators across all stock Exchanges are pooled together and is called the "Common Pool". This list which is grouped centre wise (centres as identified by SEBI), is made available to the investors on the stock Exchanges' websites. The applicants can choose any arbitrator for the required centre from the "Common Pool". If they fail to do so, the

arbitrator will be chosen by an 'automatic process' which is a randomised computer generated selection process.

The claimant has to submit the following for filing an arbitration application:

- Statement explaining the dispute and the nature of transactions, separating delivery-based transaction and squared-off transactions.
- Contract Notes pertaining to the transaction in dispute.
- Bills issued/received by the applicant.
- Copy of the accounts statement given by broker.
- Documents pertaining to receipt/delivery of shares.
- Any other documents in support of the claim.
- An accurate list of the documents produced.
- PAN/ GIR No. of the applicant.
- Certified copy of the Balance Sheet of the applicant showing the dues.
- Copy of acknowledgement of the latest Income Tax Return.

Arbitration for claims up to Rs. 25 lakh is decided by a sole arbitrator while a claim of above Rs. 25 lakh is dealt by a panel of three arbitrators. The stock exchange has to ensure that the process of appointment of arbitrator(s) is completed within 30 days from the date of receipt of application from the applicant.

After hearing both the parties and after examining all the relevant documents and the submissions given by the parties, the arbitrators close the arbitration reference. Then, the arbitrators give the award. The Award has to be a Speaking Award.²⁴ Ex-parte Awards are also given. The Final Award is taken on stamp paper of Rs. 100 (or such other higher denomination as specified by the Stamp Act of the relevant State Government) and arbitrator(s) signatures are obtained on Final Award. The award is forwarded to the applicant as well as respondent.

In case the arbitral/appellate award is in favour of the client, the stock exchange shall, on receipt of the same, debit the amount of the award from the security deposit of the member (against whom an award has been passed) and keep it in a separate escrow account. The stock exchange shall implement the arbitral award, by making payment to the client, along with interest earned on the amount that has been set aside, as soon as the time for preferring an appeal before the appellate panel of arbitrators has expired and no appeal has been preferred.

The arbitration reference shall be concluded by way of issue of an arbitral award within four months from the date of appointment of arbitrator(s). However, the Managing Director/Executive Director of the stock exchange may for sufficient cause extend the time

²⁴Speaking awards are those awards which are passed upon hearing both the parties i.e. the complainant and the respondent. This is unlike the Ex-parte award, wherein one party does not attend the proceedings even upon being served the notice and the arbitrators have to pass a decision based on a documents and arguments given by one party.

for issue of arbitral award by not more than two months on a case to case basis after recording the reasons for the same.

Arbitration Fees

Each of the parties to arbitration must deposit an amount (as prescribed by the Exchanges) at the time of making an arbitration reference. The deposits may not exceed the amount as indicated under.

Table 7.1: Arbitration Fees

Amount of claim /counter claim (whichever is higher)	If claim is filed within six months	If claim is filed after six months
≤ Rs. 10,00,000	1.3% subject to a minimum of Rs. 10,000	3.9% subject to a minimum of Rs. 30,000
> Rs.10,00,000 - ≤ Rs. 25,00,000	Rs. 13,000 plus 0.3% amount above Rs. 10 lakh	Rs. 39,000 plus 0.9% amount above Rs. 10 lakh
≥ Rs. 25,00,000	Rs. 17,500 plus 0.2% amount above Rs. 25 lakh subject to a maximum of Rs. 30,000	Rs. 52,500 plus 0.6% amount above Rs. 25 lakh subject to maximum of Rs. 90,000

A client, who is a party to the arbitration for a claim/counter claim upto Rs. 10 lakh, is exempt from the deposit provided the arbitration reference for the same is filed within six months from the end of the quarter during which the disputed transaction were executed /settled. Expenses thus arising with regard to such applications shall be borne by the stock exchanges.

On issue of the arbitral award, the stock exchange needs to refund the deposit, if any, to the party in whose favour the award is passed and appropriate the deposit, if any, made by the party, against whom the award has been passed, towards arbitration fees. A party filing an appeal before the appellate panel pays a prescribed fee, in addition to statutory dues along with the appeal.

Appellate Arbitration

A party aggrieved by an arbitral award may appeal to the appellate panel of arbitrators of the stock exchange against such an award. An appeal before the appellate panel of arbitrators may be filed within one month from the date of receipt of arbitral award. The appellate panel consists of three arbitrators who are different from the ones who passed the arbitral award appealed against. The stock exchange shall ensure that the process of appointment of appellate panel of arbitrators is completed within 30 days from the date of receipt of application for appellate arbitration. The appeal should be disposed of within three months from the date of appointment of appellate panel of such appeal by way of issue of an appellate arbitral award. The Managing Director/Executive Director of the stock exchange may for sufficient cause extend the time for issue of appellate arbitral award by

not more than two months on a case to case basis after recording the reasons for the same. A party aggrieved by the appellate arbitral award may file an application to the Court of competent jurisdiction in accordance with Section 34 of the Arbitration and Conciliation Act, 1996.

A party filing an appeal before the appellate panel is required to pay a fee not exceeding Rs. 30,000, as may be prescribed by the stock exchange, in addition to statutory dues (stamp duty, service tax, etc) along with the appeal. However if a client's appeal is upto Rs.10 lakhs, the fee cannot exceed Rs.10,000/-

Review Questions

Questions to assess your learning:

1. Who is the backbone of the securities market?

- (a) Stock Exchanges
- (b) Trading Members
- (c) Investors
- (d) Regulators

Ans: (c)

2. Arbitration aims at _____ legal resolution for the disputes.

- (a) Slower
- (b) Quicker
- (c) Routine

Ans: (b)

3. Arbitration for claims up to Rs. ____ lakh is decided by a sole arbitrator.

- (a) 25
- (b) 50
- (c) 90
- (d) 45

Ans: (a)

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Chapter 8: Other Services provided by Brokers

LEARNING OBJECTIVES:

After studying this chapter, you should know about the services provided by the trading members:

- IPO applications
- Trading of mutual fund units
- Portfolio management service
- Research Reports
- Depository Services
- Margin Trading

8.1 Introduction

Stock brokers typically do not stop only at broking or trading. In view of their expertise, they provide a number of other services to their clients, like, facilitating application in Initial Public Offerings (IPO), trading of Mutual Fund Units, Portfolio Management Services, etc. Some of the other services provided by them are enumerated here.

Typically, big stock brokers have converted themselves into financial services companies. They provide investment options in equities, derivatives, commodities, IPO, mutual funds, depository services, portfolio management services and insurance. They also offer wealth management services for high networth individuals (HNIs). They also have branches all over the country and provide services via internet or telephone. Licenses and certifications have to be obtained for each of the services offered by the stockbrokers.

They offer various types of investment products like different schemes of investments and different types of portfolios.

Normally, a stock broker's outlet offers these facilities:

- Online BSE and NSE executions through terminals
- Investment advice
- Research reports and market review
- Personalised advice
- Live market information
- Depository services

- Direct Market Access (DMA)
- Mobile trading
- Smart Order Routing (SOR)
- Algorithmic trading
- Commodities trading
- IPOs & Mutual Funds Distribution
- Internet-based Online Trading (IBT)
- Specialised research for investors
- Margin funding

In the subsequent sections we try to briefly discuss in brief the other services as provided by the brokers.

8.2 IPO Applications

An IPO is the process by which a company goes public i.e. offers its shares to the public for sale for the first time. Electronic trading through broking firms have made investing in IPOs very simple. Once the account is opened with the broker, the investor has to call or login and apply for the IPO. The IPO process is facilitated by brokers as their system is connected with the stock Exchanges main IPO system and online uploading of forms is carried out. Thus, at any given time, the online status is available on the stock Exchanges. This process is facilitated by the stock brokers.

The Book Running Lead Manager will give the list of trading members who are eligible to participate in the book building process to the Exchange.²⁵ Eligible trading members as per the prescribed format have to give the details of the user IDs they would use for the purpose of book building to the Exchange. Once this is approved by the Exchanges, the stock broker is eligible to accept applications for IPOs and submit them online through its terminals.

As and when valid offers are received by the system of the stock Exchange, they are first numbered, time stamped, and stored in the book. Each offer has a distinctive offer number and a unique time stamp on it. All the offers placed in the system will remain outstanding till the last day of the book building process. Trading Members can modify/cancel all the offers placed in the system from the start till the last day of the book-building process.

SEBI has introduced a facility called **Application Supported by Blocked Amount (ASBA)** in the Primary market for investor. ASBA provides an alternative mode of payment in issues whereby the application money remains in the investor's account till finalization of basis of

²⁵The lead merchant bankers appointed by the Issuer Company are referred to as the Book Running Lead Managers. The names of the Book Running Lead Managers are mentioned in the offer document of the Issuer Company.

allotment in the issue, or in other words, if an investor is applying through ASBA, his application money is debited from the bank account only if the investor's application is selected for allotment after the basis of allotment is finalized, or the issue is withdrawn/failed.

ASBA process facilitates retail individual investors bidding at the cut-off price, with a single option to apply through Self Certified Syndicate Banks (SCSBs), in which the investors have bank accounts. SCSBs are those banks which satisfy the conditions laid by SEBI. SCSBs accept the applications, verify the application, block the fund to the extent of bid payment amount, upload the details in the web based bidding system of the Exchange, unblock once basis of allotment is finalized and transfer the amount for allotted shares, to the issuer.

This would co-exist with the current procedure of investors applying through sub syndicate/syndicate members, with cheque as a payment instrument.

The back office must have a system in place that allows efficient handling of large amounts of data. The system must facilitate the IPO process by carrying out the following:

- Collecting bids from clients along with their cash deposit that should cover their bids. This is then to be saved in the client's IPO form.
- Allocating the proper number of stocks for each customer according to the declared ratio from the issuer.
- Affecting the client's portfolio and cash balances according to the previously applied allocation.

In October 2012, SEBI had introduced the following changes to the public issue in electronic form:²⁶

- Investors can submit public issue application form through stock brokers, who may not be syndicate members in the issue.
- This mechanism will be available for both ASBA as well as non ASBA applications.
- Application forms shall be available on the web site of Stock Exchanges and brokers. These forms should be prefilled with price-band information.
- The ASBA facility will be available in more than 1000 locations where there is presence of brokers' terminal.
- Stock Exchanges shall publish the details of these broker centres on their websites.
- The Self Certified Syndicate Banks (SCSB) who provide ASBA facility should name at least one branch where the syndicate/ sub syndicate members and brokers can submit the ASBA form.

Procedure

- Investor can submit the application form to any of the registered broker for uploading on the stock exchange platform.
- Broker shall stamp and acknowledge receipt of the application and capture the details on the stock exchange platform

²⁶ SEBI vide its circular no: CIR/CFD/14/2012 dated October 04, 2012

- If the application is non – ASBA
 - broker shall bank the cheques with any of the branches identified by the bankers to the issue, along with the electronic schedule downloaded from the exchange system.
 - Broker shall retain the physical application form and send it to Registrar to issue (RTA) after 6 months.
- In case of ASBA application, the application form along with schedule which is basically a document prepared by the bankers listing out details of the application received by them, should be forwarded to the branch named for ASBA by the broker.
- The local branch shall update the schedule based on cheque clearance (non-ASBA) and fund blocking (ASBA) and forward the schedule to the controlling branch.
- Controlling branch shall in turn consolidate the schedules and forward it to RTA
- All other processes at RTA for issue process will remain the same.

8.3 Trading of Mutual Fund Units

The client can invest in different mutual fund schemes online or through phone, availing of the tele-services offered by the trading members. The trading members who are AMFI Registration Number (ARN) holders and have passed the NISM certification examination are permitted to participate in the trading of the mutual funds units through the exchange trading platform. Further, eligible members would have to register as distributor with the mutual fund company. Apart from brokers, mutual fund distributors registered with AMFI who are permitted by the stock exchanges can also participate in this process. Hence, eligible members would be able to place orders only in respect of Mutual Fund Companies where they have registered as distributor. These members/brokers have to apply to the stock exchange and comply with the various SEBI and the Exchange regulations as notified from time to time. The NSE and BSE have the following designated trading platforms for mutual fund viz., the Mutual Funds Service System (MFSS) and the BSE Star MF respectively.

The facility is available to the stock broker to set up the mutual fund schemes on the market watch screen. The stock broker can set up the scheme individually or through 'Security List'. The schemes set up allow the user to:

- View the indicative NAV (i.e. NAV of previous day) for the scheme.
- Default the scheme descriptor while entering subscription/ redemption request thereby reducing data entry.
- View scheme details like ISIN, limits etc. by double click on the scheme.

Asset Management Companies (AMC) desirous of providing this alternate mechanism to their potential customers shall enter into an agreement with the Exchange/Clearing Corporation. AMC shall notify schemes which they wish to permit on the Mutual Fund platform.

The stock broker shall not be allowed to place an order for the client if registration details of the client are not maintained. The user can modify/ delete client registration already

maintained subject to certain restrictions. A bulk upload facility is also available to set up client registration.

A client is registered as an individual client in client registration process described above. However, depository accounts can be maintained in joint accounts.

Firstly the stock broker is required to register all joint holders for the depository account if subscription/ redemption request is to be entered with depository settlement. Then the stock broker is required to maintain DP master for such clients. The stock broker is required to provide depository ID and client beneficiary ID along with client codes. The sequence in which client codes are entered shall be the same as available for depository ID and client beneficiary ID combination.

This one time set up of DP master is mandatory if the user wishes to enter subscription/ redemption request for the client with depository settlement.

The stock broker can request following types of subscription/redemption requests:

- Physical Subscription – Fresh (first time)
- Physical Subscription – Additional
- Depository Subscription – Fresh (first time)
- Depository Subscription – Additional
- Physical Redemption
- Depository Redemption

The stock broker can declare upfront whether the subscription/redemption request would be settled in physical mode or depository mode. The stock broker can request for fresh or additional subscription. For additional subscription in physical mode the folio number would be mandatory. This field is not applicable for redemption requests.

If the DP Settlement is in depository mode, it is mandatory for the stock broker to enter depository details. The user must enter depository ID and client beneficiary ID available in DP master. The client codes linked to the combination are picked up from DP master and relevant details for such clients are picked up from the client registration. If the DP settlement is in physical mode, it is mandatory to enter the folio number for additional subscriptions and redemption requests.

The user is allowed to place order amount in multiples of rupees. Minimum amounts are specified at the scheme level for fresh and additional subscription. The subscription order would be rejected if the order amount is not greater than or equal to the amount specified.

Similarly, maximum amount is specified at the scheme level for physical redemption. Physical redemption order would be rejected if the order amount is equal to or greater than the amount specified. No subscription/ redemption order should be entered with amount equal to or greater than Rs. 1 crore. For depository redemption order amount is not applicable.

The user is allowed to place order quantity only for redemption requests. Maximum quantity is specified at the scheme level for physical redemption. Physical redemption order would be rejected if the order quantity is equal to or greater than the amount specified.

For physical subscription and redemption orders the user would enter the client code and mode of holding. The mode of holding can be 'Single' (SI)/'Joint' (JO)/'Anyone or Survivor' (AS). For depository subscription and redemption orders the client codes would be defaulted from the depository master for the given DP ID – Beneficiary ID combination. The stock broker would not be allowed to change the default client codes.

For the client code entered client name, PAN and KYC information shall be displayed from Client Registration. The user would not be allowed to change this information. For subscription request above Rs. 50,000/- KYC must be completed ('Y') for all the clients entered for the order.

Following additional facilities are provided by the stock exchanges to the brokers along with order entry:

- The facility to submit the bulk orders using offline order entry facility.
- The facility to take online backups of orders entered by the user for the day.
- The facility to print the confirmation slips either online or offline.

The facility is available to the stock brokers to view the outstanding orders in particular scheme. This information is available only for the current day. Subscription and redemption orders would be presented separately. A facility is available to modify or cancel particular order displayed in the list. This is available only during the market hours. The user would not be allowed to modify symbol, series, scheme name and depository settlement.

In the case of mutual fund distributors who are not stock brokers, they will be permitted to purchase and redeem mutual funds through this platform for their clients. However, the pay-in and pay-out of funds and units will take place directly between the clearing corporation and the investor.

Risk Management

- The corporate manager can set the limit on the total value of orders that can be entered by the specific branch within the trading member's firm by specifying the branch order value limit²⁷.

²⁷The **Corporate Manager** of the stock broker is the user placed at the highest level. Such a user can perform all offer-related activities and receive the reports for all branches of the trading member. Additionally, the Corporate Manager can define the offer value limits for the branches and individual dealers of his firm. The Corporate Manager can modify his own offer or offers of all dealers and branch managers of his trading member firm.

- The corporate manager or branch manager can set the day limit on the total value of the orders that can be entered by the specific user within the trading member's firm by specifying the user order value limit ²⁸.
- The dealer can set quantity/amount limits for individual orders entered by self by specifying the order limit. ²⁹

Settlement Procedure

With respect to **funds settlement**, the pay-in for funds for subscription shall be only through the designated bank accounts of the stock exchanges and the subscription transactions shall be settled on a T+1 basis as per the timeline as specified by the clearing corporation of the Exchanges. Pay-out of funds for redemption transactions shall be directly made to the investors from the Registrar and Transfer Agents (RTAs) for both physical mode as well as Demat mode.

Securities settlement can be done either through the RTA (if physical mode) or through the Depository (if demat mode). We here now discuss the two modes separately.

▪ **Subscription –Physical Mode:**

T-Day Activities: Investor who chooses physical mode has to submit the following documents /details along with the clear funds to the trading member/broker who is eligible as a participant to trade in mutual funds on the Exchange platform.

- Completed and signed respective scheme application form.
- Copy of the Pan card of first holder or the copy of the Pan card of each individual holder in case of joint investment.
- Copy of the KYC acknowledgement form.
- Folio number in case the subscription is an additional purchase.

The trading member/broker after verifying the application of the investor for the mandatory details which includes PAN details and KYC compliant acknowledgment shall enter the subscription order in the trading system of the Exchange with the option of physical settlement. For physical order, the folio number is also captured at the front end of the system. Once the order is created, the system generates a unique confirmation number for the order. The investor then receives from the trading member/broker a confirmation slip. This slip serves as a proof of transaction till the time the investor receives the allotment details from the trading member /broker. In addition to this, the investor also receives a statement of account from the RTA directly. The broker /trading member needs to submit

²⁸The **Branch Manager** is the user who is placed under the Corporate Manager. Such user can perform and view Bid related activities for all dealers under that branch. The Branch Manager can modify his own offer or offers of any dealer under his branch.

²⁹**Dealers** are users at the lower most level of hierarchy. A Dealer can perform and view offer related activities and information only for oneself and does not have access to information on other dealers under either, the same branch or other branches. A Dealer can modify only the Offers entered by him. Additionally, Syndicate members can view, modify and cancel bids placed by other members.

the physical documents superscribing it with the unique confirmation number to the RTA or AMC offices. In case of any discrepancy, the stock exchange informs the trading members. The clearing corporation provides the participants with the funds obligation report end of the day for all valid transactions.

T+1 Day Activities: The Clearing Corporation of the Exchange shall debit the designated clearing bank account of the broker /trading member for the required funds obligation on T+1 morning. In case of any shortage the concerned trading member / broker will be provided an opportunity to identify transactions and provide details of the transactions for which payments have been received and transactions for which payment have not been received.

The funds collected from the bank account of the trading member/broker shall be compared with the details provided by the trading member/broker on the payment received status as per above. If the funds collected from the bank account of the trading member/broker covers the details of the payments received as provided by the trading member/broker, the same shall be further processed. Wherever the funds collected from the bank account falls short of the amount indicated in the details provided by the trading member/broker, the details shall be considered defective and shall not be further processed. In such cases, the funds collected, if any, shall be returned to the designated bank account of the trading member/broker.

The stock exchange will notify RTA for all the defective transactions and rejections due to non payment of funds. The RTA will reverse such transactions for respective trading member/ broker and transactions for other trading member/broker who have fulfilled their funds obligations will be processed by the RTA. The RTA will intimate the allotment details for the accepted transactions including folio numbers. Allotment information shall be provided to the trading member/broker so that they can provide allotment details to the investor.

▪ **Redemption –Physical Mode:**

In case of redemption of MF units in physical mode the procedure followed under 'Subscription - Physical mode' for T day activities remain the same. On T+1 day the RTA will carry out the redemption processing at its end and provide final redemption information to the Exchange. The file will contain information about valid and rejected redemption orders. For successful redemptions, the file will contain the redemption NAV, units redeemed, redemption amount, securities transaction tax (STT) (if any). The payouts however will happen as per the scheme provisions and within the timelines as per SEBI regulations as applicable from time to time. Redemption information shall be provided to the participants through files so that they can provide redemption details to the investor. The redemption proceeds will be directly sent by RTA through appropriate payment mode such as direct credit, national electronic funds transfer (NEFT) or cheque as decided by AMC from time to time, as per the bank account details recorded with the RTA.

It would be the primary responsibility of the trading member/broker to ensure completeness of the documents including ensuring filling up of the all key fields by the investor before accepting the same for processing. It would also be the responsibility of the trading member /broker to ensure identity and authentication of signature affixed based on the original PAN shown at the time of accepting the redemption application form. A copy of the PAN will be sent along with the redemption request. In case of joint holding, this will be ensured by the trading member/broker for all holders. In case the subscription application form has not been reached to the RTA, the redemption request for such subscription will not be taken by the RTA and shall be rejected.

▪ **Subscription –Depository Mode:**

T-Day Activities: Investor who chooses depository mode can place order for subscription as currently followed for secondary market activities. The investor should provide their depository account details along with PAN details to the trading members /brokers. When investor desires to hold units in dematerialised form, KYC performed by DP will be considered compliant with applicable requirements specified in this regard in terms of SEBI circular ISD/AML/CIR-1/2008. This is in accordance with SEBI circular no SEBI/IMD/CIR No.11/183204/2009 dated November 13, 2009.

Trading member/broker shall enter the subscription order on the stock exchange's front-end system with the option of 'Depository' settlement. The Exchange system will identify each scheme uniquely in terms of Symbol & Series. Subscription orders would be created in terms of amount. Once the order is created, system will generate a unique confirmation number for the order. The investor will receive from the trading member/broker a confirmation slip (which will contain unique confirmation number and date and time stamp of order entry) generated from the stock exchange MF system. Till the trading member/broker provide allotment details to the investor, the order confirmation slip would be the proof of the transaction. In the case of demat mode, demat statement given by depository participant would be deemed to be adequate compliance of the requirement of Statement of Account as specified in SEBI circular number SEBI/IMD/CIR No.11/183204/2009.

The stock exchange validates these transactions in the evening of the T day evening with the RTA as well as the depository and in case of any discrepancy, the transaction details will be informed to the trading member/broker on the same day evening. The Clearing Corporation shall also provide the trading member/broker with funds obligation report at the end of day for all the valid transactions.

T+1 Day Activities: The Clearing Corporation of the Exchange shall debit the designated clearing bank account of the trading members/brokers for the required funds obligation on T+1 morning. In case of any shortage, the concerned trading member/broker will be provided an opportunity to identify transactions and provide details of the transactions for which payments have been received and transactions for which payment have not been received. The funds collected from the bank account of the trading member/broker shall be compared with the details provided by the trading member /broker on the payment

received status as per above. If the funds collected from the bank account of the trading member/broker covers the details of the payments received as provided by the trading member /broker, the same shall be further processed. Wherever the funds collected from the bank account falls short of the amount indicated in the details provided by the trading member/broker, the details shall be considered defective and shall not be further processed. In such cases, the funds collected, if any, shall be returned to the designated bank account of the trading member/broker.

The Exchange will notify RTA for all such defective transactions and rejections due to non-payment of funds. The RTA will reverse such transactions for respective trading member /broker and transactions for other trading member /broker who have fulfilled their funds obligations will be processed by the RTA. The RTA will intimate the allotment details for the accepted transactions.

Allotment information shall be provided to the trading member /broker so that they can provide allotment details to the investor. In the case of demat transaction, demat statement given by depository participant shall be considered as fulfilling the requirement of Statement of Account. RTA will also credit the depository account of the investor directly at the end of day through credit corporate action process.

▪ **Redemption –Depository Mode:**

T-Day Activities: The T day activities remain the same as under ‘Subscription –Depository mode’ for the investors who choose to redeem their MF units through the stock exchange trading route. For T+1 day activity, the RTA will carry out the redemption processing at its end and provide final redemption information to the Exchange. The file will contain information about valid and rejected redemption orders. For successful redemptions, the file will contain the redemption NAV, units redeemed, redemption amount, STT (if any). The payouts however will happen as per the scheme provisions and within the timelines as per the SEBI regulations as applicable from time to time. Redemption information shall be provided to the trading members through files so that they can provide redemption details to the investor. The redemption proceeds will then be directly sent by RTA through appropriate payment mode such as direct credit, NEFT or cheque as decided by the AMC from time to time, as per the bank account details recorded with the depository. The units will be extinguished by the RTA from the beneficiary account of the AMC(s).

8.4 Portfolio Management Service

Many stock brokers also offer Portfolio Management Services (PMS) to their clients. For this, a PMS license has to be obtained by them. This is normally offered to the High Networth Individuals (HNIs). In this kind of service, the stock broker makes the investment decision on behalf of the client and manages his portfolio. The portfolio manager decides the mix of securities that the investor will invest in. Portfolio is updated with the new stocks replacing existing stocks as and when required to optimize performance.

Apart from portfolio management, the stock brokers also offer advice on managing the client's portfolio depending upon the client's needs. Based on this advice, the client can make the investment decisions.

As per SEBI, any person who pursuant to a contract or arrangement with a client, advises or directs or undertakes on behalf of the client (whether as a discretionary portfolio manager or otherwise) the management or administration of a portfolio of securities or the funds of the client, as the case may be is a portfolio manager.

Portfolio manager can be discretionary or non-discretionary. The discretionary portfolio manager individually and independently manages the funds of each client in accordance with the needs of the client in a manner which does not partake character of a mutual fund, whereas the non-discretionary portfolio manager manages the funds in accordance with the directions of the client.

An applicant for registration or renewal of registration as a portfolio manager is required to pay a non-refundable application fee of Rs.1,00,000 (Rupees one lakh only) to SEBI. Every portfolio manager is required to pay a sum of Rs.10 lakh as registration fees at the time of grant of certificate of registration by SEBI.

SEBI takes into account all matters which it deems relevant to the activities relating to portfolio management. The applicant has to be a body corporate and must have necessary infrastructure like adequate office space, equipments and the manpower to effectively discharge the activities of a portfolio manager.

The applicant should have in its employment minimum of two persons who, between them, have atleast five years of experience as portfolio manager or stock broker or investment manager or in the areas related to fund management. The applicant also has to fulfill the capital adequacy requirements, etc.

The principal officer of the portfolio manager is to have:

(i) a professional qualification in finance, law, accountancy or business management from a university or an institution recognised by the Central Government or any State Government or a foreign university;

OR

(ii) an experience of at least ten years in related activities in the securities market including in a portfolio manager, stock broker or as a fund manager

The portfolio manager is required to have a networth of not less than Rs. 2 crores. Every portfolio manager who has total assets under management of value more than Rs.500 crore shall appoint a custodian. This condition will not be applicable to portfolio managers offering purely advisory services.

The portfolio manager, before taking up an assignment of management of funds or portfolio of securities on behalf of the client, enters into an agreement in writing with the client clearly defining the inter se relationship and setting out their mutual rights, liabilities and obligations relating to the management of funds or portfolio of securities containing the details as specified in Schedule IV of the SEBI (Portfolio Managers) Regulations, 1993.

The SEBI (Portfolio Managers) Regulations, 1993, have not prescribed any scale of fee to be charged by the portfolio manager to its clients. However, the regulations provide that the portfolio manager shall charge a fee as per the agreement with the client for rendering portfolio management services. The fee so charged may be a fixed amount or a return based fee or a combination of both. The portfolio manager shall take specific prior permission from the client for charging such fees for each activity for which service is rendered by the portfolio manager directly or indirectly (where such service is outsourced).

The portfolio manager shall not accept from the clients, funds or securities worth less than Rs.25 lakh only. A portfolio manager is permitted to invest in derivatives, including transactions for the purpose of hedging and portfolio rebalancing, through a recognized stock exchange. However, leveraging of portfolio is not permitted in respect of investment in derivatives. The total exposure of the portfolio client in derivatives should not exceed his portfolio funds placed with the portfolio manager and the portfolio manager should basically invest and not borrow on behalf of his clients.

The portfolio manager provides to the client the Disclosure Document which contains the following:

- the quantum and manner of payment of fees payable by the client for each activity for which service is rendered by the portfolio manager directly or indirectly (where such service is out sourced),
- portfolio risks,
- complete disclosures in respect of transactions with related parties as per the accounting standards specified by the Institute of Chartered Accountants of India in this regard,
- the performance of the portfolio manager and
- the audited financial statements of the portfolio manager for the immediately preceding three years.

The back office must have clear agreements with clients to whom PMS is being offered. The back office system must have provision for distinguishing the accounts of such clients and the transactions made on their behalf must be clearly earmarked as such. The fees on such accounts must be distinguished and accounted for separately.

8.5 Research Reports

Stock brokers also bring out regular research reports for use by their clients. These could include:

- Fundamental Research
- Stock Research
- Daily/weekly/fortnightly/monthly newsletters
- Special Reports to cater to needs of some investors
- Sector Reports

Research reports normally educate investors about the industry trends, sectors, which company scrips to buy, sell or hold etc. These reports are aimed at helping the investor make informed investment decisions.

Sector research includes details on how an industry is faring, whether current policies favour the industry, etc., so that the choice of investing in a particular industry rests with the investor. Further, these advice and recommendations can be obtained as SMS on to the mobile phone. So it is more online now.

SEBI however, has issued stringent rules and regulations pertaining to research based advisory services provided by the broking houses.

8.6 Depository Services

The brokers also provide depository services to investors amongst other services. To provide these services, the broker or the trading member has to get registered as a depository participant of a depository as per the SEBI Act 1992 and the Depositories Act of 1996. The relationship between the DPs and the depositories is governed by an agreement made between the two under the Depositories Act. The form of the agreement is specified in the bye-laws of the depository.

Under the Depositories Act, 1996, a DP is described as an agent of the depository. The SEBI (Depository & Participants) Regulations, 1996 and the bye-laws of depositories prescribe the eligibility criteria to become a DP.

On satisfying the conditions as laid down by the SEBI and the depositories, the certificate of registration is given to the DP for commencement of DP related activities. *The main activity being the settlement and transfer of securities from one beneficiary account to another pursuant a trading activity of an investor.* There are other services also which a DP can engage into such as:

- Dematerialisation: Dematerialisation is the process of converting securities held in physical form into holdings in book entry form.

- **Transfer and Registration:** A transfer is the legal change of ownership of a security in the records of the issuer. For effecting a transfer, certain legal steps have to be taken like endorsement, execution of a transfer instrument and payment of stamp duty, which the DP helps the investors in.
- **Corporate Actions:** DP's handle corporate actions on behalf of their depositories. In the first case, it merely provides information to the issuer about the persons entitled to receive corporate benefits. In the other case, the DP's on depository instructions takes the responsibility of distribution of corporate benefits.

8.7 Margin Trading

Margin Trading is trading with borrowed funds/securities. It is essentially a leveraging mechanism which enables investors to take exposure in the market over and above what is possible with their own resources. SEBI has been prescribing eligibility conditions and procedural details for allowing the margin trading facility from time to time.

Only corporate brokers with networth of at least Rs.3 crore are eligible for providing margin trading facility to their clients subject to their entering into an agreement to that effect. Before providing margin trading facility to a client, the member and the client have been mandated to sign an agreement for this purpose in the format specified by SEBI. It has also been specified that the client shall not avail the facility from more than one broker at any time.

The facility of margin trading is available for Group 1 securities and those securities which are offered in the initial public offers and meet the conditions for inclusion in the derivatives segment of the stock exchanges.

For providing the margin trading facility, a broker may use his own funds or borrow from scheduled commercial banks or NBFCs regulated by the RBI. A broker is not allowed to borrow funds from any other source.

The "total exposure" of the broker towards the margin trading facility should not exceed the borrowed funds and 50 per cent of his "net worth". While providing the margin trading facility, the broker has to ensure that the exposure to a single client does not exceed 10 percent of the "total exposure" of the broker.

Initial margin has been prescribed as 50 percent and the maintenance margin has been prescribed as 40 percent. When the balance deposit in the client's margin account falls below the required maintenance margin, the broker shall promptly make margin calls. However, no further exposure can be granted to the client on the basis of any increase in the market value of the securities.

The Exchange/broker shall have the discretion to increase the margins (as mentioned above) and in such a case, the margin call shall be made, as and when required.

8.7.1 Functions and importance of the margin department

SEBI has been prescribing eligibility conditions and procedural details for allowing the margin trading facility from time to time. The function of a margin department, which is critical to a stock broker, is to ensure that the margin trading of each and every client is in line with these conditions and procedure. The margin department must ensure that all the procedures given in the following paragraphs are complied with.

Before providing margin trading facility to a client, the broker and the client have been mandated to sign an agreement for this purpose in the format specified by SEBI. It has also been specified that the client shall not avail the facility from more than one broker at any time.

The broker may liquidate the securities if the client fails to meet the margin call made by the broker or fails to deposit the cheques on the day following the day on which the margin call has been made or where the cheque deposited by the client has been dishonoured.

The broker may also liquidate the securities in case the client's deposit in the margin account (after adjustment for mark to market losses) falls to 30 percent or less of the latest market value of the securities, in the interregnum between making of the margin call and receipt of payment from the client. However, the broker shall not liquidate or use in any manner the securities of the client in any situation other than the ones mentioned above.

In addition, a broker has to disclose to the stock exchange details on gross exposure including name of the client, unique identification number under the SEBI (Central Database of Market Participants) Regulations, 2003, and name of the scrip.

If the broker has borrowed funds for the purpose of providing margin trading facility, the name of the lender and the amount borrowed should be disclosed latest by the next day.

The stock exchange, in turn, has to disclose the scrip-wise gross outstanding in margin accounts with all brokers to the market. Such disclosure regarding margin-trading done on any day shall be made available after the trading hours on the following day.

The arbitration mechanism of the exchange would not be available for settlement of disputes, if any, between the client and broker, arising out of the margin trading facility. However, all transactions done on the stock exchange, whether normal or through margin trading facility, shall be covered under the arbitration mechanism of the stock exchange.

8.8 Internet Based Trading (IBT) & Securities Trading Using Wireless Technology (StWT)

Investor may also place order using an internet trading terminal or mobile phones. Orders placed through the IBT system go through automated risk management validations, before being transmitted to the Stock Exchange systems. Once the order is accepted/trade executed, the investor gets notification on their IBT terminals.³⁰

The core requirements are as follows:

- Stock Brokers wishing to offer IBT need to seek stock exchange approval and should have a minimum net worth of Rs. 50 lakhs.
- The broker shall capture the IP (Internet Protocol) address (from where the orders are originating)
- The brokers system should have built-in high system availability to address any single point failure.
- There should be secure end-to-end encryption for all data transmission between the client and the broker through a Secure Standardized Protocol.
- A procedure of mutual authentication between the client and the broker server should be implemented.
- The broker system should have adequate safety features to ensure it is not susceptible to internal/external attacks.
- In case of failure of IBT/ STWT, the alternate channel of communication shall have adequate capabilities for client identification and authentication.
- In case of no activity by the client, the system should provide for automatic trading session logout
- The following security features are mandatory for all Internet based trading systems:
 - a) User Id
 - b) First Level password
 - c) Automatic expiry of passwords at the end of a reasonable duration. Re-initialize access on entering fresh passwords
 - d) All transaction logs with proper audit facilities to be maintained in the system.
 - e) Secured Socket Level Security for server access through Internet
 - f) Suitable Firewalls between trading set-up directly connected to an Exchange trading system and the Internet trading set-up.

³⁰ SEBI vide circular no: SMDRP/Policy/CIR-06/2000 dated January 31, 2000 had specified the rules relating to IBT and vide circular no: CIR/MRD/DP/25/2010 dated August 27, 2010 for STWT.

Review Questions

Questions to assess your learning:

1. _____ is a process by which a company offers shares for sale to public for the first time.

- (a) FPO
- (b) IPO
- (c) Private Placement
- (d) QIP

Ans: (b)

2. ASBA is the acronym for _____.

- (a) Application Supported by Blocked Amount
- (b) Applying Sponsoring Brokers Amounts
- (c) Application Supports for Brokers Amount

Ans: (a)

3. The facility for modification of mutual fund order does not include _____

- (a) Scheme name
- (b) Depository settlement
- (c) Symbol and series
- (d) All of the above

Ans: (d)

ABBREVIATIONS

AA	Adjudicating Authority
ADRs	American Depositary Receipts
AMC	Asset Management Company
AMFI	Association of Mutual Funds of India
AML	Anti Money Laundering
ARN	AMFI Registration Number
ASBA	Application Supported by Blocked Amount
BG	Bank Guarantee
BOISL	Bank of India Shareholding Limited
BSE	The Stock Exchange, Mumbai
CDD	Customer Due Diligence
CDs	Certificates of Deposit
CDSL	Central Depository Services Limited
CSC	Clients of Special Category
DEA	Department of Economic Affairs
DI	Delivery Instruction
DPM	Depository Participant Management
DPs	Depository Participants
ECBs	External Commercial Borrowings
ECN	Electronic Contract Note
EFT	Electronic Fund Transfer
ETFs	Exchange Traded Funds
FATF	Financial Action Task Force
FCCBs	Foreign Currency Convertible Bonds
FIIs	Foreign Institutional Investors
FIU-IND	Financial Intelligence Unit - India
FPO	Follow-on Public Offering
GDRs	Global Depositary Receipts
GOI	Government of India
G-Sec	Government Securities
HNIs	High Networth Individuals
ID	Identification
INR	Indian National Rupees
IPL	Indian Penal Code
IPO	Initial Public Offering
ISIN	International Securities Identification Number
IT	Information Technology
KYC	Know Your Customer
MCA	Ministry of Corporate Affairs
MCX	Multi Commodity Exchange of India

MF	Mutual Fund
MFSS	Mutual Fund Service System
MTM	Mark-To-Market
NAV	Net Asset Value
NBFCs	Non-Banking Financial Companies
NCDs	Non-Convertible Debentures
NEFT	National Electronic Fund Transfer
NSCCL	National Securities Clearing Corporation Limited
NSDL	National Securities Depository Limited
NSE	National Stock Exchange
OTC	Over-The-Counter
PAN	Permanent Account Number
PCM	Professional Clearing Members
PML	Prevention of Money Laundering
PMLA	Prevention of Money Laundering Act, 2002
PMS	Portfolio Management Services
PSUs	Public Sector Undertakings
RBI	Reserve Bank of India
RTA	Registrar and Transfer Agent
SC(R)R	Securities Contracts (Regulation) Rules, 1957
SCM	Self Clearing Member
SCRA	Securities Contracts (Regulation) Act, 1956
SCSBs	Self Certified Syndicate Banks
SEBI	Securities and Exchange Board of India
SI	Standing Instruction
SPAN	Standard Portfolio Analysis of Risk
SPNs	Secured Premium Notes
SROs	Self Regulatory Organisations
STT	Securities Transaction Tax
T+1 Day	Trade + 1 Day
T+2 Day	Trade + 2 Day
T+3 Day	Trade + 3 Day
T-Bills	Treasury Bills
TCM	Trading Cum Clearing Member
T-Day	Trade Day
TGF	Trade Guarantee Fund
USD	U.S. Dollars
VaR	Value-At-Risk



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