



# Securities Operations and Risk Management



**NiSM** NATIONAL INSTITUTE OF  
SECURITIES MARKETS  
An Educational Initiative of SEBI

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

## **NISM Certification on Securities Operations and Risk Management – Workbook**

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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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## **Foreword**

NISM is a leading provider of high end professional education, certifications, training and research in financial markets. NISM engages in capacity building among stakeholders in the securities markets through professional education, financial literacy, enhancing governance standards and fostering policy research. NISM works closely with all financial sector regulators in the area of financial education.

NISM Certification programs aim to enhance the quality and standards of professionals employed in various segments of the financial services sector. NISM's School for Certification of Intermediaries (SCI) develops and conducts certification examinations and Continuing Professional Education (CPE) programs that aim to ensure that professionals meet the defined minimum common knowledge benchmark for various critical market functions.

NISM certification examinations and educational programs cater to different segments of intermediaries focusing on varied product lines and functional areas. NISM Certifications have established knowledge benchmarks for various market products and functions such as Equities, Mutual Funds, Derivatives, Compliance, Operations, Advisory and Research.

NISM certification examinations and training programs provide a structured learning plan and career path to students and job aspirants who wish to make a professional career in the Securities markets. Till March 2022, NISM has certified nearly 15 lakh individuals through its Certification Examinations and CPE Programs.

NISM supports candidates by providing lucid and focused workbooks that assist them in understanding the subject and preparing for NISM Examinations. This book covers all important aspects related to the stock brokers operations, starting from client on-boarding to trade life cycle and includes compliance requirements related to report submission and redressal of investor grievances. This book will be immensely useful to all those who want to learn about the various functions of a broker's operations and risk management in the securities markets.

**Dr. C.K.G Nair**  
**Director**

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While the NISM Certification examination will be largely based on material in this workbook, NISM does not guarantee that all questions in the examination will be from material covered herein.

### **Acknowledgement**

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### **About NISM Certifications**

The School for Certification of Intermediaries (SCI) at NISM is engaged in developing and administering Certification Examinations and CPE Programs for professionals employed in various segments of the Indian securities markets. These Certifications and CPE Programs are being developed and administered by NISM as mandated under Securities and Exchange Board of India (Certification of Associated Persons in the Securities Markets) Regulations, 2007.

The skills, expertise and ethics of professionals in the securities markets are crucial in providing effective intermediation to investors and in increasing the investor confidence in market systems and processes. The School for Certification of Intermediaries (SCI) seeks to ensure that market intermediaries meet defined minimum common benchmark of required functional knowledge through Certification Examinations and Continuing Professional Education Programmes on Mutual Funds, Equities, Derivatives Securities Operations, Compliance, Research Analysis, Investment Advice and many more.

Certification creates quality market professionals and catalyzes greater investor participation in the markets. Certification also provides structured career paths to students and job aspirants in the securities markets.

### **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](http://www.nism.ac.in)

#### **Important**

- Please note that the Test Centre workstations are equipped with either Microsoft Excel or OpenOffice Calc. Therefore, candidates are advised to be well versed with both of these softwares for computation of numericals.
- The sample questions and the examples discussed in the workbook are for reference purposes only. The level of difficulty may vary in the actual examination.

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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
- The different segments of securities market
- Products traded in Indian securities market
- Concept of International Financial Services Centres (IFSC)

### **1.1 Introduction**

The financial markets enable efficient transfer and allocation of financial 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 who 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 financial market comprises of the money market and the securities markets.

In this book however, we are going to focus specifically on securities market. The term “**Securities**” as defined in the SCRA, 1956 includes the following:

- i. Shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate;
- ii. Derivatives;
- iii. Units or any other instrument issued by any Collective Investment Scheme;
- iv. Security receipt as defined in the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002;
- v. Units or any other instrument issued by any pooled investment vehicle;

- vi. Units or any other such instrument issued to the investors under any mutual fund scheme;<sup>1</sup>
- vii. Any certificate or instrument, issued to an investor by any issuer being a special purpose distinct entity which possesses any debt or receivable, including mortgage debt, assigned to such entity, and acknowledging beneficial interest of such investor in such debt or receivable, including mortgage debt, as the case may be;
- viii. Government Securities
- ix. Such other instruments as may be declared by the Central Government to be securities, and
- x. Rights or interest in securities.
- xi. “Electronic Gold Receipt” means an electronic receipt issued on the basis of deposit of underlying physical gold in accordance with the regulations made by the Securities and Exchange Board of India under section 31 of the said Act.

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 issues (the primary market) and trading in existing issues (secondary) market.

The *primary market* is used by issuers for raising capital from the investors by making Initial Public Offers or rights issues or Further Public Offer (FPO) or private placement. 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.

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<sup>1</sup> "Securities" shall not include any unit linked insurance policy or scrips or any such instrument or unit, by whatever name called, which provides a combined benefit risk on the life of the persons and investment by such persons and issued by an insurer referred to in clause (9) of section 2 of the Insurance Act, 1938 (4 of 1938);

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 particular price, it is referred as *Rights Issue*, whereas if such issues are without involvement of any cost, it is referred 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/Screen Based Trading System (SBTS).

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

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 Portfolio Investors (FPIs), 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 providing platform for primary issuance and listing of the securities.

In the secondary market, there are the stock exchanges, clearing corporations, stock brokers (who are members of the stock exchanges), the mutual funds/asset management companies (AMCs), financial institutions, Foreign Portfolio Investors (FPIs), 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 Market**

Money Market is a short-term market and handles instrument from 1 day to 1 year. It is mostly used by Government, Banks and other corporate entities to tide over short-term requirements of funds. The entities having excess and the entities with shortage of funds participate in this market. The RBI uses the money market for transmission of its monetary policy direction by changing various Reserve ratios, conducting Open Market Operations, increasing or decreasing of policy rates, etc.

Participants in the Indian money market include Public Sector Banks, Private Sector Banks, Foreign Banks, Co-operative Banks, Financial Institutions, Insurance Companies, Mutual Funds, Primary Dealers, Bank cum Primary Dealers, Non-Banking Financial Companies

(NBFCs), Corporates, Provident / Pension Funds, Payment Banks, Small Finance Banks, etc. The money market deals primarily in short-term debt securities and investments, such as bankers' acceptances, negotiable certificates of deposit (CDs), commercial papers, repos, Call/Notice/Term money and treasury bills (T-bills).

## **1.4 Products Traded in the Indian Securities Market**

Investors in the Indian securities market have a wide choice of product base to choose from depending upon a person's risk appetite and needs. The different types of products available in equity, derivatives and debt markets are discussed below. These products are traded on various segments of Exchanges and sometimes on OTC / electronic trading also. In our workbook we will focus mainly on various segments of Stock Exchange and products traded on the same.

### **1.4.1 Equity / Cash Markets and its Products**

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

**An Equity Share** normally known as ordinary 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. Equity shares do not have a maturity date and have variable returns in the form of dividends and capital gains. Equity shareholders are entitled to voting rights. In the event of liquidation of company equities will have last preference. Typically equity securities are riskier as compared to debt securities.

**Debentures** are instruments for raising debt. Debenture is debt securities which indicate a loan to the company. Debentures typically have a maturity date and have a predefined return in the form of interest payments. 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. Thus, debentures can be pure debt or quasi-equity, as the case may be.

**Government Securities** are also known as "sovereign debt" and are generally issued via auctions and traded in the secondary market. Government bonds issued in local currency are considered risk free as the Government, being a sovereign entity, can print the currency to repay its obligation to bond holders. Government Securities are issued by central and state government. The dated securities issued by state government is known as State Development Loans (SDL).

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

**A Mutual Funds** is an investment vehicle that pools money from numerous investors who wish to save or make investments having similar investment objective. A mutual fund invests in different types of securities in consonance with the investment objectives. A mutual fund company pools money from many investors and invests the money in stocks, bonds, money-market instruments, other securities or assets, or some combination of these investments, depending on the objectives of the fund. There are funds which invest in equities, better known as equity MF schemes which are considered riskier than debt mutual funds. Liquid mutual funds invest mainly in short term and very short term money market instruments. One of the main advantages of mutual funds is that they give small investors access to professionally managed, diversified portfolios of various securities which would be quite difficult to create with a small amount of capital. Mutual Fund schemes are either open ended or close ended. Close ended mutual funds schemes are traded on the equity segment of the Exchange.

**Exchange Traded Fund :** An ETF is a marketable security that tracks an index, a commodity, bonds, or a basket of assets like an index fund. The main difference between ETFs and other types of index funds is that ETFs don't try to outperform their corresponding index, but simply replicate the performance of the Index. Unlike regular mutual funds, an ETF trades like a common stock on a stock exchange. The traded price of an ETF changes throughout the day like any other stock, as it is bought and sold on the stock exchange. The trading value of an ETF is based on the net asset value of the underlying stocks that an ETF represents.

**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). An IDR is an instrument denominated in Indian Rupees in the form of a depository receipt created by a Domestic Depository (custodian of securities registered with the Securities and Exchange Board of India (SEBI)) against the underlying equity shares of issuing company to enable foreign companies to raise funds from the Indian securities Markets.<sup>2</sup> 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 conversion/redemption into the underlying shares. Redemption/Conversion is permitted after 1 year from the date of listing of the IDRs. 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. The headroom for this purpose shall be the number of IDRs originally issued minus the number of IDRs outstanding, which is further adjusted for IDRs redeemed into underlying equity shares.

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<sup>2</sup> [https://www.sebi.gov.in/sebi\\_data/commndocs/foreigncos1\\_p.pdf](https://www.sebi.gov.in/sebi_data/commndocs/foreigncos1_p.pdf)  
[https://www.sebi.gov.in/legal/circulars/mar-2013/guidelines-for-enabling-partial-two-way-fungibility-of-indian-depository-receipts-idrs-\\_24379.html](https://www.sebi.gov.in/legal/circulars/mar-2013/guidelines-for-enabling-partial-two-way-fungibility-of-indian-depository-receipts-idrs-_24379.html)

### **1.4.2 Derivative Market and its Products**

**Derivative** is a product whose value is derived from the value of an underlying asset or group of assets—a benchmark. The derivative itself is a contract between two or more parties. The most common underlying assets for derivatives are stocks, bonds, commodities, currencies, interest rates, and market indexes. Derivative products are in the form of Forwards, Futures, Options and Swaps. Derivatives can trade over-the-counter (OTC) or on an exchange.

With Securities Laws (Second Amendment) Act, 1999, Derivatives has been included in the definition of Securities. The term Derivative has been defined in Securities Contracts (Regulations) Act, 1956 as:

- a. a security derived from a debt instrument, share, loan, whether secured or unsecured, risk instrument or contract for differences or any other form of security;
- b. a contract which derives its value from the prices, or index of prices, of underlying securities;
- c. commodity derivatives; and
- d. such other instruments as may be declared by the Central Government to be derivatives;

Further Section 18A of the act provides that notwithstanding anything contained in any other law for the time being in force, contracts in derivative shall be legal and valid if such contracts are:

- o Traded on a recognized stock exchange
- o Settled on the clearing house of the recognized stock exchange, in accordance with the rules and bye-laws of such stock exchanges.
- o Between such parties and on such term as the Central Government may, by notification in the Official Gazette specify.

A Forward contract is a promise to deliver an asset on a pre- determined date in future at a predetermined price. Forward contracts are non-standardised contracts which are traded in OTC<sup>3</sup>.

A Futures contract is an agreement between two parties to buy or sell an asset at a certain time in the future at a certain price. Future contracts are the Exchange traded organized/standardized contracts in terms of quantity, quality (in case of commodities), delivery time and place for settlement on any date in future. The contract expires on a pre-specified date which is called the expiry date of the contract. Futures contracts are special types of forward contracts in the sense that the former are standardized exchange traded contracts.

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<sup>3</sup> In case of derivatives, Over-the-counter generally indicate transaction undertaken other than Stock Exchanges and including electronic trading platform.

Options give the buyer (holder) a right but not an obligation to buy or sell an asset at a predetermined price within or at end of a specified period. Options are of two types - call and put. Call Option 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. Put Option 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. Options are traded on stock exchanges as well as on OTC.

A swap is an agreement made between two parties, to exchange cash flows in the future, according to a prearranged formula. Swaps are, broadly speaking, series of forward contracts. Swaps help market participants manage risk associated with volatile interest rates, currency exchange rates and commodity prices etc. Swaps are mainly traded in OTC.

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

**Equity Derivatives** are financial instruments whose value is derived from price movements of the underlying asset, where that asset is a stock or stock index.

**Index Futures and Options:** Currently in the Indian markets, future and options contract are available for trading on the indices such as BSE's SENSEX, MSEI SX40 and NSE's NIFTY 50 and sectoral indices of banks etc.

Index future and option contracts are available with weekly and monthly expiry and options for some indices up to three year's expiry cycle with quarterly and half-yearly expiries. Weekly Options are the exchange traded options based on an Index with shorter maturity of one or more weeks. All monthly futures contracts expire on the last Thursday of the expiry month. In case the last Thursday is a trading holiday, the contracts expire on the previous trading day. A new contract is introduced on the next trading day following the expiry of the near month contract.

All monthly option contracts expire on the last Thursday of the expiry month and have generally 3-month expiry cycle except for the long dated options contracts which are available up to 3-year expiry cycle with quarterly expiries (March, June, Sept & Dec cycle) and half yearly expiries (Jun, Dec cycle). Generally, all option contracts with expiry of more than 9 months shall be treated as long dated/long term option contracts. In case the last Thursday is a trading holiday, the contracts expire on the previous trading day. A new contract is introduced on the next trading day following the expiry of the near month contract. Weekly option contracts expire on specific day of the week. A new weekly contract is introduced on the next trading day following the expiry of the respective week 's contract. All Index future and option contracts are cash settled.

**Stock Futures and Options:** Individual stock futures and options on specific listed stocks are chosen by the stock Exchange based on the guidelines and criteria (such as market capitalization, trading volume, delivery volume etc.) defined by SEBI. Similar to index futures and options, stock futures and option contract available with weekly and monthly expiry.



All stock futures and option contracts are physically settled. Similar to index futures and options, all monthly stock futures and options contracts expire on the last Thursday of the expiry month. In case the last Thursday is a trading holiday, the contracts expire on the previous trading day. A new contract is introduced on the next trading day following the expiry of the near month contract.

**Currency Derivatives** trading was introduced in the Indian financial markets with the launch of currency futures trading in the USD-INR pair in 2008.<sup>4</sup> Currently in India, currency futures contracts are traded on four INR pairs i.e., USDINR, EURINR, GBPINR and JPYINR and on three cross currency pairs i.e., EURUSD, GBPUSD and USDJPY on the recognized stock exchanges. Currency futures and options are traded on separate segment namely “Currency Derivatives Segment” of the Exchange.

In case of currency futures, the underlying for USD-INR, EURINR, GBPINR and JPYINR pair would be the rate of Exchange between USD and INR, Euro and INR, Great Britain Pound and INR and Japanese Yen and INR respectively. The contract has a maximum of 12 months of trading cycle. The new contract is introduced following the expiry of the current contract. The expiry day/ last day for the trading of the monthly contract shall be two working days prior to the last business day of the expiry month at 12.30 pm. All these contracts are cash settled. The final settlement price for USDINR, EURINR, GBPINR and JPYINR is the FBIL (Financial Benchmarks India Pvt. Ltd.) reference rate. (FBIL)<sup>5</sup> is an independent benchmark administrator for interest rates and foreign exchange. The final settlement price for cross currency pairs is derived from crossing respective FCY-INR rates.

In case of currency options, monthly as well as weekly contracts are available. In case of monthly contracts s 3 serial monthly contracts followed by 3 quarterly contracts of the cycle March/June/September/December. The expiry is two working days prior to the last business day of the expiry month at 12.30 pm. The final settlement price is the FBIL reference rate on the date of the expiry of the contract.

There are weekly futures and options are also available in various Exchanges for certain currency pairs. Generally, such contracts are expired on last day of the week i.e., on Friday at 12:30 pm. Currently, all Exchange Traded Currency Futures and Option contracts are cash settled in INR.

**Interest Rate Derivatives** trading was introduced with introduction of Interest rate futures contract. Interest rate option was introduced in 2019.

Interest Rate Futures (IRF) are standardized interest rate derivative contracts traded on a recognized stock exchange to buy or sell a notional security or any other interest-bearing instrument or an index of such instruments or interest rates at a specified future date, at a price determined at the time of the contract. Interest Rate Futures include Money Market

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<sup>4</sup> 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 MSEI (earlier known as MCX-SX) on October 7, 2008.

<sup>5</sup> Financial Benchmark India Pvt. Ltd (FBIL) is an independent benchmark administrator for interest rates and foreign exchange.

Futures also. Currently Exchange traded interest rate futures are available on single government of India Securities within maturity basket of 4-8 year, 8-11 year and 11-15 years, 91-day T-Bills and Overnight MIBOR. All these contracts are currently cash settled.

For single bond futures available on GOI securities, 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. Typically, three Serial monthly contracts followed by three quarterly contracts of the cycle March/June/September/December available for single bond futures. 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 is cash settled. The final settlement price is value weighted average price of the underlying bond based on the prices during the last two hours of the trading on NDS-OM. If less than 5 trades are executed in the underlying bond during the last two hours of trading, then FIMMDA/FBIL price shall be used for final settlement.

Interest rate options are currently available on single bond GOI securities. Typically, three Serial monthly contracts followed by three quarterly contracts of the cycle March/June/September/December available for single bond options. 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. These contracts are cash settled. The final settlement price is value weighted average price of the underlying bond based on the prices during the last two hours of the trading on NDS-OM. If less than 5 trades are executed in the underlying bond during the last two hours of trading, then FIMMDA/FBIL price shall be used for final settlement.

Interest rate futures and Options are traded on Currency Derivatives segment of the Exchange. Though SEBI allowed physical settlement for interest rate derivatives product, currently all Interest Rate Derivatives traded on Exchanges are cash settled.

**Commodity Derivatives** are derivatives products, the price of which is derived from the underlying commodities. Commodity derivatives facilitate the trading of commodities such as gold, silver, metal, energy and agricultural goods. Commodity derivatives contract can cash settled or physically settled with actual delivery of commodity. Commodity futures and options are traded on separate segment namely “Commodity Derivatives Segment” of the Exchange.

#### **1.4.3 Debt Market and its Products**

Debt market mainly consists of government securities, money market instruments, bonds and debentures, which provide financing through the issuance of bonds, and enable the subsequent trading thereof. These instruments can be traded in OTC, Electronic Trading Platform 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 defense, central banking, creation of physical infrastructure etc. For this, it generates money by

various ways including borrowing from banks and other financial institutions. A Government Security (G-Sec) is a tradeable instrument issued by the Central Government or the State Governments. It acknowledges the Government's debt obligation. Such securities are short term (usually called treasury bills, with original maturities of less than one year) or long term (usually called Government bonds or dated securities with original maturity of one year or more). In India, the Central Government issues both, treasury bills and bonds or dated securities while the State Governments issue only bonds or dated securities, which are called the State Development Loans (SDLs). G-Secs carry practically no risk of default and, hence, are called risk-free gilt-edged instruments.

The major investors in this market are banks, insurance companies, provident funds, mutual funds, state governments, FPIs etc.

In the primary market, Government securities & Treasury Bills are issued through auctions (yield based or price based auctions) conducted by RBI. The secondary market for G-Secs in India is very active with diverse groups of market participants. Secondary market trading mainly takes place through Negotiated Dealing System-Order Matching (NDS-OM) of RBI. G-Secs are also traded in OTC market and Stock Exchanges.

**Corporate Bond Market:** The corporate bond or corporate debt market is a market where debt securities of corporate such as corporate bonds, debentures etc. 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, FPIs etc.

In India, corporate bonds are issued mainly on private placement basis (around 95%) and only small part of the total issuances are through public offer. With the majority of corporate debt issuances in India being private placements, SEBI vide its circular of April 21, 2016, facilitate/mandate private placement issuance through electronic book mechanism/electronic bidding platform (EBP) for better and transparent price discovery. SEBI further streamlined the procedure through its revised guidelines in force from April 1, 2018. The EBP guidelines are applicable for debt securities and non-convertible redeemable preference shares as defined under SEBI regulations and 'Commercial paper' and/or 'Certificate of Deposits' defined under RBI guidelines issued via private placement mechanism.

Corporate Bond secondary market is mainly OTC market, where the trades are negotiated between the participants on phone or through intermediaries. The exchanges have a corporate bond reporting platform, in which all regulated entities need to report OTC corporate bond trades within stipulated time. The Exchanges in early 2020 have launched Request for Quote Platform (RFQ) for execution and settlement of trades which will allow market participants to transact in debt securities. The RFQ Platform provides market participants range of options to seek a quote and to respond to a quote, while keeping an audit trail of all the interactions i.e. quoted yield, mutually agreed price, deal terms etc. This

has brought pre trade transparency in the transactions of eligible debt securities. RFQ facilitate participant to negotiate various terms of transaction through screen based system. Corporate bonds are also traded on Stock Exchanges.

#### **1.4.4 Other Asset Classes**

**Real Estate Investment Trusts (REIT)** are trusts registered with SEBI that invest in commercial real estate assets. REIT assets” means real estate assets and any other assets held by the REIT, on a freehold or leasehold basis, whether directly or through a holding company and/or a special purpose vehicle. SEBI (Real Estate Investment Trusts) Regulations, 2014, laid down framework for REITs. The SEBI (Real Estate Investment Trusts) Regulations, 2014 specifies conditions regarding issuance and allotment of units. Few details are given below:

A REIT shall make an initial offer of its units by way of public issue only. Any subsequent issue of units by the REIT may be by way of follow-on offer, preferential allotment, qualified institutional placement, rights issue, bonus issue, offer for sale or any other mechanism and in the manner as may be specified by SEBI. The value of the assets owned or proposed to be owned by a REIT coming out with an initial offer will not be less than Rs. 500 crore and the minimum offer size will not be less than Rs.250 crore. The minimum number of unit holders other than sponsor(s), its related parties and its associates forming part of public which shall be not less than two hundred. The maximum subscription from any investor other than sponsors, its related parties and its associates shall not be more than 25 percent of total unit capital. The minimum subscription from any investor in initial and follow-on public offer shall fall in range of ten thousand rupees to fifty thousand rupees. The units will be listed on the stock exchange. The units of the REIT listed in recognized stock exchanges shall be traded, cleared and settled in accordance with the bye-laws of concerned stock exchanges and such conditions as may be specified by the SEBI. Trading lot for the purpose of trading of units of the REIT shall consist of one unit.

**Infrastructure Investment Trusts (InvIT)** are trusts registered with SEBI that invest in the infrastructure sector. SEBI (Infrastructure Investment Trusts) Regulations, 2014, laid down framework for InvITs. The SEBI (Infrastructure Investment Trusts) Regulations, 2014 specifies conditions regarding issuance and allotment of units. The InvIT can raise funds through public issue and/or through private placement. The value of InvIT assets shall not be less than Rs. 500 crore and the offer size shall be of atleast Rs. 250 crores.

If the InvIT raises funds by public issue it shall be by way of initial public offer. Any subsequent issue of units after IPO may be by way of follow-on offer, preferential allotment, qualified institutional placement, rights issue, bonus issue, offer for sale or any other mechanism and in the manner as may be specified by SEBI. The minimum subscription amount from any investor in initial and follow-on offer shall fall within the range of Rs. 10,000 to Rs. 50,000. The maximum subscription from any investor other than sponsors, its related parties and its associates shall not be more than 25 percent of total unit capital. The InvIT shall refund money in case the number of subscribers to the initial offer forming part of public is less than twenty or fails to collect subscription of at least 90% of the issue size.

In case InvIT raises fund by way private placement, then it shall be do it through placement memorandum and from institutional investor or body corporate only, whether Indian and

foreign. The minimum investment from any investor should be of rupees one crore. Notwithstanding the above, if such privately placed InvIT invests or proposes to invest not less than eighty per cent of the value of the InvIT assets, in completed and revenue generating assets, the minimum investment from an investor shall be Rs. 25 crore. The maximum subscription from any investor other than sponsors, its related parties and its associates shall not be more than 25 percent of total unit capital. The placement from not less than five and not more than one thousand investors. It shall be mandatory for units of all InvITs to be listed on a recognized stock exchange having nationwide trading terminals, whether publicly issued or privately placed. The units of the InvIT listed in the designated stock exchanges shall be traded, cleared and settled in accordance with the bye-laws of designated stock exchanges and such conditions as may be specified by the SEBI. In case of private placement, trading lot for the purpose of trading of units on the designated stock exchange shall be Rs. 1 crore. In case of public issue, trading lot for the purpose of trading of units on the designated stock exchange shall consist of one unit.

**Sovereign Gold Bond Scheme (SGB)** was launched in 2015 to provide an alternative way for investors to take exposure to gold as an investment. SGBs are government securities denominated in grams of gold. The bonds are issued in denomination of one gram of gold and in denominations thereof. The tenor of the bond is 8 years. Each bond investor buys the bonds in Indian rupees and on redemption are paid the maturity value also in Indian rupees. The units (grams) of gold bought by the investor and represented by the bonds is protected. The value of the bond will reflect the price of gold. On maturity the value of the bond may be higher or lower depending upon the prevailing price of gold. The bonds bear an interest rate (currently 2.50% per annum) on the initial investment and is paid semi-annually to the account of the bond holder. Investors can apply for the bond when the issue of each tranche is open. The bonds are available for investment by resident individuals, HUFs, Trusts, Universities, Charitable Trusts and others. The bonds can be held in physical form or in dematerialized form. The bond is tradable on stock exchanges if held in dematerialized form.

### **1.5 International Financial Services Centres (IFSC)**

An International Financial Services Centre (IFSC) caters to customers outside the jurisdiction of the domestic economy. These centres are 'international' in the sense that they deal with the flow of finance and financial products/services across borders which includes banking, insurance, asset management, and most importantly, a well-structured and fully developed capital market for debt, equities, commodities as well as derivatives. The first IFSC in India has been set up at GIFT City, Gandhinagar, Gujarat. An IFSC is thus a jurisdiction that provides world class financial services to non-residents and residents, to the extent permissible under the current regulations, in a currency other than the domestic currency (Indian rupee) of the location where the IFSC is located.

IFSC at GIFT, Gandhinagar is a deemed foreign territory dealing in foreign currency. The entities in IFSC are recognized as non-resident entity under the FEMA regulations of Reserve Bank of India and get benefits which include exemptions from security transaction tax (STT), commodity transaction tax, dividend distribution tax, capital gains waiver and no income tax.

As per the SEBI (IFSC) guidelines, 2015, the stock exchanges operating in IFSC was permitted dealing in following types of securities and products, with a specified trading lot size on their trading platform subject to prior approval of SEBI, viz.,

- Equity shares of a company incorporated outside India;
- Depository receipt(s);
- Debt securities issued by eligible issuers;
- Currency and interest rate derivatives;
- Index based derivatives;
- Commodity derivatives;
- REITs and InvITs by whatever name called in permissible jurisdictions;
- And any other securities as may be specified by SEBI.

Currently NSE and BSE both have exchanges at IFSC and offer various products for trading viz., Index derivatives, Stock Derivatives, Currency Derivatives, Commodity Derivatives and Debt Securities.

IFSCA (International Financial Services Centres Authority) has issued operating guideline to enable the Bullion Exchange, Bullion Clearing Corporation, Bullion Depository, Vault Manager in as IFSC to operationalize these activities as per IFSCA (Bullion Exchange) Regulations, 2020.

As per SEBI (International Financial Services Centres) Guidelines, 2015, only the following persons can deal in securities listed in IFSC:

- A person not resident in India;
- A non-resident Indian;
- A financial institution resident in India who is eligible under FEMA to invest funds offshore, to the extent of permitted outward investment;
- A person resident in India who is eligible under FEMA, to invest funds offshore, to the extent allowed under the Liberalized Remittance Scheme of Reserve Bank of India, subject to a minimum investment as specified by the Board from time to time.

**Sample 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.
  
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.
  
3. All Index futures contracts are cash settled. State whether True or False?  
**(a) True**  
(b) False
  
4. The entities in IFSC are recognized as non-resident entity under the FEMA regulations of Reserve Bank of India. State whether True or False?  
**(a) True**  
(b) False

## **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
- Issuer and regulations related to issuer
- 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 (i.e., Investors) to place their surplus funds in financial claims or securities at the disposal of the spenders (i.e., Issuers) 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, investors 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 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 he is the one giving surplus resources for funding to companies (for their set-up or for expansion plans) in return for financial gains. Investors in securities market (based on primary public issuance categorization) can be broadly classified into Retail Individual Investors, Institutional Investors and Non-institutional investors (NII).

**Retail Individual Investors** means an individual investor who applies or bids for specified securities for a value of not more than two lakhs rupees;



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**Institutional Investors** comprises domestic financial institutions (DFIs), banks, insurance companies, mutual funds, and Foreign Portfolio Investors (a FPI is an entity established or incorporated outside India that proposes to make investments in India) and any other entity specified by SEBI as an Institutional.

SEBI (Foreign Portfolio Investors) Regulations, 2019, specifies the categories of FPI which are as given below:

FPI Category	Type of entity
Category 1	(i) Government and Government related investors such as central banks, sovereign wealth funds, international or multilateral organizations etc.; (ii) Pension funds and university funds; (iii) Appropriately Regulated entities such as insurance or reinsurance entities, banks, asset management companies, investment managers, investment advisors, portfolio managers, broker dealers and swap dealers; (iv) Entities from the Financial Action Task Force (FATF) member countries with certain condition (v) An entity (A) whose investment manager is from the Financial Action Task Force (FATF) member country and such an investment manager is registered as a Category I foreign portfolio investor; or (B) which is at least seventy-five per cent owned, directly or indirectly by another entity, eligible under (ii), (iii) and (iv) and such an eligible entity is from a Financial Action Task Force member country:
Category 2	i) Appropriately Regulated funds not eligible as Category-I foreign portfolio investor; ii) Endowments and foundations; iii) Charitable organizations; iv) Corporate bodies; v) Family offices; vi) Individuals; vii) Regulated entities investing on behalf of their client, viii) Unregulated funds in the form of limited partnership and trusts

Non-Institutional investor means any investor other than retail individual investor and institutional investor.

### **Accredited Investors<sup>6</sup>**

The concept of a class of investors who have an understanding of various financial products and the risks- returns associated with them and therefore, are able to take informed decisions regarding their investments, is recognized by many securities and financial market regulators around the globe. These investors are typically termed as Accredited Investors or Qualified Investors or Professional Investors. SEBI has introduced concept of Accredited Investors in Indian Market. Given below some of the details of accredited investor:

- Eligibility
  - Individuals, HUFs, Family Trusts and sole proprietorships, which meet the criteria as under:
    - (i) Annual Income  $\geq$  INR 2 Crore; OR
    - (ii) Net Worth  $\geq$  INR 7.5 Crore, out of which at least INR 3.75 Crore is in the form of financial assets; OR
    - (iii) Annual Income  $\geq$  INR 1 Crore+ Net Worth  $\geq$  INR 5 Crore, out of which at least INR 2.5 Crore is in the form of financial assets;
  - Partnership Firms set up under the Indian Partnership Act, 1932 in which each partner independently meets the Accredited Investor criteria for individuals
  - Trusts (other than family trusts) Assets under Management greater than or equal to INR 50 Crore.
  - Body corporate with net worth greater than or equal to INR 50 Crore.
  - Certain agency deemed to be accredited investors for e.g. Central and State Governments, Developmental Agencies set up under Government(s), Qualified Institutional Bidders, funds set up by government etc.
- Subsidiaries of depositories and stock exchanges or any other institutions which eligibility criteria specified by SEBI will act as “Accreditation Agency” and can issue an accreditation certificate to such investors.
- Certain benefits for accredited investors
  - To participate in investment products with an investment amount lesser than the minimum amount mandated in the respective Regulations (“lower ticket size”)
  - Relaxation from regulatory requirements applicable to investment products, such as prudential norms, investment conditions, filings with SEBI, frequency of Audit/ valuation/ reporting, etc. (“regulation-light framework”)
  - To participate in investment products designed and offered exclusively to Accredited Investors.

### **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 mobilizes the savings of the small investors. Funds can be raised in the primary market from the domestic market as well as from international markets. In the domestic market, issuer can raise funds through financial

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<sup>6</sup> [https://www.sebi.gov.in/sebi\\_data/meetingfiles/jul-2021/1626434827210\\_1.pdf](https://www.sebi.gov.in/sebi_data/meetingfiles/jul-2021/1626434827210_1.pdf)

securities like equity shares, preference shares, Debentures, Bonds etc. They can raise funds through public offer and/or through private placement.

Indian companies can also raise resources from international capital markets<sup>7</sup> through Global Depository Receipts (GDRs)/American Depository Receipts (ADRs), Foreign Currency Convertible bonds (FCCBs) and External Commercial Borrowings (ECBs) including Masala Bonds. To learn more about the different international market instruments for raising capital from overseas market please see Box 2.1.

**Box 2.1: Instruments for raising capital from overseas markets**

**Global Depository Receipts (GDRs)** is a negotiable financial instrument that is issued by a foreign depository bank other than the US representing a specified number of shares of a foreign company's stock. GDR are generally traded in European Stock Exchanges.

**American Depository Receipts (ADRs)** An American depository receipt (ADR) is a negotiable certificate issued by a U.S. depository bank representing a specified number of shares of a foreign company's stock. The ADR trades on U.S. stock markets similar to any domestic shares.

**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 predetermined 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.

**Masala Bonds** are rupee-denominated bonds issued outside India by Indian entities. They are debt instruments which help to raise money in local currency from foreign investors.

Foreign companies can 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.

***Regulations for Issuers:***

To raise resources, issuers have to adhere to different SEBI regulations which have been briefly discussed here:

- SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018

SEBI (Issue of Capital and Disclosure Requirements) Regulations 2018 hereinafter referred to as ICDR Regulations lays down general conditions for capital market issuances like public and rights issuances; eligibility requirements; general obligations of the issuer and intermediaries in public and rights issuances; regulations governing preferential issues, qualified institutional placements and bonus issues by listed companies; issue of IDRs etc. ICDR Regulations also have detailed requirements laid out with respect to disclosure and

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<sup>7</sup> The 1991 reforms allowed Indian companies to raise resources by way of equity issues in the international markets.

process requirements for capital market transactions by listed and to be listed companies. While the eligibility and disclosure obligations are applicable to the Issuer, in capital market transactions, the role of the merchant banker/ lead manager/ book runner is extremely important since they are registered entities with SEBI appointed by the issuer to manage the issue and in case of book built issue the lead manager act as Book Running Lead Manager (BRLM) for the purpose of book running

- SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015

Issuer or the issuing company desirous of listing its securities on a recognized stock exchange shall execute a listing agreement with such stock exchange in terms of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015. As per the regulations, the company is required to obtain 'in-principle approval for listing from the exchanges having nationwide trading terminals where it is listed, before issuing further shares or securities. Where the company is not listed on any exchange having nationwide trading terminals, from all the stock exchange(s) in which the securities of the issuer are proposed to be listed. Where the securities are listed on recognized stock exchange(s) having nationwide trading terminals as well as on the recognized stock exchange(s) not having nationwide trading terminals, from all recognized stock exchange(s) having nationwide trading terminals. The regulation is also providing various disclosures and obligations for listed entities.

Other important regulations include SEBI (Issue and listing of debt securities) Regulations, 2008, SEBI (Issue and listing of non-convertible redeemable preference shares) Regulations, 2013, SEBI (Issue and listing of securitized debt instrument and security receipt) Regulations, 2008, Securities and Exchange Board of India (Issue and Listing of Municipal Debt Securities) Regulations, 2015, Securities and Exchange Board of India (Issue and Listing of Non-Convertible Securities) Regulations, 2021 etc.

## **2.4 Market Structure and Participants**

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 Market Infrastructure Institutions (Stock Exchange, Clearing Corporations and Depositories)**

Stock exchanges, depositories and clearing corporations are collectively referred to as securities Market Infrastructure Institutions (MIIs).

#### **Stock Exchanges**

The stock Exchanges provide a trading platform where the buyers and sellers (investors) can meet to transact in securities. Earlier 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 corporatization and demutualization under sections 4A and 4B, or* (b) *a body corporate incorporated under the Companies Act, 1956 (1 of 1956) whether under a scheme of corporatization and demutualization or otherwise, for the purpose of assisting, regulating or coordinating the business of buying, selling or dealing in securities.*

### **Clearing Corporation**

Securities Contract (Regulation) (Stock Exchange and Clearing Corporations) Regulations 2018, defines Clearing Corporation as an entity that is established to undertake the activity of clearing and settlement of trades in securities or other instruments or products that are dealt with or traded on a recognized stock exchange and includes a clearing house and a limited purpose clearing corporation (as specified under Chapter IV- A of these regulation).

A Clearing Corporation 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 Clearing Member 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 the Clearing House/ Corporation pays money or delivers securities to the Clearing Member 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.<sup>8</sup> 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.

### **Depository**

A "Depository" is an entity facilitating holding securities in electronic form and enables transfer of securities by book entry. The main objective of depository is to provide maintenance of ownership or transfer records of securities in an electronic book entry form

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<sup>8</sup>The process of delivering securities or funds by the clearing member to the clearing house/corporation to effect settlement of a sale/purchase transaction is known as pay-in.

resulting in paper-less trading rather than paper-based trading and to ensure transferability of securities with speed, accuracy and safety.

As per the Depositories Act, 1996, a “‘depository’ means a company formed and registered under the Companies Act, 1956 and which has been granted a certificate of registration under sub-section (1A) of section 12 of the Securities and Exchange Board of India Act, 1992 (15 of 1992);”

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 dematerialization of securities and assisting in trading of securities in the dematerialized 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, Banks, Financial Institutions, NBFCs, Clearing Corporation, Registrar and Transfer Agents, Custodian of Securities, State Financial Corporation and SEBI registered trading members can become DPs.

Besides providing custodial facilities and dematerialization, 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.

## **2.4.2 Market Participants**

### **2.4.2.1 Trading Member /Clearing Member**

An important constituent of the securities market is a trading member/ stock broker<sup>9</sup> who is a member of the stock exchange. A trading member is allowed to execute trades on his own account as well as on account of his clients. A trading member can be an individual (sole proprietor), a partnership firm, Limited Liability Partnership, Corporate or a bank who is a member of a Stock Exchange<sup>10</sup>. Authorized person is not a member of a Stock Exchange but is ‘Any person, individual, partnership firm, LLP or body corporate, who is appointed as such by a Stock Broker (including Trading Member) and who provides access to trading platform of a Stock Exchange as an agent of the Stock Broker’.<sup>11</sup> Clearing Members have clearing and settlement rights in any recognised clearing corporation. Clearing Member help in clearing of the trades of their clients. In India, investors cannot access the Exchange platform directly. They have to compulsorily trade through registered stock brokers/trading member of the Exchanges. Hence, stock brokers/trading members are one of the important intermediaries of securities market.

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<sup>9</sup> Stock broker" means a person having trading rights in any recognised stock exchange and includes a trading member;

<sup>10</sup> Banks are permitted to become member of the currency derivative segment of recognized stock Exchanges subject to fulfillment of minimum prudential requirements.

<sup>11</sup> <https://www.sebi.gov.in/legal/circulars/aug-2018/role-of-sub-broker-sb-vis-a-vis-authorized-person-ap-39825.html> (Discontinuation of Sub-broker category)

Based on trading and clearing rights membership can be classified as; only trading member, trading cum self-clearing member, trading cum clearing member and professional clearing member.

**Only trading member** category of membership entitles allow to execute trades on his own account as well as on account of his clients but, clearing and settlement of trades executed through the trading member would have to be done through a Trading-cum Clearing Member or Professional Clearing Member of the Exchange. Only trading member does not have clearing and settlement rights.

**Trading cum Self-clearing member:** They have trading as well clearing rights. They clear and settle trades executed by them only, either on their own account or on account of their clients but not for custodian participants.

**Trading member–cum–clearing member:** They have trading as well clearing rights. They clear and settle their own trades as well as trades of other trading members and custodial participants.

**Professional clearing member:** They have only clearing rights and do not have trading rights. They clear and settle trades executed by trading members and custodian participants. SEBI registered custodian and Banks recognized by clearing corporations are eligible to become PCM subject to fulfilling the prescribed criteria.

### **Custodians**

Custodian means any person/entity who carries on or proposes to carry on the business of providing custodial service. 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.

### **Eligibility Criteria for a Trading Member**

The membership of the each segment of the Exchange is separate from the membership of the other segments of the Exchange. As per the SEBI (Stock Brokers ) Regulations, 1992:

- The stock broker shall have such net worth and shall deposit with the stock exchange such sum as may be specified by the SEBI/ stock exchange from time to time.
- The clearing member/ self-clearing member shall have the minimum net worth and shall deposit the minimum sum specified by SEBI or a higher amount with the clearing corporation promoted by the respective stock exchange in the manner specified from time to time.
- The quantum of net worth to be maintained by the stock broker/clearing member, as specified in said regulation, shall be reckoned for all segments/stock exchanges. The quantum of deposit to be maintained by the stock broker/clearing member shall be separately calculated segment wise.

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- The quantum of net worth to be maintained by the stock broker/clearing member, shall be reckoned for all segments/stock exchanges.

As per SEBI (Stock Brokers ) Regulations, 1992, if a new entity desires to register as a stock broker or clearing member with any stock exchange or clearing corporation, as the case may be, then the entity shall apply to SEBI through the respective stock exchange or clearing corporation in the manner prescribed in the Stock Broker Regulations. The entity shall be issued one certificate of registration by SEBI, irrespective of the stock exchange(s) / clearing corporation(s) or number of segment(s). Further, as per the SEBI (Stock Brokers ) Regulations, 1992, the existing requirement of obtaining registration as stock broker/ clearing member for each stock exchange/ clearing corporation has been done away with and instead a single registration with any stock exchange/ clearing corporation shall be required. For operating in any other stock exchange(s)/ clearing corporation(s), approval will be required from the concerned stock exchange or clearing corporation.

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.

### A. Base Minimum Capital (BMC)

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.

### B. Eligibility Criteria

Eligibility criteria for membership is subject to the regulatory norms and provisions of SEBI and as provided in the Rules, Regulations, Byelaws and Circulars of the Exchanges. Securities Contracts (Regulation) Rules, 1957 has provided details of qualifications for membership of a recognized stock exchange: -

<b><i>Individual trading membership</i></b>	
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.

<b><i>Partnership Firms registered under the Indian Partnership Act, 1932</i></b>	
Where the applicant is a partnership firm, the applicant shall identify a Dominant Promoter Group as per the norms of the Exchange at the time of making the application.	



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Any change in the shareholding of the partnership firm including that of the said Dominant Promoter Group or their sharing interest shall be effected only with the prior permission of Exchange/SEBI.	
Age	Minimum Age of designate partner: 21 years
Status	Registered Partnership firm under Indian Partnership Act, 1932
Designated Partners	Identify at least two partners as designated partners who would be taking care of the day to day management of the partnership
Education	Designated Partners should be at least HSC or equivalent qualification
Designated Partners Experience	Should have a minimum of 2 years' experience in an activity related to dealing in securities or as portfolio manager or as investment consultant or as a merchant banker or in financial services or treasury, broker, authorized agent or authorized clerk or authorized representative or remisier or apprentice to a member of a recognized stock exchange, dealer, jobber, market maker, or in any other manner in dealing in securities or clearing and settlement thereof.
Dominant Promoter Norms	Identify partner's sharing interest as per Exchange DPG norms

<b>Limited Liability Partnership</b>	
<p>A Limited Liability Partnership as defined in the Limited Liability Partnership Act, 2008 (6 of 2009), shall be eligible to be admitted as a member of a Stock Exchange if, such 'limited liability partnership' undertakes to comply with such financial requirements and norms as may be specified by the Securities and Exchange Board of India for the registration of such limited liability partnerships under sub-section (1) of section 12 of the SEBI Act, 1992 (15 of 1992);</p> <p>The designated partners of the 'limited liability partnership' are not disqualified from being members of a stock exchange under sub-rule (1) of rule 8 [except sub-clauses (b) and (f) thereof] or sub-rule (3) of rule 8 [except sub-clauses (a) and (f) thereof] of the Securities Contracts (Regulation) Rules, 1957 and the designated partners of the 'limited liability partnership' had not held the offices of Directors in any company or body corporate or partner in any firm or 'limited liability partnership', which had been a member of the stock exchange and had been declared defaulter or expelled by the stock exchange.</p>	
Status	Registered Limited Liability Partnership under Limited Liability Partnership Act, 2008
Designated Partners	Identify at least two partners as designated partners who would be taking care of the day to day management of the limited liability partnership
Age	Minimum age of designated partner(s) : 21 years
Designated Partners Education	Designated Partners should be at least HSC or equivalent qualification
Designated Partners Experience	Should have a minimum of 2 years' experience in an activity related to dealing in securities or as portfolio managers or as investment consultants
Dominant Promoter Norms	Identify partner's sharing interest as per Exchange DPG norms

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<b><i>Corporations / Companies /Institutions</i></b>	
<p>A Company as defined in the Companies Act, 1956 (1 of 1956), shall be eligible to be admitted as a member of a Stock Exchange provided: such company is formed in compliance with the provisions of Section 12 of the said Act; it undertakes to comply with such other financial requirements and norms as may be specified by the Securities and Exchange Board of India for the registration of such company under sub-section (1) of section 12 of the SEBI Act, 1992 (15 of 1992);</p> <p>The directors of such company are not disqualified for being members of a stock exchange under clause (1) of rule 8 [except sub-clauses (b) and (f) thereof] or clause (3) of rule 8 [except sub-clauses (a) and (f) thereof] of the Securities Contracts (Regulation) Rules, 1957 and the directors of the company had not held the offices of the directors in any company which had been a member of the stock exchange and had been declared defaulter or expelled by the stock exchange</p>	
Status	Corporate registered under The Companies Act, 1956 (Indian)
Minimum Paid up Equity Capital	As specified from time to time (Currently 30 lakhs)
Designated Directors	Identification of at least two directors as designated directors who would be managing the day to day trading operations
Age	Minimum age of designated director(s) : 21 years
Education	Each of the Designated Directors should be at least HSC or equivalent qualification
Designated Directors Experience	Should have a minimum of 2 years' experience in an activity related to dealing in securities or as portfolio manager or as investment consultant or as a merchant banker or in financial services or treasury, broker, authorised agent or authorised clerk or authorised representative or remisier or apprentice to a member of a recognised stock exchange, dealer, jobber, market maker, or in any other manner in dealing in securities or clearing and settlement thereof.
Dominant Promoter Norms	Identify dominant group as per Exchange DPG norms

**C. Other Criteria:**

At any point of time the applicant has to ensure that either the proprietor/one designated director/partner or the Compliance Officer of the applicant entity should be meeting the certification requirements as specified by SEBI or the Stock Exchanges. The certification requirements mandated by SEBI or by the exchanges make the members eligible for continued admittance norm for membership of the Exchange. Further, member should satisfy the minimum net worth and deposit requirement as specified by SEBI/Exchanges/Clearing Corporation from time to time.

The Exchange may also specify such standards for investor service and infrastructure with regards to any category of applicants as it may deem necessary, from time to time.

**Who is not eligible to become a Member:**

Further to the capital and net worth requirements, no entity shall be admitted as a member/partner or director of the member if:

- it has been adjudged bankrupt or a receiver order in bankruptcy has been made against him or he has been proved to be insolvent even though he has obtained his final discharge;
- it has compounded with his creditors for less than full discharge of debts;
- it has been convicted of an offence involving a fraud or dishonesty;
- it is engaged as a principal or employee in any business other than that of Securities, except as a broker or agent not involving any personal financial liability or for providing merchant banking, underwriting or corporate or investment advisory services, unless he undertakes to sever its connections with such business on admission, if admitted;
- it has been at any time expelled or declared a defaulter by any other Stock Exchange or he has been debarred from trading in securities by a Regulatory Authorities like SEBI, RBI etc.;
- it incurs such disqualification under the provisions of the Securities Contract (Regulations) Act, 1956 or Rules made there-under so as to disentitle such persons from seeking membership of a stock exchange;
- it incurs such disqualification consequent to which Exchange determines it to be not in public interest to admit him as a member on the Exchange, provided that in case of registered firms, body corporates and companies, the condition from (will apply to, all partners in case of partnership firms, all directors in case of companies); Exchange may from time to time modify / expand the scope of activities that could be considered as relevant experience for the above purpose.

**Fit and Proper Person<sup>12</sup>**

For the purpose of determining whether an applicant or the stock broker, Authorized Persons trading member and clearing member is a fit and proper person, the SEBI Board may take into account of any consideration as it deems fit including but not limited to the following criteria in relation to the applicant or the intermediary, the principal officer [the director, the promoter] and the key management persons by whatever name called:

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

**Authorized Person:**

Authorized person is not a member of a Stock Exchange but is 'Any person, individual, partnership firm, LLP or body corporate, who is appointed as such by a Stock Broker (including Trading Member) and who provides access to trading platform of a Stock

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<sup>12</sup> Schedule II, SEBI (Intermediaries) Regulations, 2008.

Exchange as an agent of the Stock Broker'. Trading members are entitled to appoint authorized person to operate the trading workstations of various segment, with the approval of the exchange. The trading member has to obtain specific prior approval for each such person, and it is segment specific. Authorized Person (AP) should satisfy the criteria as specified by SEBI/stock exchanges from time to time. The AP should have the necessary infrastructure like adequate office space, equipment and manpower to effectively discharge the activities on behalf of the stock broker.

#### **2.4.2.2 Custodian**

Custodian means any person who carries on or proposes to carry on the business of providing custodial service. To provide custodian services entity has registered with SEBI and obtain certificate to carry custodian services. 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.
- Maintaining and reconciling records of the above services

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 corporate 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 and the commodity derivatives 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.
- International Financial Services Centres Authority (IFSCA) is a unified authority for the development and regulation of financial products, financial services and financial institutions in the IFSC in India.
- Ministry of Finance (MOF)
- Ministry of Corporate Affairs (MCA)

We would be discussing about the role of SEBI as it is the regulatory authority for the securities market in India.

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, Authorized Persons 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, from time to time SEBI issues rules, regulations, guidelines, circulars etc. The details of the same is available on SEBI website. Given below details of few Regulations/Acts which are also of high importance in the regulation of Indian Securities Markets:

- Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2018
- SEBI (Stock Brokers) Regulations, 1992
- SEBI (Prevention of Insider Trading) Regulations, 2015
- The Prevention of Money laundering Act, 2002
- SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to the Securities Market) Regulations 2003
- SEBI (Custodians) Regulations, 1996
- SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011
- SEBI {KYC(Know Your Client) Registration Agency} Regulations, 2011
- SEBI (Intermediaries) Regulations, 2008
- SEBI (Depositories & Participants) Regulations, 2018.

### **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 to penalize 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. The orders of SEBI under the securities laws are appealable before a Securities Appellate Tribunal (SAT).

### **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 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 indicated clearly in this Act.

**Companies Act, 2013**

The Companies Act, 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.

Section 24 of the Companies Act 2013, delegates the power to regulate and transfer securities to SEBI. The provision contained in chapter VI, section 127 and section 24 shall,-

- (a) In so far as they relate to – (i) issue and transfer of securities; and (ii) non-payment of dividend; by listed companies or those companies which intend to get their securities listed on any recognized stock exchange in India, except as provided under this Act, be administered by the SEBI by making regulations in this behalf.
- (b) in any other case, be administered by the Central Government.

**Securities Contract (Regulation) Rules, 1957**

Central Government has made this rules in exercise of the powers conferred by section 30 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956). The Securities Contract (Regulation) Rules, 1957 (SCRR 1957) provide guidelines on application and recognition of stock exchanges, qualifications for membership on a recognised stock exchange, Books of account and other documents to be maintained and preserved by every recognised stock exchange and stock brokers, requirements with respect to the listing of securities, units or any other instrument of a Collective Investment Scheme on a recognised stock exchange.

**Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2018**

The Securities Contract (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2018 (SECC Regulations) were notified on October 03, 2018. These regulations provide for procedural norms on recognition, net worth, ownership and governance for stock exchanges, and clearing corporations. These regulations provide for modalities for monitoring shareholding limits and compliance with ‘fit and proper’ criteria for all shareholders. SECC Regulations mandates that the compensation policy for key management personnel of stock exchange/ clearing corporation to be in accordance with the norms specified by SEBI. These regulations also enlist the mechanism for listing of stock exchanges. The SECC Regulations mandate segregation of regulatory departments in stock exchange from other departments. These regulations are required to be read in conjunction with the SCRA 1956, SCRR 1957, and other applicable laws.

**SEBI (Stock Broker) Regulation, 1992**

The SEBI (Stock Brokers) Regulation, 1992 lays down the rules and regulation for registration of Stock Brokers including deposit and net worth criteria. 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 holding certificate of membership. The schedule II, regulation 7 of the SEBI (Stock Broker) regulation provided code of conduct for stock broker. It 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 to maintain the different books of accounts, records and documents. These have been discussed in the chapter 3, under section 3.4.4. Some code of conduct to be adhered to by stock-brokers are given in Annexure 1.

### **Prevention of Money Laundering Act, 2002**

In the PMLA, 2002, money laundering has been defined as “any process or activity connected with proceeds of crime including its concealment, possession, acquisition or use and projecting or claiming it as untainted property”.

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.

(i) a person shall be guilty of offence of money-laundering if such person is found to have directly or indirectly attempted to indulge or knowingly assisted or knowingly is a party or is actually involved in one or more of the following processes or activities connected with proceeds of crime, namely (a) concealment; or (b) possession; or (c) acquisition; or (d) use; or (e) projecting as untainted property; or (f) claiming as untainted property, in any manner whatsoever.

(ii) the process or activity connected with proceeds of crime is a continuing activity and continues till such time a person is directly or indirectly enjoying the proceeds of crime by its concealment or possession or acquisition or use or projecting it as untainted property or claiming it as untainted property in any manner whatsoever.

**Section 4** of the PMLA describe the punishment for money laundering. Whoever commits the offence of money-laundering shall be punishable with Rigorous imprisonment of 3 to 7 years and shall also be liable to fine.

**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 this 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 the Act stipulates that every reporting entity (i.e., a banking company, financial institution, intermediary or a person carrying on a designated business or profession) shall—  
(a) Maintain a record of all transactions, including information relating to transactions in such manner as to enable it to reconstruct individual transactions. The records shall be maintained for a period of five years from the date of transaction between a client and the reporting entity.

(b) Furnish to the Director within such time as may be prescribed, information relating to such transactions, whether attempted or executed, the nature and value of which may be prescribed;<sup>13</sup>

(c) Maintain record of documents evidencing identity of its clients and beneficial owners as well as account files and business correspondence relating to its clients. The records shall be maintained for a period of five years after the business relationship between a client and the reporting entity has ended or the account has been closed, whichever is later.

(d) Every information maintained, furnished or verified, save as otherwise provided under any law for the time being in force, shall be kept confidential.

The Central Government may, by notification, exempt any reporting entity or class of reporting entities from any obligation.

**Section 12 AA of PMLA** stipulates enhanced due diligence by reporting entities.

1. Every reporting entity shall, prior to the commencement of each specified transaction,—

(a) verify the identity of the clients undertaking such specified transaction by authentication under the Aadhaar (Targeted Delivery of Financial and Other Subsidies, Benefits and

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<sup>13</sup> Director means a Director or Additional Director or Joint Director, as the case may be, appointed under sub-section (1) of section 49 (Appointment and powers of authorities and other officers)

Services) Act, 2016 (18 of 2016) in such manner and subject to such conditions, as may be prescribed, provided that where verification requires authentication of a person who is not entitled to obtain an Aadhaar number under the provisions of the said Act, verification to authenticate the identity of the client undertaking such specified transaction shall be carried out by such other process or mode, as may be prescribed.

(b) take additional steps to examine the ownership and financial position, including sources of funds of the client, in such manner as may be prescribed.

(c) take additional steps as may be prescribed to record the purpose behind conducting the specified transaction and the intended nature of the relationship between the transaction parties.

The information obtained while applying the enhanced due diligence measures shall be maintained for a period of five years from the date of transaction between a client and the reporting entity.

(2) Where the client fails to fulfil the above conditions, the reporting entity shall not allow the specified transaction to be carried out. Specified transaction means:

- any withdrawal or deposit in cash, exceeding such amount.
- any transaction in foreign exchange, exceeding such amount.
- any transaction in any high value imports or remittances.
- such other transaction or class of transactions, in the interest of revenue or where there is a high risk of money-laundering or terrorist financing, as may be prescribed.

(3) Where any specified transaction or series of specified transactions undertaken by a client is considered suspicious or likely to involve proceeds of crime, the reporting entity shall increase the future monitoring of the business relationship with the client, including greater scrutiny or transactions in such manner as may be prescribed.

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

**Section 24** makes it clear that in the case of person charges with the offense of money laundering under section 3, the Authority or court shall, unless the contrary is proved, presume that such proceeds of crime are involved in money-laundering. Hence, 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 Appellate Tribunal .

**Section 41 & 42** deals with appeals to high court against any decision or order of the Appellate Tribunal within stipulated time.

**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.

**SEBI Guidelines on Anti-Money Laundering**

SEBI has laid down guidelines/master circulars on Anti-Money Laundering (AML) Standards and Combating the Financing of Terrorism (CFT) /Obligations of Securities Market Intermediaries under the PMLA 2002 and Rules framed for all the intermediaries registered with SEBI.

These guidelines have been divided into two parts; the first part is an overview on the background and essential principles that concern combating Money Laundering (ML) and Terrorist Financing (TF). They also provide guidance on the practical implications of the Prevention of Money Laundering Act, 2002 (PMLA). The Directives also set out the steps that a registered intermediary or its representatives shall implement to discourage and to identify any money laundering or terrorist financing activities. The second part provides a detailed account of the procedures and obligations to be followed by all registered intermediaries to ensure compliance with AML/CFT directives. These guidelines are also applicable for registered intermediaries' branches and subsidiaries located abroad, especially, in countries which do not or insufficiently apply the FATF Recommendations, to the extent local laws and regulations permit. When local applicable laws and regulations prohibit implementation of these requirements, the same shall be brought to the notice of SEBI. The detailed guidelines can be referred to on SEBI website.<sup>14</sup>

Every individual who wishes to invest in securities markets has to be KYC compliant. An individual has to provide personal details such as name, address, financial status, occupation and other personal information in the prescribed KYC form. Along with the same, individual investors are required to produce proof of identity and proof of address, as prescribed, in the form. Non-individual investors are required to produce documents relating to its constitution/ registration to fulfil the KYC process.

SEBI master circular has advised member to categorized client as Low Risk, Medium Risk and High Risk based on the due diligence or KYC documents. By classifying the clients under various risk categories, effective monitoring and due diligence can be applied to thwart any illegal/unlawful transactions. The risk category of the client is based on several parameters such as location of client, nature of business activity, volume and value of turnover, nature of transaction, manner of payments, etc.

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<sup>14</sup>[https://www.sebi.gov.in/legal/master-circulars/oct-2019/guidelines-on-anti-money-laundering-aml-standards-and-combating-the-financing-of-terrorism-cft-obligations-of-securities-market-intermediaries-under-the-prevention-of-money-laundering-act-2002-a-\\_44657.html](https://www.sebi.gov.in/legal/master-circulars/oct-2019/guidelines-on-anti-money-laundering-aml-standards-and-combating-the-financing-of-terrorism-cft-obligations-of-securities-market-intermediaries-under-the-prevention-of-money-laundering-act-2002-a-_44657.html)

**SEBI (Prohibition of Insider Trading) Regulations, 2015**

Insider Trading essentially denotes dealing in a company's securities on the basis of confidential information relating to the company which is not published or not known to the public (known as unpublished price sensitive information), used to make profits or avoid loss.

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 with effect from 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, proposed to be 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 (regulation 2(d)); or
- ii) in possession of or having access to unpublished price sensitive information;

*NOTE: Since "generally available information" is defined, it is intended that anyone in possession of or having access to unpublished price sensitive information should be considered an "insider" regardless of how one came in possession of or had access to such information. Various circumstances are provided for such a person to demonstrate that he has not indulged in insider trading. Therefore, this definition is intended to bring within its reach any person who is in receipt of or has access to unpublished price sensitive information. The onus of showing that a certain person was in possession of or had access to unpublished price sensitive information at the time of trading would, therefore, be on the person leveling the charge after which the person who has traded when in possession of or having access to unpublished price sensitive information may demonstrate that he was not in such possession or that he has not traded or he could not access or that his trading when in possession of such information was squarely covered by the exonerating circumstances.*

As per regulation, "Connected Person" includes any person who is or has during the six months prior to the concerned act, been associated with the company, directly or indirectly, in any capacity including by reason of frequent communication with its officers or by being in any contractual, fiduciary or employment relationship or by being a director, officer or an employee of the company or holds any position including a professional or business relationship between himself and the company whether temporary or permanent, that allows such person, directly or indirectly, access to unpublished price sensitive information or is reasonably expected to allow such access.

The person falling within the following categories shall be deemed to be connected person unless the contrary is established.

- 1) An immediate relative or connected person.
- 2) A holding company or associate company or subsidiary company.
- 3) An intermediary as specified in Section 12 of SEBI Act or an employee or director thereof.
- 4) An investment company, trustee company, assets management company, or an employee or director thereof.
- 5) An official of a stock exchange or a clearinghouse or corporation.
- 6) A member of the board of trustees of a mutual fund or a member of the board thereof.
- 7) A member of the board of directors or an employee of a public financial institution as defined in Section 2(72) of the Companies Act, 2013.
- 8) An official or an employee of a self-regulatory organization recognised or authorised by the SEBI.
- 9) A banker of the company
- 10). A concern, firm, Hindu undivided family, company, or an association of persons wherein a director of the company or his immediate relative or banker of the company, has more than ten percent of the holding of interest.

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;

*NOTE: It is intended that information relating to a company or securities, that is not generally available would be unpublished price sensitive information if it is likely to materially affect the price upon coming into the public domain. The types of matters that would ordinarily give rise to unpublished price sensitive information have been listed above to give illustrative guidance of unpublished price sensitive information.*

Chapter II of regulation describe restriction on communication and trading by Insiders and Chapter III specifies disclosure of trading by Insiders.

**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.

As per Regulation 2(1) (c) “fraud” includes any act, expression, omission or concealment committed whether in a deceitful manner or not by a person or by any other person with his connivance or by his agent while dealing in securities in order to induce another person

or his agent to deal in securities, whether or not there is any wrongful gain or avoidance of any loss, and shall also include—

- (1) a knowing misrepresentation of the truth or concealment of material fact in order that another person may act to his detriment;
- (2) a suggestion as to a fact which is not true by one who does not believe it to be true;
- (3) an active concealment of a fact by a person having knowledge or belief of the fact;
- (4) a promise made without any intention of performing it;
- (5) a representation made in a reckless and careless manner whether it be true or false;
- (6) any such act or omission as any other law specifically declares to be fraudulent,
- (7) deceptive behavior by a person depriving another of informed consent or full participation,
- (8) a false statement made without reasonable ground for believing it to be true.
- (9) the act of an issuer of securities giving out misinformation that affects the market price of the security, resulting in investors being effectively misled even though they did not rely on the statement itself or anything derived from it other than the market price.

Section 3 describes prohibition of certain dealing in securities. No person shall directly or indirectly—

- (a) buy, sell or otherwise deal in securities in a fraudulent manner;
- (b) use or employ, in connection with issue, purchase or sale of any security listed or proposed to be listed in a recognized stock exchange, any manipulative or deceptive device or contrivance in contravention of the provisions of the Act or the rules or the regulations made there under;
- (c) employ any device, scheme or artifice to defraud in connection with dealing in or issue of securities which are listed or proposed to be listed on a recognized stock exchange;
- (d) engage in any act, practice, course of business which operates or would operate as fraud or deceit upon any person in connection with any dealing in or issue of securities which are listed or proposed to be listed on a recognized stock exchange in contravention of the provisions of the Act or the rules and the regulations made there under.

Section 4 describes prohibition of manipulative, fraudulent and unfair trade practices. No person shall indulge in a manipulative, fraudulent or an unfair trade practice in securities markets.<sup>15</sup>

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

- a) Knowingly indulging in an act which creates a false or misleading appearance of trading in the securities market.

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<sup>15</sup> Any act of diversion, misutilisation or siphoning off of assets or earnings of a company whose securities are listed or any concealment of such act or any device, scheme or artifice to manipulate the books of accounts or financial statement of such a company that would directly or indirectly manipulate the price of securities of that company shall be and shall always be deemed to have been considered as manipulative, fraudulent and an unfair trade practice 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) inducing any person to subscribe to an issue of the securities for fraudulently securing the minimum subscription to such issue of securities, by advancing or agreeing to advance any money to any other person or through any other means.
- d) inducing any person for dealing in any securities for artificially inflating, depressing, maintaining or causing fluctuation in the price of securities through any means including by paying, offering or agreeing to pay or offer any money or money's worth, directly or indirectly, to any person.
- e) Any act or omission amounting to manipulation of the price of a security including influencing or manipulating the reference price or bench mark price of any securities".
- f) Knowingly publishing or causing to publish or reporting or causing to report by a person dealing in securities any information relating to securities, including financial results, financial statements, mergers and acquisitions, regulatory approvals, 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, counterfeit or fraudulently issued securities whether in physical or dematerialized form: Provided that if: (i) the person selling, dealing in or pledging stolen, counterfeit or fraudulently issued securities was a holder in due course; or (ii) the stolen, counterfeit or fraudulently issued securities were previously traded on the market through a bonafide transaction, (iii) such selling, dealing or pledging of stolen, counterfeit or fraudulently issued securities shall not be considered as a manipulative, fraudulent, or unfair trade practice.
- i) Disseminating information or advice through any media, whether physical or digital, which the disseminator knows to be false or misleading and which is designed or likely to influence the decision of investors dealing in securities.
- j) A market participant entering transactions on behalf of client without the knowledge of or instructions from client or mis-utilizing or diverting the funds or securities of the client held in fiduciary capacity.
- k) Circular transactions in respect of a security entered into between "persons including intermediaries to artificially provide a false appearance of trading in such security or to inflate, depress or cause fluctuations in the price of such security.
- l) Fraudulent inducement of any person by a market participant to deal in securities with the objective of enhancing his brokerage or commission or income.
- m) An intermediary predating or otherwise falsifying records including contract notes, client instructions, balance of securities statement, client account statements.
- n) Any order in securities placed by a person, while directly or indirectly in possession of information that is not publicly available, regarding a substantial impending transaction in that securities, its underlying securities or its derivative.
- o) Knowingly Planting false or misleading news or information which may induce sale or purchase of securities



- p) Mis-selling<sup>16</sup> of securities or services relating to securities market.
- q) 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' means usage of non-public information to directly or indirectly, buy or sell securities or enter into options or futures contracts, in advance of a substantial order, on an impending transaction, in the same or related securities or futures or options contracts, in anticipation that when the information becomes public; the price of such securities or contracts may change." 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 is 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. Under the SEBI Act, any person who indulges in fraudulent and unfair trade practices shall be liable with penalty. In addition to this, SEBI has the ability to initiate parallel civil enforcement proceedings on the same set of facts.

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<sup>16</sup> Mis-selling" means sale of securities or services relating to securities market by any person, directly or indirectly, by (i) knowingly making a false or misleading statement, or (ii) knowingly concealing or omitting material facts, or (iii) knowingly concealing the associated risk, or (iv) not taking reasonable care to ensure suitability of the securities or service to the buyer.

**Box 2: Illegal Trading in Securities (Dabba Trading) and Consequences thereof <sup>17</sup>**

As per SCRA 1956, trading in the shares of companies between persons other than members of a recognized stock exchange is illegal. Members of stock exchange are required to get certificate of registration as “Stock Broker” from the SEBI for buying, selling or dealing in the securities. However, certain un-registered persons carry out trades in securities outside the stock exchange mechanism which are illegal trades and are referred to as “Dabba Trading”.

Dabba trading is carried out by person not registered with SEBI wherein one person or group of persons carry out trading in securities by using price/quotes of securities available from the stock exchange trading platform / internet/tv screen etc. The details of such dealings are **noted** down in separately maintained **book** which may be either in physical or electronic form. In order to avoid audit trail, settlement of transaction is largely done by receiving /paying the difference on account of price movements of securities and without receipt/delivery of securities. Payment/receipt of funds in dabba trades is done using cash i.e., without using the banking system.

*Consequences of Illegal Trading (Dabba Trading)*

In such illegal trading, investors are subjected to credit risk as there is a possibility of persons who has carried out illegal (dabba) trading defaulting in making payment to the investors or that person becoming an insolvent/bankrupt. In such situations, the investors would not have access to the official complaints redressal/arbitration mechanism as is available to investors who have dealt through a SEBI registered stock broker of a recognized stock exchange.

These kind of trades are carried out in cash and hence encourages growth of the “Black Money”; Perpetuates parallel economy, money laundering and criminal activities; leads to tax evasion incurring loss to the exchequer; no guarantee for settlement of transactions and circumvents regulatory environment.

Anybody indulging in dabba trading violates the following provisions of SCRA 1956:

- Section 13: Contracts in securities otherwise than between members of a recognised stock exchange in a notified area are prohibited by this section. Application of section 13 to a particular state or area is done by Central Government through notification in the Official Gazette.
- Section 16: All contracts in securities except spot delivery contracts and contracts permissible under SCRA and the rules, bye-laws and regulations of a recognised stock exchange are illegal.
- Section 17: This section prohibits the business of dealing in securities except with a license granted by SEBI.
- Section 18A: It provides that contracts in derivatives shall be legal and valid only if such contract are traded on a recognised stock exchange and settled on the clearing house of the recognised stock exchange in accordance with the rules and bye laws of such stock exchange.

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<sup>17</sup> F. No. 7/10/SM/2009: Guidance Note on Illegal Trading in Securities (Dabba Trading), issued by Ministry of Finance, Department of Economic Affairs, Capital Market Division, Secondary Markets.

- Section 19: It specifically prohibits organising or assistance in organising or being a member of any stock exchange, other than recognised stock exchange, for the purpose of assisting in, entering into or performing any contract.

**Punishment under securities law:**

In terms of sections 23(1) of SCRA, any entity/person who contravenes sections 13, 16, 17 or 19 of the SCRA shall be prosecuted and on conviction, he shall be punishable with imprisonment for a term which may extend to ten years or with fine up to Rs. 25 crores or with both. As per section 25 of the SCRA, offences punishable under section 23 are cognizable offences within the meaning of Code of Criminal Procedure, 1973 and as such can be investigated by state law enforcement authorities also. Further section 26 of SCRA permits lodging of complaints of violation of the Act by the state authorities.

In addition to being violative of the securities law, illegal trading (dabba trading) also falls within the purview of section 406, 420 and section 130-B of the Indian Penal Code, 1870.

**SEBI (Custodian) Regulation, 1996**

Custodian means any person who carries on or proposes to carry on the business of providing custodial service. 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.
- Maintaining and reconciling records of the above services.

The SEBI (Custodian) Regulation 1996, states that to provide custodian services entity has to be registered with SEBI and obtain certificate to carry custodian services. 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 and fulfill other eligibility criteria. For determining whether custodian is a fit and proper person the SEBI may take into account the criteria specified in Schedule II of the SEBI (Intermediaries) Regulations, 2008.

Chapter III of regulation describes general obligation and responsibilities of custodians. Every custodian shall abide by the Code of Conduct as set out in the Third Schedule of this regulation. Every custodian shall have adequate mechanisms for the purposes of reviewing, monitoring and evaluating the custodian's controls, systems, procedures and safeguards. The activities relating to his business as custodian shall be separate and segregated from all other activities. Further, its officers and employees engaged in providing custodial services shall not be engaged in any other activity carried on by him. 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 shall open a separate custody account for each client, in the name of the client whose securities are in its custody and the assets of one client shall not be mixed with those of another 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. Every custodian shall have appropriate safekeeping measures to ensure that such securities goods, assets or documents are protected from theft and natural hazards.

### **SEBI {KYC (Know Your Client) Registration Agency} Regulations, 2011**

In 2011 SEBI introduced the concept of KYC Registration Agency with a view to eliminate duplication of KYC process to be executed by the investors and have uniform KYC process across SEBI registered intermediaries. The regulation provides details about criteria, procedure for registration of KRAs. It also lists down the functions and obligations for the KRAs and Intermediary<sup>18</sup>. All members have to be registered with any one or more KRAs registered by SEBI as per the SEBI KRA Regulations 2011. The details of functions and obligations for intermediary is given below:

(a) The intermediary shall perform the initial KYC/due diligence of the client, upload the KYC information with proper authentication on the system of the KRA, furnish the scanned images of the KYC documents to the KRA, and retain the physical KYC documents. However, this differs in case of clients of Mutual Funds, where the RTA appointed by the AMC performs the initial KYC/due diligence of the client, upload the KYC information with proper authentication on the system of the KRA, and furnish the scanned images of KYC documents to the KRA. The intermediary or the mutual fund, as the case may be, shall furnish the physical KYC documents or authenticated copies thereof to the KRA, whenever so desired by the KRA.

(b) When the client approaches another intermediary subsequently, the intermediary shall verify and download the client's details from the system of KRA. Provided that upon receipt of information on change in KYC details and status of the clients by the intermediary or when it comes to the knowledge of the intermediary, at any stage, the intermediary shall be responsible for uploading the updated information on the system of KRA and retaining the physical documents.

(c) An intermediary shall not use the KYC data of a client obtained from the KRA for purposes other than it is meant for; nor shall it make any commercial gain by sharing the same with any third party including its affiliates or associates.

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<sup>18</sup> Intermediary means an entity associated with securities market and registered under sub-section (1A), (1B) and (1) of Section 12 of the SEBI Act, 1992; who is required to do KYC of its clients.

(d) The Member shall have the ultimate responsibility for the KYC of its clients, by undertaking enhanced KYC measures commensurate with the risk profile of its clients. The member shall, at all times, have adequate internal controls to ensure the security and authenticity of data uploaded

#### **SEBI (Intermediaries) Regulations, 2008**

“Intermediary” means a person mentioned in clauses (b) and (ba) of sub-section (2) of section 11 and sub-section (1) and (1A) of section 12 of the SEBI Act, 1992 and includes an asset management company in relation to the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, a clearing member of a clearing corporation or clearing house, foreign portfolio investors and a trading member of a derivative segment or currency derivatives segment of a stock exchange but does not include foreign venture capital investor, mutual fund, collective investment scheme and venture capital fund;

This regulation provide details on Registration of Intermediaries, General obligation of intermediaries including redressal of investor grievance, appointment of compliance officer, investment advice, code of conduct, Inspection and disciplinary proceedings etc.

#### **SEBI (Depositories and Participants) Regulations, 2018**

This regulation provide details on registration, ownership and governance of depositories and depositories participants. It provides rights and obligation of depositories and depositories participants, procedure of creating pledge and hypothecation listing of security, surrender of security etc.

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**Sample Questions**

1. “Entering into a transaction in securities without the intention to perform it or without the intention to change the ownership of such securities” is an example of \_\_\_\_\_.  
(a) Insider Trading  
**(b) Fraudulent and Unfair Trade**  
(c) Money Laundering
  
2. Professional Clearing Members does not have any trading rights? State Whether True or False?  
**(a) True**  
(b) False
  
3. Providing financial guarantee for all transactions executed on the Exchange, is known as \_\_\_\_\_.  
**(a) Novation**  
(b) Insurance  
(c) Indemnification  
(d) Coverage
  
4. The records under PMLA shall be maintained for a period of \_\_\_\_ years from the date of transaction between a client and the reporting entity.  
**(a) Five**  
(b) Seven  
(c) Three  
(d) Ten

## **Chapter 3: Introduction to Securities Broking Operations**

### **LEARNING OBJECTIVES**

After studying this chapter, you should know about:

- Concept of securities 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

### **3.1 Introduction to the Securities 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 placed on the stock market has a cycle which can be broken down into pre-trade and post-trade events. Trading of securities involves multiple participants like the investors, brokers, Exchanges, Clearing agency/corporation, Clearing banks, Depository Participants, Custodians etc.

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

1. Placing of an Order by the investor / client / broker
2. Risk management and routing of order through the trading platform
3. Matching of order and its conversion into trade
4. Confirmation of trades
5. Clearing and Settlement of trades

The above mentioned steps in a trade ‘s life cycle can easily be categorized into front office, middle office and back office operations of broking firms wherein the placing of an order by the investor / client / broker, matching of order and its conversion into trade and routing of order through the trading platform are generally the front office functions; Risk management is the middle office function; Confirmation of trades and Clearing and Settlement of trades 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 typical trade life cycle for cash/equity segment.

**Figure 3.1: A Typical Securities Trade Life Cycle**



### **3.1.1 Placing of order**

#### **3.1.1.1 Trader Workstation**

The trader workstation (TWS) is the terminal from which the member accesses the trading system of Exchange. From TWS member entered order into the Exchange trading system. Exchange provides own trading platforms to its member. Each trader has a unique identification by way of Trading Member ID and User ID through which they are able to log on to the system for trading or inquiry purposes.

TWS provides mainly two kinds of information which are:

Trading member's own transaction Information:

- Order entered
- Order Modified
- Outstanding Order
- Order Log
- Trade details

Market Information:

- Order book
- Securities / contract price information
- Securities / contract trade information
- Additional information

Exchanges have allowed members to develop their customized trading workstation as per their requirements and connect to Exchange trading system. Under this facility, the Exchanges has made available product such as Computer to Computer Link (CTCL) / Internet based trading (IBT) / Direct Market Access (DMA) / Security trading thought wireless technology facility (STWT) / Automated / Algorithm Trading (ALGO) / Smart order router



(SOR) to the Trading Members. Trading member can connect to the system by various mode such as lease line, VSAT, co-location<sup>19</sup> etc.

#### **3.1.1.2 Placing of client orders**

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), Securities trading using wireless technology facility (STWT)/ Automated /Algorithm Trading (ALGO)/ Smart order router (SOR) etc. To strengthen the regulatory provisions against un-authorized trades and to harmonise the requirements across equity & derivative market, all brokers shall execute trades of clients only after keeping evidence of the client placing such order, it could be, inter alia, in the form of: (a) Physical record written & signed by client, (b) Telephone recording, (c) Email from authorized email id, (d) Log for internet transactions, (e) Record of SMS messages, (f) Any other legally verifiable record.

SEBI further instructed that wherever the order instructions were received from clients through the telephone, the stock broker shall mandatorily use telephone recording system to record the instructions and maintain telephone recordings as part of its records.<sup>20</sup>

Internet trading can take place through order routing systems, which will route client orders to exchange trading systems for execution. Thus, a client sitting in any part of the country would be able to trade using the Internet as a medium through brokers' Internet trading systems. SEBI-registered brokers can introduce internet based trading after obtaining permission from respective Stock Exchanges. SEBI has stipulated the minimum conditions to be fulfilled by trading members to start internet based trading and services.

Direct Market Access (DMA) is a facility which allows brokers to offer clients direct access to the exchange trading system through the broker's infrastructure without manual intervention by the broker. Some of the advantages offered by DMA are direct control of clients over orders, faster execution of client orders, reduced risk of errors associated with manual order entry, greater transparency, increased liquidity, lower impact costs for large orders, better audit trails and better use of hedging and arbitrage opportunities through the use of decision support tools / algorithms for trading. SEBI in 2008, introduced Direct Market Access (DMA) and permitted institutional investors to use DMA facility. The facility of the DMA provided by the stock broker shall be used by the client or an investment manager of the client. A SEBI registered entity is permitted to act as an investment manager on behalf of institutional clients. In case the facility of DMA is used by the client through an investment manager, the investment manager is required to execute the necessary documents on behalf of the client(s). Exchange can also specify

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<sup>19</sup> The facility of co-location or proximity hosting (or by whatever name called) is offered by the stock exchanges to stock brokers and data vendors whereby their trading or data-vending systems are allowed to be located within or at close proximity to the premises of the stock exchanges, and are allowed to connect to the trading platform of stock exchanges through direct and private network

<sup>20</sup> SEBI Circular Ref No.: SEBI/HO/MIRSD/DOP1/CIR/P/2018/54 Dated March 22, 2018.

the categories of investors to whom the DMA facility can be extended. SEBI-registered brokers can introduce DMA facility to their clients after obtaining permission from respective Stock Exchanges. Brokers must specifically authorize clients or investment managers acting on behalf of clients for providing DMA facility, after fulfilling KYC requirements, documentation and carrying out necessary due diligence, records of which should be properly maintained.

Another feature which has been introduced in the Indian securities market is **Algorithmic Trading and High Frequency Trading**. Algorithmic Trading – Any order that is generated using automated execution logic shall be known as algorithmic trading<sup>21</sup>. Automated Trading” shall mean and include any software or facility by the use of which, upon the fulfillment of certain specified parameters, without the necessity of manual entry of orders, buy/sell orders are automatically generated and pushed into the trading system of the Exchange for the purpose of matching.

SEBI has advised the stock exchanges to ensure that all algorithmic orders are necessarily routed through broker servers located in India and the stock exchange has appropriate risk controls mechanism to address the risk emanating from algorithmic orders and trades. The minimum order-level risk controls shall include price check, quantity limit check, order value check etc. Stock exchange shall ensure that the stock broker shall provide the facility of algorithmic trading only upon the prior permission of the stock exchange. SEBI also advised stock exchanges to ensure fair and equitable access to their co-location facility. The stock broker, desirous of placing orders generated using algos, shall satisfy the stock exchange with regard to the implementation of the minimum levels of risk controls at its end as specified by SEBI and Exchanges from time to time. The stock brokers that provide the facility of algorithmic trading shall subject their algorithmic trading system to a system audit every six months in order to ensure that the requirements prescribed by SEBI / stock exchanges with regard to algorithmic trading are effectively implemented.<sup>22</sup>

High frequency trading (HFT) is a type of algorithmic trading which is latency sensitive and is characterized by a high daily portfolio turnover and high order-to-trade ratio (OTR).

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.

### **3.1.2 Risk Management and Order Routing**

An efficient risk management system is integral to an efficient settlement system. The goal of a risk management system is to measure and manage a trading firm's exposure to various risks identified as central to its operations. For each risk category, the trading firm must employ procedures to measure and manage firm-level exposure. These help in the following:

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<sup>21</sup> SEBI Circular Ref. no. CIR/MRD/DP/09/2012 Dated March 30, 2012.

<sup>22</sup> SEBI/HO/MRD2/MRD2\_DCAP/P/CIR/2021/0000000591 dated July 05, 2021, “Master Circular for Stock Exchange and Clearing Corporation, Chapter 2 - Trading Software and Technology”.

**Establish Standards and Reports:** Every broker has a set of standards which they adhere to, and these are the standards against which a client is measured. In general, and not only among brokers, certain standards must be met before rating a company or a client. These must be reported to the management for their perusal and action.

**Impose Position Limits and Rules:** A key element of financial risk management is deciding which risk to bear and to what degree. A broker firm needs to impose limits to cover exposures, and overall position concentrations relative to systematic risks. SEBI and exchanges prescribe from time to time open position limit for various categories of products and various categories of investors in the Equity, Currency Derivative, Interest Rate Derivatives and Commodity Derivative segments.

**Set Investment Guidelines and Strategies:** A 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 a firm's financial activities generate and avoiding unprofitable risk positions. The board's role is usually described as setting the risk appetite of the organization; however, this is not possible if risks are understated or ill defined. 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.

### **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 and messages. (To understand about a contract note read Box 3.1).

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 and as per the trade annulment policy prescribed by SEBI and Exchanges from time to time. These generally occur due to order entry errors and are not a common practice.

### **3.1.4 Affirmation and Confirmation (*For Institutional Clients*)**

Institutional clients trading in the Indian securities market use the services of a custodian to assist them in the clearing and settlement of executed trades in cash/equity segment.

Custodians are clearing members of the Exchange. On behalf of their clients, they settle the trades that have been executed through brokers. A broker assigns a particular trade to a custodian for settlement by entering custodian participant code at the time of order entry. Upon confirmation by the custodian whether he would settle the trade, the clearing corporations 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. While confirming the trade Custodian verifies security details, side of the trade, price range etc. as specified by the institutional client.

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.<sup>23</sup> 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. STP thus streamlines the process of trade execution and settlement and avoids manual entry and re-entry of the details of the same trade by different market intermediaries and participants. Usage of STP enables orders to be processed, confirmed, settled in a shorter time period and in a more cost effective manner with fewer errors. Apart from compressing the clearing and settlement time, STP also provides a flexible, cost effective infrastructure, which enables e-business expansion through online processing and access to enterprise data.

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<sup>23</sup> SEBI Circular Ref. No. DNPd/Cir- 22 /04 dated April 1, 2004.

**Box 3.1: What is a Contract Note?**

Contract note is the legal record of any transaction carried out on a stock exchange through a stockbroker. It serves as the confirmation of trade done on a day on behalf of a client on a stock exchange. Every stock broker shall issue a contract note to its clients for trades executed in such format as specified 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. The digitally signed Electronic Contract Notes (ECNs) may be sent only to those clients who have opted to receive the contract notes in an electronic form, either in the account opening kit or by a separate letter. The usual mode of delivery of ECNs to the clients shall be through e-mail. For this purpose, the client shall provide an appropriate e-mail account to the member which shall be made available at all times for such receipts of ECNs. The acknowledgement of the e-mail shall be retained by the member in a soft and non-tamperable form. The proof of delivery i.e., log report generated by the system at the time of sending the contract notes shall be maintained by the member. Stock-Broker should also maintain a bounce mail log showing details of the contract notes that were not delivered to the clients/e mails rejected or bounced back. Whenever ECNs have not been delivered or has bounced, Member should send the physical copy of the contract note to such clients within the stipulated time under the extant regulations of SEBI/stock exchanges and maintain the proof of delivery. All ECNs sent through the e-mail shall be digitally signed, encrypted, non-tamperable and shall comply with the provisions of the IT Act, 2000. In case the ECN is sent through e-mail as an attachment, the attached file shall also be secured with the digital signature, encrypted and non-tamperable. In addition to the e-mail communication of the ECNs in the manner stated above, in order to further strengthen the electronic communication channel, the member shall simultaneously publish the ECN on his designated web-site in a secured way and enable relevant access to the clients.

The contract notes should be unique running serially numbered starting from the beginning of the financial year. They should be issued with the client's name, PAN 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 price of trade should contain an annexure with the details thereon.

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 authorized signatory of the stock broker as per the guideline specified by SEBI/Exchanges from time to time. 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), Goods and Service Tax (GST), stamp duty etc.), Regulatory levies / charges (e.g., SEBI turnover fees, Exchange transaction charges, etc.), Brokerage etc. Contract notes should be affixed with the brokers note stamps, as a percentage of the total value of the contract, as per the government stamp acts / rules. Contracts note also should clearly specify the complete address, phone number, e-mail IDs, fax numbers, the name of the compliance officer, his telephone number and e-mail address etc. of the broker along with the PAN.

### **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. In case of cash segment, institutional trades are sent to custodian and in derivatives custodian participant code trade sent to clearing member for confirmation. 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.

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 used to follow the T+2 Rolling Settlement in cash/equity segment, which means that the clearing corporation will settle the transactions with members 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. SEBI vide circular dated September 07, 2021, provided guideline for "Introduction of T+1 rolling settlement on an optional basis. All Exchanges, clearing corporations and depositories has decided to introduced T+1 rolling settlement in phased manner. The first list of securities with T+1 settlement were introduced in end of February 2022. It is proposed to fully implement the T+1 rolling settlement by the end of FY 2022-23. In case of T+1 rolling settlement, the trades executed on Wednesday, has to be settled on Thursday (provided Thursday is working day) 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 order capture and execution. This is where the order/trade originates, and the client relationship is maintained. The front office makes/takes orders and executes them. Dealers 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 communicate 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 in networking and bringing on-board clients.

### **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 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. With a view to simplify the account opening kit, SEBI has decided that stock broker/depository participant shall make available standard documents to the clients either in electronic or physical form, depending upon the preference of the client as a part of the account opening kit. The preference of the client shall be sought as part of the account opening form. In case the documents are made available in electronic form, the logs of the same shall be maintained by the broker/depository participant.<sup>24</sup>

The standard documents which form a part of the account opening kit are:

- 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** 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 detailing risk associated with dealing in the securities market.
- 4) Guidance Note detailing Do's and Don'ts for trading on Exchanges for the education of the investor.
- 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 (compliance officer in particular) 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. Few Documents like Rights and Obligations, RDD and Guidance Note for Do's and Don'ts are provided by the Exchanges in Vernacular languages too.

With a view to encourage participation of new individual investors in the securities market, SEBI has prescribed a new simplified Account Opening Form ('AOF') termed as 'SARAL AOF' for new individual investors participating in the cash segment of the Exchange but not

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<sup>24</sup> Vide SEBI Circular no. CIR/MIRSD/64/2016 dated July 12, 2016

availing facilities such as internet trading, margin trading, derivative trading and use of power of attorney. The investors who open account through SARAL AOF will also have the option to obtain other facilities, whenever they require, on furnishing of additional information as per prescribed regulations/circulars. The standard set of documents viz. Rights and Obligations document, Uniform Risk Disclosure Document and Guidance Note and documentary proof related to identity and address as specified by SEBI shall continue to remain applicable. It is further clarified that the provisions laid down under the PML Act, PML Rules, SEBI Master Circular on AML is applicable to these set of investors.

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) also allows brokers to accept e-KYC service provided by UIDAI as a valid process for KYC verification. The information containing relevant client details and photograph made available from UIDAI as a result of e-KYC process shall be treated as sufficient Proof of Identity and Address of the client. However, the client shall have to authorize the intermediary to access his data through UIDAI system. The intermediary shall perform verification of the client with UIDAI through biometric authentication (fingerprint or iris scanning). Accessing the details enabling client identification and authentication from UIDAI based on client authorization on voluntary basis intermediaries who utilizes the services of KYC Services Agencies would be registered as KYC User Agencies with UIDAI.

Know Your Customer (KYC) and Customer Due Diligence (CDD) policies as part of KYC are the foundation of an effective Anti-Money Laundering process. The KYC process requires every SEBI registered intermediary to collect and verify the Proof of Identity (PoI) and Proof of Address (PoA) from the investor. The provisions as laid down under the Prevention of Money-Laundering Act, 2002, Prevention of Money-Laundering (Maintenance of Records) Rules, 2005, SEBI Master Circular on Anti Money Laundering (AML) dated October 15, 2019 and relevant KYC / AML circulars issued from time to time shall continue to remain applicable. Further, the SEBI registered intermediary shall continue to ensure to obtain the express consent of the investor before undertaking online KYC. With a view to allow ease of doing business in securities market, SEBI vide its circular has allowed use of technology innovations which can facilitate online KYC.<sup>25</sup> Some of them are given below:

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<sup>25</sup>[https://www.sebi.gov.in/legal/circulars/apr-2020/clarification-on-know-your-client-kyc-process-and-use-of-technology-for-kyc\\_46565.html](https://www.sebi.gov.in/legal/circulars/apr-2020/clarification-on-know-your-client-kyc-process-and-use-of-technology-for-kyc_46565.html)



- The eSign mechanism of Aadhaar shall be accepted in lieu of wet signature on the documents provided by the investor. Even the cropped signature affixed on the online KYC form under eSign shall also be accepted as valid signature.
- Investor's KYC can be completed through online/App based KYC, in-person verification through video, online verification of Officially Valid Document (OVD) / other document under eSign as per procedure laid down in the above circular.
- SEBI registered intermediaries are allowed to implement their own Application (App) for undertaking online KYC of investors.
- To enable ease of completing IPV (In person verification) of an investor, intermediary may undertake the VIPV (Video IPV) of an individual investor through their app.
- IPV/ VIPV would not be required when the KYC of the investor is completed using the Aadhaar authentication / verification of UIDAI. IPV / VIPV shall not be required by the Registered Intermediaries when the KYC form has been submitted online, documents have been provided through digi-locker or any other source which could be verified online.

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. Self-attested copy of PAN card is mandatory for all clients, including Promoters/Partners/Karta/Trustees and whole time directors and persons authorized to deal in securities on behalf of company/firm/others. The original PAN card is for verification only and will be returned to the client immediately. PAN is the sole identification number for all participants transacting in securities market, irrespective of the amount of transactions.

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.

- 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.
- In case of institutional clients, namely, FPIs, MFs, VCFs, FVCIs, Scheduled Commercial Banks, Multilateral and Bilateral Development Financial Institutions, State Industrial Development Corporations, Insurance Companies registered with IRDAI 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. It has further been specified by SEBI, that the E-PAN issued by CBDT can also be produced by FPI for KYC compliance.<sup>26</sup>

- **Proof of Address Document:** List of documents admissible for Proof of Address are given below, however the 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.
  - 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.

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<sup>26</sup> SEBI Circular Ref. no: SEBI/HO/IMD/FIIC/CIR/P/2017/068, dated June 30, 2017.

If the proof of identity or address is in a foreign language, then translation into English is required. In person verification (IPV) is also required to be made by the broker or by the person authorized by him of each new client added on the books. To enable ease of completing IPV of an investor, intermediary may undertake the Video in Person Verification (VIPV) of an individual investor through their App. IPV/ VIPV would not be required when the KYC of the investor is completed using the Aadhaar authentication / verification of UIDAI. IPV / VIPV shall not be required by the Registered Intermediaries when the KYC form has been submitted online, documents have been provided through digi-locker or any other source which could be verified online.

- **Bank account details:** The client must also have a valid bank account from which transactions can be made for pay-in/pay-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 to settle an account:** The settlement of funds shall be done within 24 hours/ 1 working day of the payout, unless specifically authorized by client to maintain running account. However, the client can authorize the Broker to retain funds in his Trading Account and maintain it as Running Account. This is called Running Account Authorization. To facilitate this SEBI has approved brokers to collect running authority letter from the client. Authorization shall be signed by the client only & not by any POA holder. In spite of this letter, actual settlement of funds shall be done by the broker, at least once in a calendar quarter or month depending on preference of the client.
- The **e-KYC service** launched by UIDAI is accepted as a valid process for KYC verification, provided the client has authorized the intermediary to access his data through UIDAI system.
- **Rights and Obligations:** The document provides the rights and obligations of the stock broker, authorized persons and client for trading on exchanges. It provides information about client, brokerage charges, margins, transaction & settlement, liquidation/close out, dispute resolution and termination of relationship. It also includes additional rights & obligations in case of internet / wireless technology based trading by the client.

- **Risk Disclosure Document:** This document contains important information on risks involved during trading in Equities/Derivatives Segments of the stock exchanges. All clients are required to read this document and understand the nature of the relationship into which they are entering and the extent of their exposure to risk before trading in Equities/Derivatives Segments of the Exchanges. The documents make the clients aware of various risks such as risk of higher volatility, risk of lower liquidity, risk of rumors, risk of news announcements, system risks and risks involved on holding or writing options. The documents also require members to inform the client any additional provisions defining the features, risks, responsibilities, obligations and liabilities associated with securities trading through wireless technology/ smart order routing or any other technology.
- The stock broker shall have documentary evidence of financial details provided by the clients who opt to deal in the derivative segment. In respect of other clients, the stock broker shall obtain the documents in accordance with its risk management system.

List of Illustrative documents

- Copy of ITR Acknowledgement
- Copy of Annual Accounts
- In case of salary income - Salary Slip, Copy of Form 16
- Net-worth certificate
- Bank account statement for last 6 months
- Copy of Holding statement of de-mat account
- Any other relevant documents substantiating ownership of assets
- Self-declaration along with relevant supporting

### **3.2.1.3 KRA Agency (Know Your Client Registration Agency)**

SEBI has 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 has 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. Further, SEBI has advised brokers to upload the existing clients KYC details in the KYC Registration Agency KRA system by the intermediaries". This is in order to make it convenient for the clients registered prior to January 1, 2012 ('existing clients') and to expand the centralized database of the KYC records of the entire securities market, it was decided to upload the KYC details of the existing clients of the intermediaries in the current KRA system, in a phased manner.

The brokers or trading members, after completing the client account opening procedures, the intermediary shall perform the initial KYC/due diligence of the client, upload the KYC

information with proper authentication on the system of the KRA, furnish the scanned images of the KYC documents to the KRA, and retain the physical KYC.<sup>27</sup>

#### **3.2.1.4 Central Know Your Client (CKYC)**

Government of India has authorized the Central Registry of Securitization and Asset Reconstruction and Security interest of India (CERSAI), set up under subsection (1) of Section 20 of Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, to act as, and to perform the functions of, the Central KYC Records Registry under the PML Rules 2005, including receiving, storing, safeguarding and retrieving the KYC records in digital form of a “client”, as defined in clause (ha) sub-section (1) of Section 2 of the Prevention of Money Laundering Act, 2002 . As per the 2015 amendment to PML (Maintenance of Records) Rules, 2005 (the rules), every reporting entity shall capture the KYC information for sharing with the Central KYC Records Registry in the manner mentioned in the Rules, as per the KYC template for “individuals” finalised by CERSAI. CKYC refers to Central KYC (Know Your Customer), an initiative of the Government of India which aims to have a system which allows investors to complete their KYC only once before interacting with various entities across the financial sector. CKYC is managed by CERSAI (Central Registry of Securitization Asset Reconstruction and Security Interest of India), which is authorized by Government of India to function as the Central KYC Registry (CKYCR). Thus, CKYCR will act as centralized repository of KYC records of investors in the financial sector with uniform KYC norms and inter-usability of the KYC records across the sector. CKYC requires additional information (for e.g. - investor’s maiden name, mother’s name, FATCA information etc.) to be collected and submitted to CERSAI for completion of the CKYC formalities of an investor. Initially, CKYC is applicable only to Individuals (both Resident Individuals and Non-Resident Individuals (NRIs)). CKYCR, in its communication no. CKYC/2020/11 dated January 04, 2021, has specified that since CKYCR is fully operational for individual clients, it has been decided to extend CKYCR to Legal Entities (LE) as well. Accordingly, trading members required to upload the KYC records of LE accounts opened on or after April 01, 2021 on to CKYCR in terms of Rule 9 (1A) of the Prevention of Money Laundering (Maintenance of Records) Rules, 2005.

#### **3.2.1.5 Unique Client Code (UCC)**

In 2001, SEBI made it mandatory for brokers to use unique client codes for all clients.<sup>28</sup> 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 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 should be mapped with the PAN number of the client.

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<sup>27</sup>SEBI 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. SEBI {KYC (Know Your Client) Registration Agency} (Amendment) Regulations, 2011, SEBI circular no. LAD-NRO/GN/2012-13/35/6998 dated March 22, 2013

<sup>28</sup> SEBI Circular no: SMDRP/Policy/CIR-39/2001 dated July 18, 2001

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 regular basis. If the broker fails to register the unique client code with the Exchange, he is liable to be penalized.

#### **3.2.1.6 Execution of Power of Attorney (PoA) by the Client in favour of the Stock Broker / Stock Broker and Depository Participant**

SEBI vide circular no. CIR/MRD/DMS/13/2010 dated April 23, 2010, and circular no. CIR/MRD/DMS/28/2010 dated August 31, 2010, has issued guidelines and clarification for execution of Power of Attorney (PoA) by the client favouring Stock Broker / Stock Broker and Depository Participant to standardize the norms to be followed by stock brokers/ stock broker and depository participants while obtaining PoA from the clients. However, it has been observed that PoA is invariably obtained from the investor as part of the KYC and account opening process. Such PoA executed by clients has further found to have been misused by the stock brokers by taking authorization even for activities other than activities specified in SEBI circular. SEBI vide circular “Execution of Power of Attorney (PoA) by the Client in favour of the Stock Broker / Stock Broker and Depository Participant” dated August 27, 2020, has reiterated the following:

- I. PoA is optional and should not be insisted upon by the stock broker / stock broker depository participant for opening of the client account.
- II. PoA executed in favour of stock broker / stock broker depository participant by the client shall be utilized
  - a. For transfer of securities held in the beneficial owner accounts of the client towards Stock Exchange related deliveries / settlement obligations arising out of trades executed by clients on the Stock Exchange through the same stock broker.
  - b. For pledging / re-pledging of securities in favour of trading member (TM) / clearing member (CM) for the purpose of meeting margin requirements of the clients in connection with the trades executed by the clients on the Stock Exchange.
  - c. For limited purpose as specified in paragraph 1(iii) and 2 of the Enclosure to the POA Guidelines, 2010.
- III. For limited purpose to transfer of funds from the bank account(s) of the clients for the following:
  - a. For meeting the settlement obligations of the client(s)/ margin requirements of the client(s) in connection with the trades executed by the clients on the stock exchange through the same Stock Broker.
  - b. For recovering any outstanding amount due from the client(s) arising out of clients trading activities on the stock exchanges through the same Stock Broker.
  - c. For meeting obligations arising out of the client subscribing to such other products/facilities/services through the Stock Broker like Mutual Funds, Public Issues (shares as well as debentures), rights, offer of shares etc.

- d. Towards monies/fees/charges, etc. due to the Stock Broker/Depository Participant/ Principal payable by virtue of the client using/subscribing to any of the facilities/services availed by the client at his/her instance.
- IV. All off-market transfer of securities shall be permitted by the Depositories only by execution of Physical Delivery Instruction Slip (DIS) duly signed by the client himself or by way of electronic DIS.

#### **3.2.1.7 Execution of 'Demat Debit and Pledge Instruction' (DDPI) for transfer of securities towards deliveries / settlement obligations and pledging / re-pledging of securities<sup>29</sup>**

In order to make the process more transparent and simpler, the two conditions as specified in paragraphs II (a) & (b) of section 3.2.1.6, is made part of a separate document viz. 'Demat Debit and Pledge Instruction'(DDPI), under which the clients shall explicitly agree to authorize the stock broker/stock broker and depository participant to access their BO account for the limited purpose of meeting pay-in obligations for settlement of trades executed by them. The DDPI shall serve the same purpose of PoA and significantly mitigate the misuse of PoA. The use of DDPI shall be limited only for the two purposes as mentioned in paragraph II (a) & (b) of section 3.2.1.6. The client may use the DDPI or opt to complete the settlement by issuing physical Delivery Instruction Slip (DIS) or electronic Delivery Instruction Slip (eDIS) themselves. Hence, with the implementation of this circular, PoA shall no longer be executed for the conditions specified in paragraph II (a) & (b) of section 3.2.1.6. For further information participants may refer SEBI circular.

#### **3.2.1.8 Brokerage**

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

- Brokerage rule for equity segment:
  - Maximum brokerage that brokers can charge is 2.5% of the trade value exclusive of statutory levies.
  - 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 Derivatives segment:
  - Brokerage rule for future is similar to the equity segment
  - In the case of options contracts, maximum brokerage can be 2.5% of the option premium or Rs.100/- per lot 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
- Online brokers cater to niche segment of retail clients.

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<sup>29</sup> [https://www.sebi.gov.in/legal/circulars/apr-2022/execution-of-demat-debit-and-pledge-instruction-ddpi-for-transfer-of-securities-towards-deliveries-settlement-obligations-and-pledging-re-pledging-of-securities\\_57546.html](https://www.sebi.gov.in/legal/circulars/apr-2022/execution-of-demat-debit-and-pledge-instruction-ddpi-for-transfer-of-securities-towards-deliveries-settlement-obligations-and-pledging-re-pledging-of-securities_57546.html)

- 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 / No. of Contract
- Security/Contract (What to buy and what to sell))
- Action (Buy / Sell)
- Client identity (UCC)

A trading member can enter various types of orders depending upon his/her requirements. The order conditions are broadly classified into three categories: price related conditions, time-related conditions, and quantity related conditions. We will see about the order condition in following section. Trading members are allowed to enter order during market hours only. Following are some examples of order entry:

Security Details Symbol/Code/Name		Buy / Sell	Quantity	Price	Time Condition	Pro / Cli	UCC & PAN	CP Code
ABCDE	12345	B	5	76.50	Day	Cli	A001 XXXXXXXXXX	-

#### 3.2.2.1 Types of order

Price, time and quantity are three major components of an order. A stock broker can enter various types of orders depending upon his/her requirements. These conditions are broadly classified into three categories: price related conditions, time-related conditions, and quantity related conditions..

##### **A. Price Condition:**

##### **Market Order - Basic Trade**

A market order is where a trader purchases or sells their security at the best market price available across the market depth to complete the order quantity. 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/s in the market at that point in time. The second type of market order i.e. market with protection order is a combination of market and limit order. It allows the market order to be executed till a specified level mentioned by trader. The risk of an order getting executed at any price is protected by using such order.

**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

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 -**

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 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.807.60. 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

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

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Rs.807.60. Orders lying unmatched in the system are 'passive' orders and orders that come in to match the existing orders are called 'active' orders. It should be noted that the order is always matched with the passive order price. The balance buy order for 100 shares @ Rs.807.60 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	807.60	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

**Stop Orders (orders with stop loss triggers)**

The one that allows the Trading Member to place an order which gets activated only when the market price of the relevant security reaches or crosses a threshold price. Until then the order does not enter the market.

In stop order, the client enters two prices: one is trigger price and the other is limit/market 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 sell 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 buy order in the Stop Loss book gets triggered when the last traded price in the normal market reaches or exceeds the trigger price of the order.

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 or below, 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 (which can be equal to or less than trigger 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 or above, 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 (which can be equal to or more than trigger 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 buying 400 ABC shares at Rs.890/-. It will match only if a corresponding sell order exists for Rs.890/- or better.
- If it is stop loss market order, once triggered it will match with the best counter order 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.

**B. Time Condition:**

DAY - A Day order, as the name suggests, is an order which is valid for the day on which it is entered. If the order is not matched during the day, the order gets cancelled automatically at the end of the trading day.

IOC - An Immediate or Cancel (IOC) order allows a Trading Member to buy or sell a security as soon as the order is released into the market, failing which the order will be removed from the market. Partial match is possible for the order, and the unmatched portion of the order is cancelled immediately.

**Example 3.3: Illustration of a typical IOC order**

Order is placed to buy 200 shares of ABC Industries Ltd. at Rs.807.60 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

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78	807.40	807.85	42
1	807.35	807.90	86

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.807.60 will be cancelled as it is an IOC order and there is no match for the remaining 100 shares.

GTC - A Good Till Cancelled (GTC) order is an order that remains in the system until it is cancelled by the Trading Member. It will therefore be able to span trading days if it does not get matched. The maximum number of days a GTC order can remain in the system is notified by the Exchange from time to time.

GTD - A Good Till Days/Date (GTD) order allows the Trading Member to specify the days/date up to which the order should stay in the system. At the end of this period the order will get flushed from the system. Each day/date counted is a calendar day and inclusive of holidays. The days/date counted are inclusive of the day/date on which the order is placed. The maximum number of days a GTD order can remain in the system is notified by the Exchange from time to time.

Cancel on Logout (COL): If member / user entered order with COL, all outstanding order of the user will get cancelled once user logs out from the TWS.

Note: Currently, GTC and GTD orders are not available on the system as per SEBI directives.

**C. Quantity Condition:**

Disclosed Quantity (DQ)- An order with a DQ condition allows the Trading Member to disclose only a part of the order quantity to the market. For example, an order of 1000 with a disclosed quantity condition of 200 will mean that 200 is displayed to the market at a time. After this is traded, another 200 is automatically released and so on till the full order is executed. The Exchange may set a minimum disclosed quantity criteria from time to time.

MF - Minimum Fill (MF) orders allow the Trading Member to specify the minimum quantity by which an order should be filled. For example, an order of 1000 units with minimum fill 200 will require that each trade be for at least 200 units. In other words there will be a maximum of 5 trades of 200 each or a single trade of 1000. The Exchange may lay down norms of MF from time to time.

AON - All or None orders allow a Trading Member to impose the condition that only the full order should be matched against. This may be by way of multiple trades. If the full order is not matched it will stay in the books till matched or cancelled.

Note: Currently, AON and MF orders are not available on the system as per SEBI directives.

Other conditions

- Pro: 'Pro' means that the orders are entered on the trading member's own account.
- Cli: 'Cli' means that the trading member enters the orders on behalf of a client.

### **Proprietary Trading**

Trading members are also allowed to trade on own behalf. To facilitate the same Stock Exchanges provide facility of placing order on proprietary (pro) account. Facility of placing orders on proprietary account through trading terminals shall be extended only at one location of the members as specified / required by the members. Trading terminals located at places other than the above location shall have a facility to place orders only for and on behalf of a client by entering client code details as required / specified by the Exchange / SEBI. Proprietary trading is allowed from more than one location is subject to certain conditions. Prior approval of Exchange is required to members for facility of 'proprietary-account' through trading terminals from more than one location and / or CTCL terminal.

#### **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 subject to availability of counter order. If it is a limit order it is 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.

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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	120.80	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, only 50 shares get executed and the order for remaining 450 stays at the top on the sell side at Rs. 121.20.

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.

Let us take another example:-

Buy Qty./Lot	Buy Price	Sell Price	Sell Qty./Lot
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

Order is placed to buy 200 shares at Rs.807.65. 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 and not at Rs. 807.65. 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.

### **3.2.3 Order Modification/ Cancellation**

Sometimes 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 during market hours which have not been fully or partially executed.

### **3.2.4 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. Once the order is executed it turns into trade and exchange sends notification of the trade to the broker. The broker in turn communicates these trades to the client either immediately or end of day. Official communication from broker is done to the client through contract note.

Trade modification is allowed for parameters like client code and custodian participant code. However, there are certain conditions and timings for such modifications. Also these modifications may attract penalties.

Trade annulment: Trading members are allowed to provide trade annulment request on trading system. The request should be submitted within 30 minutes from trade execution. Trade annulment request should satisfy certain condition for further processing. A fee based on value of trade(s) for which annulment is requested, subject to minimum and maximum fee shall be charged as annulment application fee for accepting the request.

## **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 wilfully produce an abnormal effect on prices and/or volumes, goes against the fundamental objective of 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. As we know that obligation to settle the trades lies with the broker, if any client makes any trade default, then the same has to be made good by the broker to the clearing corporation. When orders are accepted and sent to exchange these orders go through various risk management checks for clients. The broker system should have an on-line risk management capability for all orders placed on the Exchange platform. Further, brokers should have various trading limits (like Order Quantity and Value Limits, User / Branch Order Limit, Order Price limit, etc.) on the system and only such orders which are

within the parameters specified by the risk management system be allowed to be pushed into exchange trading platform. Margin is an amount that clearing corporations levy on the brokers for maintaining positions on the exchange. The amount of margin levied is proportional to the exposure and risk the broker is carrying. Since positions may belong to a broker's clients, it is the broker's responsibility to collect the margin upfront from clients and allow trading to client based on the collateral provided by the client. The broker system should have capability to generate reports relating to margin requirements, payments, and delivery obligations. 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. Broker system should assess the risk of the client as soon as the order comes in, further broker can have system-based control on the trading limits of clients, and exposures taken by clients. Brokers are required to set pre-defined limits on the exposure and turnover of each client. SEBI/Stock Exchanges have specified various system/risk management requirement based on the type of broker example Brokers who trade through exchange provided terminals, brokers trade through CTCL, IBT, STWT, SOR and brokers who use Algorithmic Trading facility. 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 3.3. 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.



### **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 risk arises on account of handling of client assets, regulatory non-compliance, trading error, non-payment for buying or selling a scrip, non-delivery of scrip(s), denial of matched order by clients, sudden closure of banks where funds are deposited etc.

**Market risk** refers to the possibility of incurring large losses from adverse changes in financial asset prices such as stock prices. For the stock broker, market risks are essentially risk arises on account of concentration of client collateral in stocks/sectors, brokers own investment in stocks/sectors etc. 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.

**Credit risk** is the risk of default on a debt that may arise from a borrower failing to make required payments. The credit risk for broker can arise on account of Loans to Group Companies/ Related Parties, debit balance of clients, funding of clients, short collection of margins, Non-confirmation of DVP trade by custodian etc.

A stock broking firm must identify factors that can trigger operational, market and credit risk. 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 defined as process of including additional information in one instruction in a trade which is already being executed.

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.

For the purpose of back office operations, the back-office systems maintain masters relating to brokerage rate client wise, Goods and services tax (GST), stamp duty and Securities Transaction Tax charge tables.

When the trade data is uploaded into the back office, the above information is appended to 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. Brokers also need to upload the allocation details to clearing corporation.

### **3.4.3 Clearing and Settlement Process**

Clearing and Settlement is a post trading activity that constitutes the core part of equity trade life cycles. After the trade 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 Exchanges. The Clearing House/Corporation gives an obligation report to the brokers (clearing member) 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 for equities (cash segment) can happen on T+1 day or on T+ 2 day by 10.30a.m., and pay-out of securities and funds happen on T+1 day or

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T+2 by 1.30 p.m. SEBI vide circular dated September 07, 2021<sup>30</sup>, provided guideline for “Introduction of T+1 rolling settlement on an optional basis. All Exchanges, clearing corporations and depositories has decided to introduced T+1 rolling settlement in phased manner. The first list of securities with T+1 settlement were introduced in end of February 2022. It is proposed to fully implement the T+1 rolling settlement by the end of FY 2022-23. The pay-in and pay-out days for funds and securities are prescribed as per the settlement cycle. A typical normal settlement cycle for cash/equity segment is given in Table 3.1:

**Table 3.1 Normal Settlement Cycle:**

	Activity	Day (For T+2 Rolling Settlement)
Trading	Rolling Settlement Trading	T
Clearing	Custodial Confirmation on or by	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
	Valuation Debit	T+2 working days
Post Settlement	Auction on or by <sup>31</sup>	T+2 working days
	Auction settlement on or by	T+3 working days

	Activity	Day (For T+1 Rolling Settlement)
Trading	Rolling Settlement Trading	T
Clearing	Custodial Confirmation on or by	T +0 working days
	Delivery Generation	T +0 working days
Settlement	Securities and Funds pay in	T+1 working days
	Securities and Funds pay out	T+1 working days
	Valuation Debit	T+1 working days
Post Settlement	Auction on or by	T+1 working days
	Auction settlement on or by	T+2 working days

In a T+2 rolling settlement, for all trades executed on trading day i.e., T day the obligations are determined on the T+1 day and settlement on T+2 basis i.e., on the 2nd working day. For arriving at the settlement day all intervening holidays, which include bank holidays, Exchange holidays, Saturdays and Sundays are excluded. In a T+1 rolling settlement, for all trades executed on trading day i.e., T day the obligations are determined on the T+0 day and settlement on T+1 basis i.e., on the next working day. For arriving at the settlement day all intervening holidays, which include bank holidays, Exchange holidays, Saturdays and Sundays are excluded.

<sup>30</sup> [https://www.sebi.gov.in/legal/circulars/sep-2021/introduction-of-t-1-rolling-settlement-on-an-optional-basis\\_52462.html](https://www.sebi.gov.in/legal/circulars/sep-2021/introduction-of-t-1-rolling-settlement-on-an-optional-basis_52462.html)

<sup>31</sup> SEBI Circular Ref. No. Cir/MRD/DRMNP/8/2015 Dated May 14, 2015.

#### **3.4.4 Accounting**

The stock brokers are required to maintain books of account as prescribed by the Securities Contracts (Regulation) Rules 1957, SEBI (Stock brokers) Regulations 1992, and requirements of Stock Exchanges. These are to be maintained for a minimum period of 5 years. In case such documents are maintained in electronic form, provisions of Information Technology Act, 2000 in this regard shall be complied with.

##### **3.4.4.1 Different types of accounts, records, etc.**

The broker has to keep and maintain the required books of accounts, records, documents as per Rule 15 of the Securities Contracts (Regulation) Rules 1957 and Regulation 17 of SEBI (Stock Broker) 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 stock brokers are also required to maintain client-wise separate books of accounts. With respect to segments forming part of clearing corporation interoperability, client financial ledgers can be prepared Segment wise and consolidated across Exchanges. However, during inspections, Stock Brokers should be able to demonstrate the break-up of trades (Segment-wise & Exchange-wise) for the bills so posted.

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, KYC, client account opening form etc. 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 etc.
- 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 book and bank pass book** contain records of all cash and cheque transactions and are normally balanced daily.
- Documents register containing, inter alia, particulars of securities received and delivered in physical form and the statement of account and other records relating to receipt and delivery of securities provided by the depository participants in respect of dematerialized securities.

- 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. Stock brokers are required to maintain duplicate copy or counter foil of the contract notes.
- Written consent of clients in respect of contracts entered into as principals.
- The **margin deposit book** contains details of margins paid and collected and payable and collectable.
- Member's contract books showing details of all contracts entered into by him with other members of the same exchange or counterfoils or duplicates of memos of confirmation issued to such other members.
- Client account opening form in the format as may be specified by the Board.

As per regulation 18 of the SEBI (Stock Broker) Regulations, 1992, every stock broker shall preserve the books of account and other records maintained under regulation 17 for a minimum period of five years.

The broker also has to keep copies of KYC forms, agreement with clients, 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.

Brokers need to maintain proper records of client collateral and to prevent misuse of client collateral. Brokers should have adequate systems and procedures in place to ensure that client collateral is not used for any purposes other than meeting the respective client's margin requirements / pay-ins. Brokers should also maintain records to ensure proper audit trail of use of client collateral.

#### **3.4.5 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 features 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:<sup>32</sup>

- (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).

SEBI has mandated periodic system audit to members based on the category of stock brokers (broker using Exchange system, Broker using CTCL/DMA, Broker using Algorithmic trading etc.). The system audit mainly covers system controls and capabilities, risk management system, password security, network integrity, access control, back-up recovery, database security, software change management etc.

Since stock brokers and depository participants perform significant functions in providing services to holders of securities, it is desirable that these entities have robust cyber security and cyber resilience framework in order to provide essential facilities and perform systemically critical functions relating to securities market. In view of the above, SEBI, prescribed the framework for Cyber Security & Cyber Resilience for Stock Brokers / Depository Participants.<sup>33</sup> Further, the Stock Brokers / Depository Participants are mandated to conduct comprehensive cyber audit at least once in a financial year. All Stock Brokers / Depository Participants is required to submit with Stock Exchange/Depository a declaration from the MD/ CEO/ Partners/ Proprietors certifying

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<sup>32</sup> Vide SEBI circular no: CIR/MRD/DP/07/2014 dated February 11, 2014.

<sup>33</sup> Vide SEBI circular SEBI/HO/MIRSD/CIR/PB/2018/147 dated December 03, 2018

compliance by the Stock Brokers / Depository Participants with all SEBI Circulars and advisories related to Cyber security from time to time, along with the Cyber audit report.<sup>34</sup>

#### **3.4.5.1 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.

#### **3.4.6 Securities Transaction Tax<sup>35</sup>**

Securities Transaction Tax (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 collected by the broker from their client and remitted to the Stock Exchanges /Clearing Corporations.

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

<b>Sr.No.</b>	<b>Taxable securities transaction</b>	<b>Current Effective Rates</b>	<b>Payable by</b>
1.	Purchase of an equity share in a company or a unit of a business trust, where- (a) the transaction of such purchase is entered into in a recognized stock exchange and (b) 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-
2.	Sale of an equity share in a company or a unit of a business trust, where- (a) the transaction of such sale is entered into in recognized stock exchange and (b) 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
2A	Sale of a unit of an equity-oriented fund, where- (a) the transaction of such sale is entered into in recognized stock exchange and	0.001 per cent	Seller

<sup>34</sup> Vide SEBI circular SEBI/HO/MIRSD/TPD/P/CIR/2022/80 dated June 07, 2022

<sup>35</sup> <https://www.incometaxindia.gov.in/pages/acts/securities-transaction-tax-act.aspx>

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	(b) the contract for such unit is settled by the actual delivery or transfer of such share or unit		
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- (a) the transaction of such sale is entered into in a recognized stock exchange and such (b) the contract for the sale of such share or unit is settled otherwise than by the actual delivery or transfer of such share or unit .	0.025 per cent	Seller

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

Sr.No.	Taxable securities transaction	Current Rates	Effective	Payable by
1	Sale of an option in securities	0.05 per cent on premium		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

STT rate applicable to the delivery-based transaction shall also be applicable on the physical settled stock derivatives (both futures and options). STT is not applicable on Currency Derivatives, Interest Rate Derivatives and Debt Securities transactions.

Stock Exchanges/Clearing Corporation 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.

### 3.4.7 Stamp Duty with respect to securities market instrument<sup>36</sup>

In order to facilitate ease of doing business and to bring in uniformity of the stamp duty on securities across States and thereby build a pan-India securities market, the Central Government, through requisite amendments in the Indian Stamp Act, 1899 and Rules made thereunder, has created the legal and institutional mechanism to enable states to collect stamp duty on securities market instruments at one place by one agency (through Stock Exchange or Clearing Corporation authorized by it or by the Depository) on one Instrument. A mechanism for appropriately sharing the stamp duty with relevant State Governments has also been developed which is based on the state of domicile of the buyer.

<sup>36</sup>[https://upload.indiacode.nic.in/showfile?actid=AC\\_CEN\\_2\\_2\\_00036\\_189902\\_1523339055436&type=rule&filename=stamp\\_act,\\_2019.pdf](https://upload.indiacode.nic.in/showfile?actid=AC_CEN_2_2_00036_189902_1523339055436&type=rule&filename=stamp_act,_2019.pdf) and <http://egazette.nic.in/WriteReadData/2019/214585.pdf>



The relevant provisions of the Finance Act, 2019 amending the Indian Stamp Act, 1899 and the Indian Stamp (Collection of Stamp-Duty through Stock Exchanges, Clearing Corporations and Depositories) Rules, 2019 were notified simultaneously. The Amendments in the Indian Stamp Act, 1899 brought through Finance Act 2019 and Rules made thereunder came into effect from July 01, 2020.

Following are some of the salient features:

- i. The stamp-duty on sale, transfer and issue of securities shall be collected on behalf of the State Government by the collecting agents who then shall transfer the collected stamp-duty in the account of the concerned State Government.
- ii. In order to prevent multiple incidences of taxation, no stamp duty shall be collected by the States on any secondary record of transaction associated with a transaction on which the depository / stock exchange has been authorised to collect the stamp duty.
- iii. The collecting agents shall be the Stock Exchanges or authorized Clearing Corporations and the Depositories.
- iv. For all exchange based secondary market transactions in securities, Stock Exchanges shall collect the stamp duty;
- v. The collecting agent shall transfer the collected stamp-duty in the account of concerned State Government with the Reserve Bank of India or any scheduled commercial bank, as informed to the collecting agent by the Reserve Bank of India or the concerned State Government.

Mechanism similar to STT has been implemented by Exchange/Clearing Corporation for determination and collection of stamp duty from brokers. Brokers have to collect the stamp duty from their clients and remit to Exchange/Clearing Corporation.

### **3.4.8 Bulk Deals & Block Deals**

#### **Bulk Deals**

With a view to imparting transparency in bulk deals and to prevent rumors/speculation about such deals causing volatility in the scrip price, it was decided by SEBI to bring about greater disclosure of such bulk deals as mentioned below: <sup>37</sup>

- The disclosure shall be made with respect to all transactions in a scrip where total quantity of shares bought/sold is more than 0.5% of the number of equity shares of the company listed on the stock exchange. The quantitative limit of 0.5% can be reached through one or more transaction executed during the day in the normal market segment.
- 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. In case of Bulk Deals:

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<sup>37</sup> Vide SEBI Circular SEBI/MRD/SE/Cir-7/2004) dated January 14, 2004

- Single Trade: Immediately upon the execution of the order where the traded quantity either buy or sell on account of any trade (client / proprietor) is more than 0.5% of the number of equity shares of the company listed on the stock exchange.
- Cumulative Trades for the Day: Within one hour from the closure of the trading hours, the quantity traded on that day either purchases or sale under proprietary or any single client code is more than 0.5% of the number of equity shares of the company listed on the stock exchange

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.<sup>38</sup> The Exchange has introduced revised Block deal window mechanism from January 01, 2018.<sup>39</sup> This window allows large size trades to be executed as a single transaction without putting the buyer or seller at a disadvantageous position. A trade, with a minimum value of Rs.10 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:

- ‘Block Deal’ windows is available twice a day under the names “Morning Block Deal Window” and “Afternoon Block Deal Window”. The morning block deal window operates between 8.45 a.m. to 9.00 a.m. and the afternoon window operates between 2.05 p.m. to 2.20 p.m.
- The reference price for execution of block deals in the Morning Window shall be the previous day closing price or adjusted close price/base price of the stock. The stock exchanges shall set their trading hours between 8.45 a.m. to 9.00 a.m. with a stipulation that between this time, the stock exchanges shall operate only for executing trades in the block deal window.
- The reference price for execution of block deals in the afternoon window shall be the volume weighted average market price (VWAP) of the trades executed in the stock in the cash segment between 01.45 p.m. to 02.00 p.m. Between the period 02.00 p.m. to 02.05 p.m., the stock exchanges shall calculate and disseminate necessary information regarding the VWAP applicable for the execution of block deals in this window. In case no trades are executed in the security in the cash segment between 01:45 PM to 02:00 PM, the reference price shall be considered as follows:

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<sup>38</sup>Vide SEBI circular number: MRD/DoP/SE/Cir- 19 /05 dated September 2, 2005

<sup>39</sup> Vide SEBI Circular number: Cir/MRD/DP/118/2017 dated October 26, 2017

- VWAP based on trades executed in the security between 9:00 am to 1:45 pm shall be taken as reference price. For the computation of VWAP, the trades of pre-open / special pre-open session, shall also be considered.
- In case VWAP not available as per above, then previous day close price or adjusted close price / base price of stock
- The orders may be placed in this window at a price not exceeding  $\pm 1\%$  of the applicable reference price in the respective block deal window.
- An order may be placed for a minimum value of Rs.10 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.
- The applicability of all other trading and settlement related practices as well as surveillance and risk containment measures shall be ensured by the stock exchanges.

#### **3.4.9 Regulatory Compliances**

The stock broker has to follow certain regulatory compliances under the law, rules, regulations and bye laws of SEBI and the Exchanges. These are mandatory and non-compliance to these rules, regulations, circulars, 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, SEBI Stock Broker regulation, 1992 (e.g. Souda book etc.);
- Compliance related to use of terminal, office management etc.;
- Compliance related to dealing with other intermediaries including Authorized Person;
- Compliance related to dealing with clients;
- Sending account statements to clients;
- Submission of various periodic reports to the stock Exchanges etc.

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

### Sample Questions

Questions to assess your learning:

1. Direct Market Access facility is mainly introduced for \_\_\_\_\_.
  - a. Retail Investors.
  - b. Institutional Clients.**
  - c. Specific International Broking Firms.
  
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.**
  
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.
  
4. Maintenance of different types of Books by stock brokers is prescribed under \_\_\_\_\_.
  - a. SC(R)R 1957**
  - b. SCRA 1956
  - c. SEBI Intermediaries Regulations
  - d. Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2018

## **Chapter 4: Risk Management**

### **LEARNING OBJECTIVES:**

**After studying this chapter, you should know about:**

- Risk management framework for capital market and derivatives segment
- Compliances and Regulatory Reporting by the Stock Brokers
- Core Settlement Guarantee Fund

### **4.1 Risk Management**

#### **4.1.1 Risk Management Framework for Capital Market / Equity 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/clearing member to fulfill their obligation. In order to safeguard against such failures, the clearing agency is required to carry out the risk management measures as specified by SEBI through its various circulars.

In case of Cash / Equity Market segment, Broker should have a prudent system of risk management to protect themselves from client default. Margins are an important element of such a system. The 'margins' for this purpose shall mean VaR margin, extreme loss margin (ELM), mark to market margin(MTM), delivery margin, special / additional margin or any other margin as prescribed by the Exchange to be collected by TM/CM from their clients. The risk management system should be well documented and be made accessible to the clients and the Exchange / Clearing Corporation. Like in derivatives segment, the TMs/CMs in cash segment are also required to mandatorily collect upfront Value at Risk (VaR) margins and Extreme Loss Margin (ELM) from their clients.<sup>40</sup> The TMs/CMs will have time till 'T+2' working days to collect margins (except VaR margins and ELM) from their clients). The clients shall ensure that the VaR margins and ELM are paid in advance of trade and other margins are paid as soon as margin calls are made by the Stock Exchanges/TMs/CMs. As like in derivatives segments, the TMs/CMs shall report to the Stock Exchange on T+5 day the actual short-collection/non-collection of all margins from clients. The TM/CM can collect the margin from its client in a manner specified by SEBI/Exchanges/Clearing Corporation from time to time.

Clearing Corporations, Risk containment measures include capital adequacy requirements of members, monitoring of member performance and track record, stringent margin

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<sup>40</sup> Vide SEBI CIR/HO/MIRSD/DOP/CIR/P/2019/139 November 19, 2019 and SEBI/HO/MRD2/DCAP/CIR/P/2020/127 dated July 20, 2020

requirements, position limits based on capital, online monitoring of member positions and automatic disablement from trading when limits are breached, etc.

Following are the salient features of Clearing Corporation Risk Management System:

- On-line real time risk management
  - Online monitoring of margin against liquid assets
  - On-line position limit monitoring
- Scientific way of identifying margin level
- Different kind of margins to cover all kind of losses
- Intra-day and end of day mark to market
- Client level margining
- Alert to member on various level of collateral utilization
- Risk reduction mode
- Automatic disablement from trading when limits are breached
- Cross margining facility
- Capital adequacy requirements of members
- Monitoring of member performance and track record

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 across all its clients. Based on the computation, the clearing corporation will ensure that the liquid assets deposited by members is sufficient to cover the potential loss.

SEBI has, from time to time, put in place various risk containment measures to address the risks involved in the cash and derivatives market. With a view to keeping up pace with the changing market dynamics and to bring more efficiency in the risk management framework, a comprehensive review of the margin framework was done in consultation with the Risk Management Review Committee (RMRC) of SEBI and changes implemented.<sup>41</sup>

In Cash/Equity Segment the clearing corporation computes and collects three kinds of margins namely:

- Value at Risk Margin (VaR) to cover potential losses for 99.9% of the days.
- Mark to Market (MTM) Loss Margin: Mark to market losses on outstanding settlement obligations of the member. (Also include intraday Crystallized MTM losses)

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<sup>41</sup> Vide SEBI Circular SEBI/HO/MRD2/DCAP/CIR/P/2020/27 Dated February 24, 2020.

- 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 99.9% of the days (99.9% Value at Risk). For margin purpose securities were classified in three groups based on the liquidity, impact cost namely; Liquid Securities, Less Liquid Securities and Illiquid Securities.

*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.

The VaR Margins are specified as follows for different groups of stocks:

**Table 4.1: VaR Margins for different group of stocks**

<b>Liquidity Categorization</b>	<b>VaR Margin Rate</b>
Liquid Securities (Group I)	Based on $6\sigma$ , subject to minimum of 9%
Less Liquid Securities (Group II)	Based on $6\sigma$ , subject to minimum of 21.5%
Illiquid Securities (Group III)	50% if traded at least once per week on any stock exchange; 75% otherwise

### **Note:**

- Index ETFs are based on a basket of securities. However, for computing margins on ETFs they are treated at par with stocks and margins that are applicable on stocks are being applied for ETFs. In order to bring efficiency, in case of ETFs that track broad based market indices and do not include ETFs which track sectoral indices, the VaR margin rate shall be 6 sigma( $\sigma$ ), subject to minimum of 6%.
- In case of Group III the securities shall be monitored on a weekly basis, and the VaR - margin rates shall be increased to 75% if the security has not traded for a week. In case the VaR margin rate is 75% and the security trades during the day, the VaR margin rate shall be revised to 50% from start of next trading day.

### **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.

**VaR Margin Rate**

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.

**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 shall be 3.5% for any stock and 2% for ETFs that track broad based market indices and do not include ETFs which track sectoral indices. The Extreme Loss Margin shall be 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. For this purpose, there would be no netting off of positions across different settlements. The Extreme Loss Margin collected shall be released on completion of pay-in of the settlement.

**Margins for securities in Trade for Trade-Surveillance market (TFTS)**

Upfront margin rates (VaR Margin + Extreme Loss Margin) applicable for all securities in the TFTS shall be 100%.

**Mark to Market Losses**

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 assets of the member.
- 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. For this purpose, the position of a client would be netted for each of its various securities and the positions of all the clients of a broker would be grossed.
- In case of security in Trade For Trade Surveillance market (TFTS), each trade shall be marked to market based on the closing price of that security.
- There would be no netting off of the positions and setoff against mark to market profits across two different settlements.



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

Clearing Corporation shall calculate and levy the Intraday Crystallized Mark to Market Losses (ICMTM) in the following manner:

- ICMTM shall be computed for all trades subject to upfront margining which are executed and closed out on the same trading day.
- ICMTM shall be calculated based on weighted average prices of trades
- ICMTM shall be adjusted against the liquid assets of the member on a real time basis.
- Crystallised losses at a security level for a client shall be adjusted against the crystallised profit, if any, from another security for the same client to arrive at client level profit or loss. However, there will be no setoff against crystallised profits across two rolling settlements.
- All client level losses including losses on proprietary positions if any shall be grossed up to arrive at member level ICMTM.
- ICMTM shall not be computed in case of security in TFTS.
- ICMTM shall be included in the end of day MTM computation.

#### **Additional Margin on High Volatile Stocks**

- i. For securities with intra-day price movement (maximum of [High-Low], [High-Previous Close], [Low-Previous Close]) of more than 10% in the underlying market for 3 or more days in last one month, the minimum total margins shall be equal to the maximum intra-day price movement of the security observed in the underlying market in last one month. The same shall be continued till monthly expiry date of derivative contracts which falls after completion of three months from date of levy.
- ii. For securities with intra-day price movement (maximum of [High-Low], [High-Previous Close], [Low-Previous Close]) of more than 10% in the underlying market for 10 or more days in last six months, the minimum total margins shall be equal to the maximum intraday price movement of the security observed in the underlying market in last six months. The same shall be continued till monthly expiry date of derivative contracts which falls after completion of one year from date of levy.

It is to be noted that the same is applicable for the F&O segment also.

#### **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, 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 core of the risk management system is the liquid assets deposited by members with the exchange/clearing corporation. These liquid assets shall cover the following four requirements namely; Mark to Market Losses, VaR Margins, Extreme Loss Margins, Base Minimum Capital.

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<sup>42</sup>**

Item	Haircut	Limits
<b><i>Cash Equivalents</i></b>		
Cash	0	No limit
Bank fixed deposits (*)	0	No limit
Bank guarantees	0	Limit on Exchange's/Clearing Corporation exposure to a single bank <sup>43</sup>
Securities of the Central Government	Refer Note	No limit
Units of liquid mutual funds or government securities mutual funds	10 percent	No limit
<b><i>Other liquid assets (Non-Cash Component)</i></b>		
1. Cannot be used for mark to market losses		
2. Total of other liquid assets cannot exceed total of Cash Equivalents		
Liquid (Group I) Equity Shares	Same as the VaR margin for the respective shares	Limit on Exchange's exposure to a single issuer. (Refer Note)
Mutual fund units other than those listed under cash equivalents	Same as the VaR margin for the units computed using the traded price on stock exchange, if available, or else, using the NAV of the unit treating it as a liquid security	

<sup>42</sup> SEBI master circular for Stock Exchanges and Clearing Corporations SEBI/HO/MRD2/MRD2\_DCAP/P/CIR/2021/0000000591 dated July 05, 2021.

<sup>43</sup> The exchanges/clearing corporation shall lay down exposure limits either in rupee terms or as percentage of the TGF/SGF 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 towards total liquid assets.

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Corporate Bonds <sup>44</sup>	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.
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**Note:**

A. The valuation of the liquid assets shall be done on a daily basis.

B. The exchanges shall lay down exposure limits either in rupee terms or as percentage of the Trade Guarantee Fund (TGF) / Settlement Guarantee Fund (SGF) 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 towards total liquid assets. Not more than 5% of the TGF/SGF or 1% of the total liquid assets deposited with the exchange, whichever is lower, shall be exposed to any single bank which has a net worth of less than Rs 500 Crores and is not rated P1 (or P1+) or equivalent, by a RBI recognized credit rating agency or by a reputed foreign credit rating agency, and not more than 50% of the TGF/SGF or 10% of the total liquid assets deposited with the exchanges, whichever is lower, shall be exposed to all such banks put together.

C. Mark to market losses shall be paid by the member in the form of cash or cash equivalents.

D. Cash equivalents shall be at least 50% of liquid assets. This would imply that Other Liquid Assets in excess of the total Cash Equivalents would not be regarded as part of Total Liquid Assets.

E. The exchanges shall lay down exposure limits either in rupee terms or as percentage of the Trade Guarantee Fund (TGF)/Settlement Guarantee Fund (SGF) that can be exposed to a single issuer directly or indirectly and in any case the exposure of the TGF/SGF to any single issuer shall not be more than 15% of the total liquid assets forming part of TGF/SGF of the exchange.

F. Acceptance of Fixed Deposit Receipts (FDRs) by Clearing Corporations as Collaterals Clearing corporation shall not accept Fixed Deposit Receipts (FDRs) from trading/clearing members as collateral, which are issued by the trading/ clearing member themselves or banks who are associate of trading/clearing member. Explanation - for this purpose, 'associate' shall have the same meaning as defined under Regulation 2 (b) of SECC Regulations 2018.

G. Haircut on securities of the Central Government<sup>45</sup>

Type and Tenor of Securities	Haircut
Treasury Bills and liquid Government of India Dated Securities having residual maturity of less than 3 years	2%
Liquid Government of India Dated Securities having residual maturity of more than 3 years	5%
For all other semi-liquid and illiquid government of India Dated Securities	10%

<sup>44</sup> Circular No. CIR/MRD/DRMNP/9/2013 dated March 20, 2013.

<sup>45</sup> Circular No. SEBI/HO/MRD/DRMNP/CIR/P/2019/33 Dated February 21, 2019.

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Clearing Corporation generally provides list of approved securities and other collateral related information on monthly basis.

### **Liquidity Categorization of Securities**

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

Group	Trading Frequency over the previous six months	Impact Cost
Liquid Securities (Group I)	At least 80% of the days	Less than or equal to 1%
Less Liquid Securities (Group II)	At least 80% of the days	More than 1%
Illiquid Securities (Group III)	Less than 80% 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 15<sup>th</sup> of each month on a rolling basis considering the previous 6 months for impact cost and previous 6 months for trading frequency. On the basis of the trading frequency and impact cost so calculated, the securities shall move from one group to another group from the first of the next month. For the first month, till the time of monthly review, a newly listed stock shall be categorized 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. Subsequently, after one month, whenever the next monthly review is carried out, the actual trading frequency and impact cost of the security shall be computed, to determine the liquidity categorization of the security. In case any corporate action results in a change in ISIN, then the securities bearing the new ISIN shall be treated as newly listed scrip for group categorization.

### **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.
- c) The computation of the impact cost adopted by the Exchange shall be disseminated on the website of the exchange.

- d) The exchanges shall use a common methodology for carrying out the calculations for mean impact cost.
- e) The details of calculation methodology and relevant data shall be made available to the public at large through the website of the exchanges. Any change in the methodology for the computation of impact cost shall also be disseminated by the exchange.

### **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. For rolling settlement of T+2<sup>46</sup>, institutional trades shall be margined on a T+1 basis with the margin being collected from the custodian upon confirmation of trade. Institutional investors shall include SEBI registered category I & II FPIs<sup>47</sup>, Mutual Funds, Public Financial Institutions as defined under section 4A of the Companies Act, Banks, i.e., a banking company as defined under Section 5(1)(c) of the Banking Regulations Act 1949, Insurance companies registered with IRDA, Pension Fund registered with PFRDA.

In respect of institutional transactions confirmed by the custodians the margins shall be levied on the custodians. In respect of institutional transactions rejected/not accepted by the custodians the margins shall be levied on the members who have executed the transactions.

#### **4.1.1.3 Shortfall of Margins / Pay-in of funds**

In case of any shortfall in margin, the Clearing Corporation may advise the Exchange to withdraw any or all of the membership rights of the clearing member including the withdrawal of trading facilities of all trading members and/ or clearing facility of custodial participants clearing through such clearing members. Additionally, there is a penalty for margin violation.

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 fund's shortage known as the 'funds shortage collateral' for a period of ten rolling settlements which shall not be used for margin purposes. The Exchange/Clearing Corporation may levy a penal interest of not less than 0.07 percent per day on the pay-in shortage of the member.

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<sup>46</sup> With introduction of T+1 settlement, there may be change in the time of margining for institutional trades.

<sup>47</sup> The trades of FPIs shall be margined on a T+1 basis. However, the trades of Category II FPIs who are corporate bodies, Individuals or Family offices shall be margined on an upfront basis as per the extant margining framework for non-institutional trades. .

#### **4.1.1.4 Base Minimum Capital <sup>48</sup>**

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

**Table 4.3: Base Minimum Capital Requirement of Members**

<b>Categories</b>	<b>BMC Deposit</b>
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 Brokers with Algo	Rs 50 Lacs

- 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 BMC deposit shall be maintained for meeting contingencies in any segment of the exchange.
- 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.
- For stock brokers of exchanges not having nation-wide trading terminals, the deposit requirement shall be 40% of the above said BMC deposit requirements.
- Stock Exchanges shall maintain the BMC at Rs. 1 lakh if the average daily turnover is less than Rs.1 crore for any three consecutive months.

#### **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 Provision of early pay-in**

Necessary systems are required to be put in place by clearing corporations to enable early pay-in of funds and securities by the trading members/clearing 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. If Early Pay-In (EPI) of securities has been made to the Clearing Corporation (CC), then all margins would be deemed to have

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<sup>48</sup> SEBI Circular No. MRD/DRMNP/36/2012 dated December 19, 2012.

been collected and penalty for short /non-collection of margin including other margins shall not arise. Further, SEBI has provided a mechanism of block in the demat account of clients undertaking sale transactions.<sup>49</sup>

#### **4.1.1.7 Pre-trade Risk Controls**

There are various pre-order (checks which are applicable before order entering into the trading system) and Pre-trade (checks which are applicable before execution of trade) checks which are available on TWS and trading system of the Exchange. Certain checks are monitored by trading member and certain checks are monitored by Exchange trading system. Some of the pre-order and pre trade checks are given below. Pre-trade risk control helps to prevent aberrant orders or uncontrolled trades.

##### **Pre-order 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'.<sup>50</sup> 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 scrips on which derivatives products are available. 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 for such securities. 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 at a time in the direction of price movement during the day.

There are no day minimum/maximum price ranges applicable for index futures and stock futures. However, in order to prevent erroneous order entry by trading members, dynamic price band/operating ranges are kept at +/- 10%.

##### **UCC/PAN check**

Trading member can put this check to ensure that order is not entered for unregistered client.

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<sup>49</sup>[https://www.sebi.gov.in/legal/circulars/jul-2021/block-mechanism-in-demat-account-of-clients-undertaking-sale-transactions\\_51170.html](https://www.sebi.gov.in/legal/circulars/jul-2021/block-mechanism-in-demat-account-of-clients-undertaking-sale-transactions_51170.html)

<sup>50</sup> Vide SEBI circular CIR/MRD/DP/09/2012 dated March 30, 2012.

#### **Pre-trade checks**

- Trade Execution Range: Orders shall be matched, and trades shall take place only if the trade price is within the trade execution range based on the reference price of the contract, which is applicable in derivatives segment.
- Self-Trade Check: Pro / Client orders entered by same/different members are resulting in self-trade due to same PAN or CP code, as the case may be, on the active and passive side, the same shall result in active or passive order will get cancelled due to self-trade checks .
- Market price protection: market with protection order is a combination of market and limit order. It allows the market order to be executed till a specified level mentioned by trader. The risk of an order getting executed at any price is protected by using such order.
- Kill Switch: This will facilitate member to cancel all outstanding order with one single command.
- Cancel on Logout (COL): If member / user entered order with COL, all outstanding order of the user will get cancelled once user get logout from the TWS.

#### **4.1.1.8 Risk Reduction Mode**

Stock Exchanges/Clearing Corporation shall ensure that the stock brokers are mandatorily put in risk-reduction mode when specific percent (currently 90%) 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. Fresh order placed by member to reduce the open position will be accepted. Fresh order that increase the position shall be checked for the sufficiency of margin and order that do not satisfy the sufficiency of margins will be rejected.
- 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 percent utilization level specified by the clearing corporation from time to time (currently 85%).

Additionally, when the member is in risk reduction mode.

- Members shall not be allowed to place orders with custodial participant code.
- Client and Custodial Participant code modification shall not be permitted.

For monitoring of the risk reduction mode (90% utilization or such applicable limit), the following procedure shall be adopted:<sup>51</sup>

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<sup>51</sup> [https://www.sebi.gov.in/legal/circulars/jul-2021/segregation-and-monitoring-of-collateral-at-client-level\\_51265.html](https://www.sebi.gov.in/legal/circulars/jul-2021/segregation-and-monitoring-of-collateral-at-client-level_51265.html)



- TM level risk reduction mode: Client margin in excess of 90% of the client collateral shall be identified for each client under a TM. The total of such client margin in excess of 90% of the client collateral, plus the proprietary TM margin shall be assessed against the TM proprietary collateral for monitoring of TM level risk reduction mode.
- CM level risk reduction mode: Sum of client margin in excess of 90% of the client collateral for each client under a TM plus the proprietary TM margin, in excess of 90% of TM proprietary collateral shall be calculated as TM margin in excess of 90% of TM collateral. Sum of such margin for each TM clearing through a CM, plus sum of client margin in excess of 90% of the client collateral for each client clearing through such CM, plus the proprietary CM margin shall be assessed against the proprietary CM collateral for monitoring of CM level risk reduction mode.

#### **4.1.2 Risk Management Framework for Derivatives (Future and Option) Segment**

Risk Management framework for derivatives will consist of the following:

- Margins
- Liquid Net worth & Liquid Assets
- Pre-trade risk control
- Risk Reduction Mode
- Position Limits

We will study risk management framework for equity derivatives segment in this section.

##### **4.1.2.1 Types of Margins**

###### **Initial Margin Computation**

Initial margin is payable on all open positions of clearing members, up to client level and shall be payable upfront by Clearing Members in accordance with the margin computation mechanism adopted by the Clearing Corporation. Initial margin shall include SPAN margins, Margin on consolidated crystallized obligation<sup>52</sup>, delivery margins and such other additional margins that may be specified by the clearing Corporation from time to time.

Initial margin for client positions shall be netted at the level of individual client and grosses across all clients, at the trading/clearing member level, without any set-offs between clients. Initial margin requirement for proprietary positions shall be netted at trading/clearing member level without any set-offs between client and proprietary positions. The margins computed shall be aggregated first at the trading member level and then aggregated at the clearing member level.

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<sup>52</sup> SEBI/HO/MRD2/DCAP/CIR/P/2020/27 dated February 24, 2020

Clearing Corporation adopted SPAN<sup>53</sup> system for the purpose of real time initial margin computation. The SPAN methodology shall be adopted to take an integrated view of the risk involved in the portfolio of each individual client. Initial Margin requirement shall be based on a worst scenario loss of a portfolio of an individual client comprising his positions in options and futures contracts on the same underlying across different maturities and across various scenarios of price and volatility changes. Initial margin requirements shall be based on 99% value at risk (VaR) over a one day time horizon. Value-at-risk (VaR) is a measure of maximum likely price change over a given interval (called “horizon”) and at a given confidence level (called “percentile”). 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 shall be computed over a two day time horizon by applying an appropriate statistical formula. SPAN margining uses VaR to compute initial margin but improves upon it with two modifications. It generates 16 “what-if” scenarios. The second and more important feature of SPAN margin is that it considers the entire portfolio of an investor for computing the portfolio-wide margin. The margin is not computed for each position separately. The methodology for computation of value at risk percentage shall be as per the recommendations of SEBI from time to time.

For the purpose of SPAN Margin, various parameters as specified hereunder will be applicable:

**Price Scan Range**

Product	Price Scan Range
Index Derivatives	Based on $6\sigma$ , scaled up by $\sqrt{2}$ subject to at least 9.3% of the underlying price after considering scaling up.  In case of index option contracts with residual maturity of more than 9 months, the price scan range shall be based on $6\sigma$ , scaled up by $\sqrt{2}$ subject to at least 17.7% of the underlying price after considering scaling up.
Single stock derivatives	Based on $6\sigma$ , scaled up by $\sqrt{2}$ subject to at least 14.2% of the underlying price after considering scaling up.  The price scan range thus arrived shall be further scaled up by $\sqrt{3}$ , if the impact cost of the security (as used for categorization of securities for margining in Cash Market) is greater than 1%.

**Volatility calculation**

The standard deviation (volatility estimate) is calculated using the Exponential Weighted Moving Average (EWMA). The estimate at the end of time period  $t$  ( $\sigma_t$ ) shall be estimated using the volatility estimate at the end of the previous time period. i.e. as at the end of  $t-1$  time period ( $\sigma_{t-1}$ ), and the return ( $r_t$ ) observed in the futures market during the time period  $t$ . The formula shall as under:

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<sup>53</sup> It is a product developed by Chicago Mercantile Exchange (CME) and is extensively used by leading stock Exchanges of the world. SPAN<sup>®</sup> uses scenario-based approach to arrive at margins. It generates a range of scenarios and highest loss scenario is used to calculate the SPAN margin.

$$(\sigma_t)^2 = \lambda (\sigma_{t-1})^2 + (1 - \lambda) (r_t)^2$$

The value of  $\lambda$ , the parameter which determines how rapidly volatility estimation changes in the Exponential Weighted Moving Average (EWMA) method, shall be fixed at 0.995.

#### **Volatility Scan Range**

Product	Volatility Scan Range
Index Derivatives	25% of annualized EWMA volatility subject to minimum 4%
Single Stock Derivatives	25% of annualized EWMA volatility subject to minimum 10%

#### **Updation of Risk Parameters**

In order to ensure that the most recent scenario are applied for computation of the portfolio values and the initial margin, the scenario contract values shall be updated at least 5 times in the 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.

#### **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 portfolio consisting of a near month option with a delta of 100 and a far month option with a delta of –100 would bear a spread charge equal to the spread charge for a portfolio which is long 100 near month futures and short 100 far month futures. A calendar spread position shall be granted calendar spread treatment till the expiry of the near term contract.

Product	Calendar Spread Charge
Index Derivatives	1.75% of the far month contract
Single Stock Derivatives	2.2% of the far month contract

#### **Margin on consolidated crystallized obligation**

The margin on consolidated crystallized obligation in derivatives shall represent:

On Intra-day Basis	Payable crystallized obligations based on the closed-out futures positions and payable/receivable premium at client level.
At end-of-day basis	Payable obligations at client level considering all futures and options positions.

### **Intraday basis**

On intraday basis, the net payable/receivable amount at client level shall be calculated using:

1. Premium payable/receivable
2. Futures crystallized profit or loss (calculated based on weighted average prices of trades executed).

If the overall amount at client level is payable, such amount shall be the intraday consolidated crystallized obligation margin for the client.

### **End-of-day basis**

At the end of day, the payable/receivable amount at client level shall be calculated using:

1. Futures mark to market profit/loss to be settled
2. Options premium payable/receivable
3. Options exercise/assignment for expired contracts
4. Futures final settlement for expired contracts

If the overall amount at client level is payable, such amount shall be the end of-day consolidated crystallized obligation margin for the client. The margin on consolidated crystallized obligations shall be released on completion of settlement.

The margin on consolidated crystallized obligations has replaced the net buy premium, intraday crystallized losses, assignment margin and futures final settlement margin levied.

To make the risk management system more robust, the payment of MTM is mandatorily to be paid by all members before start of trading on the next day.

### **Net Option Value**

Net Option Value is computed as the difference between the long option positions and the short option positions, valued at the last available closing price of the option contract and shall be updated intraday at the current market value of the relevant option contracts at the time of generation of risk parameters. The Net Option Value shall be added to the Liquid Net Worth of the clearing member. Thus, mark to market gains and losses shall not be settled in cash for options positions.

### **Delivery Margins**

Delivery margins shall be levied on lower of potential deliverable positions or in-the-money long option positions four (4) days prior to expiry of derivative contract which must be settled through delivery. Example- If expiry of derivative contract is on Thursday, the delivery margins on potential in-the-money long option position shall be applicable from previous Friday EOD.

- Delivery margins at the client level shall be computed as per the margin rate applicable in Capital Market segment (i.e. VAR, Extreme Loss Margins) of the respective security.

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- Delivery margins shall be levied at client level and collected from clearing member in a staggered manner as under
  - o 10% of Delivery margins computed on Expiry - 4 EOD
  - o 25% of Delivery margins computed on Expiry - 3 EOD
  - o 45% of Delivery margins computed on Expiry - 2 EOD
  - o 70% of Delivery margins computed on Expiry - 1 EOD
- The delivery margins shall be recomputed only at EOD basis considering the revised position, underlying prices and margin rates.
- Post expiry, positions which are converted to settlement by delivery, margins as applicable in Capital Market segment (i.e. VAR, Extreme Loss Margins, Mark to Market margins) shall be applicable and levied as delivery margins.
- Delivery margins shall be part of the initial margins of the clearing member.
- VAR and Extreme Loss Margins: - The VAR and Extreme Loss percentage as computed in the Capital Market segment shall be applied on client level settlement obligations.
- Delivery margins blocked shall be released on completion of settlement.
- Assignment margins shall not be computed on positions which shall be identified for settlement through delivery.
- Mark to Market margins - End of day mark to market margins shall be computed on expiry day and expiry + 1 day as difference between settlement obligation and value of positions at closing price of the security in the Capital Market segment of the Exchange. Mark to market loss in one security shall be netted against profit of other security for same client. Net loss at client level shall be grossed to arrive at clearing member level mark to market margins.

### **Extreme Loss Margin**

Clearing members shall be subject to extreme loss margins in addition to initial margins.:

Product		Extreme Loss Margin
Index Futures		2% of the notional value of the gross open positions in futures contracts, based on the last available trading price of the relevant futures contract
Single Futures	Stock	3.5% of the notional value of the gross open positions in futures contracts, based on the last available trading price of the relevant futures contract
Short Options	Index	2% of the notional value of the short open position
Short Options	Stock	3.5% of the notional value of the short open position

#### **Notes:**

1. In case of calendar spread positions in futures contracts, extreme loss margin shall be levied on one third of the value of the open position of the far month futures contract.

2. In case of index options contracts that are deep out of the money (i.e., strikes out of the money by more than 10% from the previous day closing underlying price), the applicable Extreme Loss Margin shall be 3%.
3. In case of index option contracts with residual maturity of more than 9 months, the applicable Extreme Loss Margin shall be 5%.
4. In case of single stock options contracts that are deep out of the money (i.e., strikes out of the money by more than 30% from the previous day closing underlying price), the applicable Extreme Loss Margin shall be 5.25%.

### **Additional Margin**

Exchanges/clearing corporations have the right to impose additional risk containment measures over and above the risk containment system mandated by SEBI. Some of the additional margins are Surveillance Margin, Additional Margin for highly volatile stock, additional margin for security in ban period, additional margin for client concentration etc. Further, in certain cases the option value is collected only in cash.

### **Cross Margining**

In order to improve the efficiency of the use of the margin capital by market participants SEBI has introduced cross margin across Cash and Derivatives segment and made available to all categories of market participants.<sup>54</sup> The positions of clients in both the Capital market and F&O segments to the extent they offset each other shall be considered for the purpose of cross margining. Position eligible for cross margining benefit: -

- a. Index futures and constituent stock futures in F&O segment
- b. Index futures and constituent stock positions in Capital market segment
- c. ETF and constituent stock futures in F&O segment
- d. ETF and constituent stock positions in Capital market segment
- e. Index futures and ETF in Capital market segment
- f. Stock futures in F&O segment and stock positions in Capital market segment
- g. Index Futures contract in F&O Segment on eligible equity indices

In order to facilitate efficient use of collateral by market participants, SEBI vide its circular dated November 8, 2019 has decided to extend cross margining facility to off-setting positions in highly co-related equity indices.<sup>55</sup>

Client can avail cross margin benefit in both the scenario namely when a same Clearing Member clears for client/ entities in Cash and Derivatives segments and when different Clearing Members clear for client/entities in Cash and Derivatives segments. A basket of positions in index constituent stock/stock futures, which is a complete replica of the index in the ratio specified by the Exchange/Clearing Corporation, shall be eligible for cross margining benefit. The constituents and the number of units of the constituent stocks/ stock futures required in the basket to be considered as a complete replica of the ETF shall be the

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<sup>54</sup> SEBI Circular Ref. No.: SEBI/DNPD/Cir-44/2008 dated December 02, 2008

<sup>55</sup> [https://www.sebi.gov.in/legal/circulars/nov-2019/introduction-of-cross-margining-facility-in-respect-of-offsetting-positions-in-corelated-equity-indices\\_44896.htm](https://www.sebi.gov.in/legal/circulars/nov-2019/introduction-of-cross-margining-facility-in-respect-of-offsetting-positions-in-corelated-equity-indices_44896.htm)

same as that of the respective underlying Index for availing cross margin benefit. The positions in the derivatives segment for the stock futures and index futures shall be in the same expiry month to be eligible for cross margining benefit.

#### **4.1.2.2 Liquid Net Worth and Exposure Limits of a Clearing Member**

##### **Liquid Net Worth**

The Liquid Net Worth is defined as the total liquid assets deposited with the Exchange/Clearing Corporation towards initial margin and capital adequacy, LESS initial margin, and extreme loss/exposure 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 shall not be less than Rs. 50 lacs at any point of time.

##### **Liquid Assets**

Clearing member may deposit liquid assets in the form of cash, bank guarantees, fixed deposit receipts, approved securities and any other form of collateral as may be prescribed by the Clearing Corporation from time to time.

These liquid assets are segregated as cash component and non-cash component. Cash component shall mean cash, bank guarantees, fixed deposit receipts, units of money market mutual fund, Gilt funds, Government of India Securities, Sovereign Gold Bonds and any other form of collateral as may be prescribed by the Clearing Corporation from time to time. Non-cash component shall mean all other forms of collateral deposits like deposit of approved list of demat securities, units of the other mutual funds and any other form of collateral as may be prescribed by the Clearing Corporation from time to time.

Item	Haircut	Limits
<b><i>Cash Equivalents</i></b>		
Cash	0	No limit
Bank fixed deposits	0	No limit
Bank guarantees	0	Limit on Exchange's/Clearing Corporation exposure to a single bank (See Note)
Securities of the Central Government	Refer Note	No limit
Units of liquid mutual funds or government securities mutual funds	10 percent	No limit

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Foreign Sovereign Securities	The haircut may either be a fixed percentage or VaR based	Value of the sovereign securities shall not be more than 10% of the total value of the cash component of the liquid assets of the clearing member.
<b><i>Other liquid assets (Non-Cash Component)</i></b>		
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 computed using the traded price on stock exchange, if available, or else, using the NAV of the unit treating it as a liquid security	
Corporate Bonds <sup>56</sup>	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.

**Note:**

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

a. 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.

b. Not more than 5% of the trade guarantee fund or 1% 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% of the trade guarantee fund or 10% of the total liquid assets deposited with the clearing house, whichever is lower, shall be exposed to all such banks put together.

<sup>56</sup> Circular No. CIR/MRD/DRMNP/9/2013 dated March 20, 2013.



c. 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.

B) The total exposure of the clearing corporation to the debt or equity securities of any company shall not exceed 75% of the trade guarantee fund or 15% of the total liquid assets of the clearing corporation / house whichever is lower.

C) At least 50% of the total liquid assets shall be in the form of cash and cash equivalents

D) Clearing corporation shall not accept Fixed Deposit Receipts (FDRs) from trading/clearing members as collateral, which are issued by the trading/ clearing member themselves or banks who are associate of trading/ clearing member. Explanation - for this purpose, 'associate' shall have the same meaning as defined under Regulation 2 (b) of SECC Regulations 2018.

E) Only FPIs are permitted to offer foreign sovereign securities with AAA ratings.

F) Haircut on securities of the Central Government

Type and Tenor of Securities	Haircut
Treasury Bills and liquid Government of India Dated Securities having residual maturity of less than 3 years	2%
Liquid Government of India Dated Securities having residual maturity of more than 3 years	5%
For all other semi-liquid and illiquid government of India Dated Securities	10%

#### **4.1.2.3 Pre-trade risk control and Risk Reduction Mode**

With the view to ensure orderly trading and market integrity, like cash segment stock exchanges/clearing corporation has implemented pre-trade risk controls in derivatives segment like quantity freeze, price band, dynamic price band, trade execution range, self-trade check etc.

Similar to cash segment, in derivatives segment also Stock Exchanges/Clearing Corporation shall ensure that the stockbrokers are mandatorily put in risk-reduction mode when specific percent (currently 90%) of the stock broker's collateral available for adjustment against margins gets utilized on account of trades that fall under a margin system.

#### **4.1.2.4 Position and Exposure Limits**

SEBI has prescribed various kind of position limit and Exposure limits in Derivatives Segment. The position limits may be applicable at instrument level, stock-broker level, clearing member level, limits for FPIs/MFs, non-institutional clients, market wide position limits etc. Exchanges and Clearing Corporation has to implement/put in place necessary procedures to monitor these limits. Violation of these limits attracts penal action against the participants.

#### **4.1.3 Margins from the Client**

Trading Members/Clearing 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

### **Capital Market Segment**

The TMs/CMs in cash segment are also required to mandatorily collect upfront VaR margins and ELM from their clients. The TMs/CMs will have time till 'T+2' working days to collect margins (except VaR margins and ELM) from their clients. (The clients must ensure that the VaR margins and ELM are paid in advance of trade and other margins are paid as soon as margin calls are made by the Stock Exchanges/TMs/CMs. The period of T+2 days has been allowed to TMs/CMs to collect margin from clients taking into account the practical difficulties often faced by them only for the purpose of levy of penalty and it should not be construed that clients have been allowed 2 days to pay margin due from them.) If TM / CM collects minimum 20% upfront margin in lieu of VaR and ELM from the client, then penalty for short-collection / non-collection of margin shall not be applicable. However, it is reiterated that Clearing Corporation shall continue to collect the upfront margin from the TM / CM based on VaR and ELM<sup>57</sup> The TMs/CMs will have time till 'T+2' working days to collect other margins (except VaR margins and ELM) from their clients. The clients must ensure that other margins are paid as soon as margin calls are made by the Stock Exchanges/TMs/CMs. TMs/CMs shall be required to report a single consolidated value comprising of , minimum margin, additional margins and MTM collected. The TMs/CMs shall report to the Stock Exchange/Clearing Corporation the actual short-collection/non-collection of all margins from clients within the specified time which is currently T+5 day. SEBI further clarified that If pay-in (both funds and securities) is made by T+2 working days, the other margins would deemed to have been collected and penalty for short/ non collection of other margins shall not arise. If Early Pay-In of securities has been made to the Clearing Corporation (CC), then all margins would deemed to have been collected and penalty for short /non-collection of margin including other margins shall not arise.

### **F&O Segment**

In the F&O segment, it is mandatory for Trading Members to collect initial margins (excluding delivery margins) & Extreme loss margin from respective clients on an upfront basis. It must be ensured that all upfront margins are collected in advance of trade. Delivery Margin and margin on consolidated crystallized obligation shall be collected from clients by T+1 day. TMs/CMs shall report to the Stock Exchange on T+5 day the actual short-collection/non-collection of all margins from clients.

### **Currency Derivative Segment**

In case of Currency Derivatives segment also, it is mandatory for Trading Members to collect initial margin and extreme loss margins from their client on an upfront basis. It must be ensured that all upfront margins are collected in advance of trade. Margin on consolidated

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<sup>57</sup> Vide SEBI CIR/HO/MIRSD/DOP/CIR/P/2019/139 November 19, 2019, SEBI/HO/MIRSD/DOP/CIR/P/2020/146 dated July 31, 2020 and SEBI/HO/MIRSD/DOP/CIR/P/2020/173 dated September 15, 2020.

crystallized obligation shall be collected from clients by T+1 day. However, in case of currency future contracts, final settlement amount shall be collected by T+2 day. TMs/CMs shall report to the Stock Exchange on T+5 day the actual short-collection/ non-collection of all margins from clients.

The TM/CM can collect the margin from its client in a various form as specified by SEBI/Exchanges/Clearing Corporation from time to time after taking into account their risk management policy and liquidity aspects. SEBI also provided “Framework to Enable Verification of Upfront Collection of Margins from Clients in Cash and Derivatives segments.”<sup>58</sup> Stock Exchange/Clearing Corporation shall levy penalty to TM/CM for short collection/non-collection of margin. All instances of non-reporting shall amount to 100% short collection and the penalty as applicable shall be charged on these instances in respect of short collection. If during inspection it is found that a member has reported falsely the margin collected from clients, the member shall be penalized 100% of the falsely reported amount along with suspension of trading for 1 day in that segment.

#### **4.1.4 Mechanism for Client Collateral**

In order to strengthen the mechanism of protection of client collateral from misappropriation/ misuse by TM/ CM, default of TM/CM and/or other clients and upfront collection of margin from clients SEBI has issued various measures like:

1. Margin obligations to be given by way of Pledge/ Re-pledge in the Depository System<sup>59</sup>. Salient features are given below:
  - Collateral from clients in the form of securities is allowed only by way of ‘margin pledge’, created in the Depository system
  - Procedure provided by depositories for the manner of creating pledge of the dematerialized securities should be followed. Any other procedure for creating pledge is prohibited.
  - It is clarified that an off-market transfer of securities leads to change in ownership and shall not be treated as pledge. Transfer of securities to the demat account of the TM / CM for margin purposes (i.e., title transfer collateral arrangements) is prohibited.
  - Depositories provides a separate pledge type viz. ‘margin pledge’, for pledging client’s securities as margin to the TM / CM. The TM / CM shall open a separate demat account for accepting such margin pledge, which shall be tagged as ‘Client Securities Margin Pledge Account’.
  - For the purpose of providing collateral in form of securities as margin, a client shall pledge securities with TM, and TM shall re-pledge the same with CM, and CM in turn shall re-pledge the same to Clearing Corporation (CC). The complete trail of such re-pledge shall be reflected in the de-mat account of the pledgor.

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<sup>58</sup> SEBI/HO/MRD2/DCAP/CIR/P/2020/127 dated July 20, 2020

<sup>59</sup> SEBI circular SEBI/HO/MIRSD/DOP/CIR/P/2020/28 dated February 25, 2020

- In client account, margin pledge or re-pledge shall be reflected against each security, if it is pledged / re-pledged and in whose favour i.e. TM / CM / CC.
  - The TM shall re-pledge securities to the CM's 'Client Securities Margin Pledge Account' only from the TM's 'Client Securities Margin Pledge Account'. The CM shall create a re-pledge of securities on the approved list to CC only out of 'Client Securities Margin Pledge Account'.
  - In this context, re-pledge would mean endorsement of pledge by TM / CM in favour of CM/CC, as per procedure laid down by the Depositories.
  - The TM and CM shall ensure that the client's securities re-pledged to the CC shall be available to give exposure limit to that client only.
  - Securities that are not on the approved list of a CC may be pledged in favour of the TM / CM. Each TM / CM may have their own list of acceptable securities that may be accepted as collateral from client.
  - CM shall be allowed to re-pledge acceptable/approved client securities with the CC by furnishing the UCC wise client details. CC shall not allow any exposure to the CM on re-pledged securities of the client / TM.
  - In case of a trade by a client / TM whose securities are re-pledged with CC, the CC shall first block the available collateral provided by CM. However, at periodical interval (latest by end of day), CC shall release the blocked securities collateral of CM to the extent of re-pledged securities collateral of that client / TM available with the CC.
2. Framework to enable verification of upfront collection of margins from clients in Cash and Derivatives segments<sup>60</sup>:

The guideline reiterated that the applicable upfront margins are required to be collected from the clients in advance of the trade. With an objective to enable uniform verification of upfront collection of margins from clients by TM/ CM and levy of penalty across segments, SEBI has specified framework to the Stock Exchanges/ Clearing Corporations for the purpose of 'Mechanism for regular monitoring of and penalty for short-collection/ non-collection of margins from clients' in Cash and Derivatives segments. .

3. Segregation and Monitoring of Collateral at Client Level<sup>61</sup>. Salient features are given below:
- With a view to providing visibility of client-wise collateral (for each client) at all levels, viz., TM, CM and Clearing Corporation (CC), a reporting mechanism, covering both cash and non-cash collateral, shall be specified by the CCs.
  - TM shall report disaggregated information on collaterals up to the level of its clients to the CM.

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<sup>60</sup> SEBI circular SEBI/HO/MRD2/DCAP/CIR/P/2020/127 dated July 20, 2020

<sup>61</sup> SEBI circular SEBI/HO/MRD2\_DCAP/CIR/2021/0598 dated July 20, 2021,  
SEBI circular SEBI/HO/MRD2/DCAP/P/CIR/2022/0022 dated February 24, 2022

- CM shall report disaggregated information on collaterals up to the level of clients of TM and proprietary collaterals of the TMs to the Stock Exchanges (SEs) and CCs in respect of each segment.
- A web portal facility shall be provided by the CCs/ SEs to allow clients to view aforesaid disaggregated collateral reporting by TM/CM.
- The CCs shall provide a facility to CMs for upfront segment-wise allocation of collateral to a TM/ client or CM's own account. The CCs shall use such collateral allocation information to ensure that the collateral allocated to a client is used towards the margin obligation of that client only.
- There shall be no change in the procedures pertaining to placing of securities as collateral through the margin pledge/re-pledge mechanism in the Depository system, and this collateral will be identified as belonging to a client or as being proprietary securities of the TM or CM, as the case may be, as per the existing procedures.
- While depositing other forms of collateral i.e. Cash, Fixed Deposits (FDs), Bank Guarantees (BGs) or Government Securities provided through the SGL/CSGL route, etc., the CM shall allocate these collaterals into proprietary account of CM, and/or proprietary account of any TM clearing through the CM, and/or account of any of the clients(including Custodial Participants(CPs)) clearing through the CM, and/or of any of the clients trading through the TM who in turn is clearing through the CM, segment-wise.
- In case of such collateral received by the CM from any TM, the CM shall not accept the same without the TM specifying break-up of such collateral into proprietary account of the TM and/or uniquely identified client account. Similarly, the CC shall not accept such collateral without the CM specifying appropriate break-up of such collateral into proprietary account of CM/ proprietary account of TM/ client account. The CM shall ensure that the sum of break-up of such collateral provided by TM is equal to the total value of such collateral provided by TM, and that the allocation of such collateral to any entity as reported to the CC does not exceed the allocation of collateral reported by the TM for that entity.
- The members shall ensure that allocated collateral plus value of securities collateral re-pledged to the CC for a client is at all times greater than or equal to the minimum margin collection requirement for the respective client in the respective segment.
- CMs are required to maintain at least 50% of the total collateral in the form of cash or cash equivalents. At individual client level, a client may have allocation of cash equivalent, less than the value of non-cash collateral provided by the client. In other words, the minimum 50% cash equivalent collateral requirement may not be applied at the client level. For the purpose of monitoring of at least 50% cash-equivalent collateral at the level of CM, the excess cash-equivalent collateral of a client shall not be considered for other client or for proprietary account of TM/CM. However, the excess cash-equivalent collateral of proprietary account of TM/CM can be considered for clients trading/clearing through them, for the purpose of monitoring minimum 50% cash-equivalent requirement.
- The terms "Client Collateral", "TM Collateral", "CP Collateral" and "CM Collateral" shall mean the total of the allocated collateral value plus the value of demat

securities collateral provided through margin pledge/re-pledge by any individual client, TM, CP and CM respectively to the level of CC. The TM/CM collateral shall mean the proprietary collateral of the TM/CM only and shall not include the collateral of any of their clients.

- On receipt of a trade from a client account by the CC, the margin shall first be blocked from the value of the client collateral. If the client collateral is not sufficient, the residual margin shall be blocked from the TM proprietary collateral of the TM of such client. If the TM proprietary collateral is also not sufficient, then the residual margin shall be blocked from the CM proprietary collateral of the CM of such TM.
- In case of a trade from the proprietary account of a TM, the margin shall first be blocked from the TM proprietary collateral, and in case such collateral is not sufficient, then the residual margin shall be blocked from the CM proprietary collateral.
- Margins based on trades from proprietary account of the CM shall be blocked from the proprietary collateral of the CM only.
- In case of CP trades executed by TMs, the margin shall be blocked in the following order- (i) CP collateral through the executing TM, if any, (ii) residual margin from the proprietary collateral of the executing TM, and (iii) residual margin from the proprietary collateral of the CM of the executing TM. Upon confirmation of such trades by CM of the CP, the margin so blocked prior to the confirmation shall be released, and shall be blocked in the following order- (i) CP collateral through the confirming CM, and (ii) residual margin from the proprietary collateral of the confirming CM. In case of CP trades, the requirement to ensure that sufficient collateral is allocated to clients to cover their margin requirements shall be on the confirming CM. However, if the trade is confirmed under the auto approval facility provided by the CC, then margin shall be directly blocked in the following order- (i) CP collateral through the confirming CM, and (ii) residual margin from the proprietary collateral of the confirming CM.
- CMs shall be permitted to change the allocation of collateral deposited with the CC, subject to the value allocated to any client not exceeding the value of actual collateral received from that client (excluding the securities collateral re-pledged to CC through margin pledge mechanism).

For additional details participants are requested to refer the relevant circulars.

#### **4.1.5 Providing margin related information to clients**

Stock Brokers should send margin related information across all segment to their clients, which shall, inter-alia, include:

- Client code and name, Trade day (T)
- Margin deposit available for the client on day T (with break-up in terms of cash, FDRs, BGs and pledged/re-pledged securities)
- Margin adjustments (including MTM losses) for day T after adjusting MTM profit if any.
- Margin status (balance with the member / due from the client) at the end of T day.

Such margin related information (Daily margin statement) should be issued by Stock Brokers to clients on T-Day itself or by such timelines as may be specified from time to time.

Brokers should maintain proper records of client collateral and to prevent misuse of client collateral

- Brokers should have adequate systems and procedures in place to ensure that client collateral is not used for any purposes other than meeting the respective client's margin requirements/pay-ins. Brokers should also maintain records to ensure proper audit trail of use of client collateral.
- Additionally, every Stock Broker shall maintain proper records of collateral received from clients as under:
  - Receipt of collateral from client and acknowledgement issued to client on receipt of collateral
  - Client authorization for deposit of collateral with the exchange/ clearing corporation/ clearing house towards margin
  - Record of deposit of collateral with exchange/ clearing corporation/ clearing house
  - Record of return of collateral to client
  - Credit of corporate action benefits to clients
- The records should be periodically reconciled with the actual collateral deposited with the broker.

In case client collateral is found to be mis-utilized, the broker would attract appropriate deterrent penalty for violation of norms provided under Securities Contract Regulation Act, SEBI Act, SEBI Regulations and circulars, Exchange Byelaws, Rules, Regulations and circulars.

Stock-Broker/Clearing 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.

#### **4.1.6 Enhanced Supervision of Stock Brokers <sup>62</sup>**

To strengthen the Risk Management process and to increase investor confidence in the secondary market, SEBI constituted a committee on “Enhanced Supervision of Stock Brokers”, which included representatives from all stake holders that gave certain recommendations/guidelines under the aforesaid heading. These guidelines cover the following broad areas:

- Uniform nomenclature to be followed by stock brokers for Naming/Tagging of Bank and Demat Accounts and the reporting of such accounts to the Stock Exchanges/Depositories. All new bank and demat accounts opened by the stock brokers shall be named as per the SEBI specified nomenclature and the details

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<sup>62</sup> SEBI Cir No. SEBI/HO/MIRSD/MIRSD2/CIR/P/2016/95 dated September 26, 2016 and SEBI Cir. No. SEBI/HO/MIRSD/MIRSD2/CIR/P/2017/123 Dated November 29, 2017.

shall be communicated to the Stock Exchanges within one week of the opening of the account.

- Monitoring of Clients' Funds lying with the Stock Broker by the Stock Exchanges, through a sophisticated alerting and reconciliation mechanism, to detect any mis-utilisation of clients fund. Stock broker on weekly basis upload information related to above to Exchange as per the format provided by Exchange from time to time.
- Changes in the existing system of internal audit for stock brokers/depository participants viz. appointment, rotation of Internal Auditors, formulation of objective sample criteria, monitoring of quality of Internal Audit Reports, timeline for submissions of Internal Audit Reports, etc
- Monitoring of financial strength of stock brokers by stock exchanges so as to detect any signs of deteriorating financial health of stock brokers and serve as an early warning system to take pre-emptive and remedial measures. The Stock Exchanges shall monitor the various financial indicators and financial ratios of stock brokers. Stock Brokers shall submit financial statements to Stock Exchanges in the same format as prescribed under Companies Act, 2013. Also specify condition related to appointment and re-appointment of statutory auditor.
- Imposition of uniform penal action on stock-brokers/depository participants by the Stock Exchanges/Depositories in the event of non-compliance with specified requirements.
- Exchange shall put in place a mechanism and ensure that stock brokers upload following data on a periodic basis for every client onto each stock exchange system (a) exchange wise end of day fund balance as per the client ledger, consolidated across all segments and also net funds payable or receivable by the broker to/from the client across all exchanges; (b) end of day securities balances ISIN wise and end of day securities balances consolidated ISIN wise; etc. Stock Exchange will onwards transmit this information to clients for better transparency.
- Members are required to submit various data related each client on periodic basis. This includes client funds lying with stock broker, holding statement, client fund and securities balance, reporting of financial indicator data etc.
- Clarification on running account viz. time gap between two running account settlement, mode of transfer for funds settlement etc.
- The stock brokers shall provide Permanent Account Numbers of all their Directors, Key Management Personnel and dealers to the Stock Exchanges. Any change in the aforesaid details/information shall be intimated to the Stock Exchanges within seven days of such change.
- Brokers shall not grant further exposure to the clients when debit balances arise out of client's failure to pay the required amount and such debit balances continues beyond the fifth trading day, as reckoned from date of pay-in, except, in accordance with the margin trading facility provided vide SEBI circular CIR/MRD/DP/54/2017 dated June 13, 2017, or as may be issued from time to time.



SEBI vide circular<sup>63</sup> dated June 2022 has specified “Naming / Tagging of demat accounts maintained by Stock Brokers”. Highlights of the circular are as follows:

- All demat accounts of stock brokers which are untagged need to be appropriately tagged by June 30, 2022.
- Credit of securities shall not be allowed in any demat account left untagged from July 01, 2022, onwards
- Debit of securities shall also not be allowed in any demat account left untagged from August 01, 2022
- Stock Broker shall obtain permission from Stock Exchanges to allow tagging of such demat accounts from August 01, 2022, onwards. Stock Exchange shall grant such approval within two working days after imposing penalty as per their internal policy.

#### **Graded Surveillance Measure (GSM) and Additional Surveillance Measure (ASM)<sup>64</sup>**

To enhance market integrity and safeguard interest of investors, SEBI has introduced Graded Surveillance Measures (GSM) on securities which witness an abnormal price rise not commensurate with financial health and fundamentals like Earnings, Book value, Fixed assets, Net-worth, P/E multiple, etc. Similarly, ‘Additional Surveillance Measures’ (ASM) on securities with surveillance concerns based on objective parameters viz. Price variation, Volatility etc. have been introduced.

The main objective of these measures is:

- To alert and advice investors to be extra cautious while dealing in these securities
- To advice market participants to carry out necessary due diligence while dealing in these securities.

#### **4.2 Compliances and Regulatory Reporting**

SEBI and the Stock Exchanges issued various directives/guidelines/circulars to be followed by stock brokers. These include directives on client registration, dealing with clients, issuance of contract note, margin requirements, guideline related to trading software, smooth functioning of pay-in/pay-out, dealing with branches & Authorized Person, maintenance & preservation of books of accounts and other documents, trading restrictions, base minimum capital, etc. Other requirements include submission of various reports, disclosures including audit reports along with the annual reports to the Exchanges and payments of fees specified by SEBI from time to time.

The stock broker shall bring to the notice of the relevant Exchange the information about default in payment/delivery and related aspects by a client. In case where defaulting client

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<sup>63</sup> [https://www.sebi.gov.in/legal/circulars/jun-2022/naming-tagging-of-demat-accounts-maintained-by-stock-brokers\\_59830.html](https://www.sebi.gov.in/legal/circulars/jun-2022/naming-tagging-of-demat-accounts-maintained-by-stock-brokers_59830.html)

<sup>64</sup> [https://static.nseindia.com/s3fs-public/inline-files/FAQs\\_Additional\\_Surveillance\\_Measure.pdf](https://static.nseindia.com/s3fs-public/inline-files/FAQs_Additional_Surveillance_Measure.pdf)  
[https://static.nseindia.com/s3fs-public/inline-files/FAQs\\_Graded\\_Surveillance\\_Measure\\_0.pdf](https://static.nseindia.com/s3fs-public/inline-files/FAQs_Graded_Surveillance_Measure_0.pdf)  
[https://www.bseindia.com/downloads1/FAQs\\_on\\_ASM.pdf](https://www.bseindia.com/downloads1/FAQs_on_ASM.pdf)  
[https://www.bseindia.com/downloads1/FAQ\\_GSM.zip](https://www.bseindia.com/downloads1/FAQ_GSM.zip)

is a corporate entity/partnership/proprietary firm or any other artificial legal entity, then the name(s) of Director(s)/Promoter(s)/Partner(s)/Proprietor as the case may be, shall also be communicated by the stock broker to the relevant Exchange(s).

In case of any change in the designated director, shareholding, change of control, change in name, amalgamation, merger, demerger, scheme of arrangement, conversion of membership etc., stock broker has to obtain prior/final approval of SEBI/Exchange/Clearing Corporation as per the procedure specified by SEBI/Exchanges in this regards.

Stock brokers adhere to the directives specified in various regulations like SEBI Stock Broker Regulation, SEBI Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market Regulations, SEBI KRA regulation, SEBI (Prevention of Insider Trading) Regulation, Securities Contracts (Regulations) Rules, 1957, Securities Contracts (Regulation) Act, 1956, Guidelines on Anti-Money Laundering (AML) Standards and Combating the Financing of Terrorism (CFT) /Obligations of Securities Market Intermediaries under the Prevention of Money Laundering Act, 2002 and Rules framed there under etc.

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

Section 15A deals with penalty for failure to furnish information, return, etc. It states that a person shall be liable to a penalty which shall not be less than 1 lakh rupees, but which may extend to 1 lakh rupees for each day during which such failure continues subject to a maximum of one crore rupees, if he fails to:

- Furnish any document, return or report to SEBI as required by the Act or who furnishes or files false, incorrect or incomplete information, return, report, books or other documents.
- File any return or furnish any information, books or other documents within the time specified, as required by the Act or who furnishes or files false, incorrect or incomplete information, return, report, books or other documents.
- Maintain books of accounts or records.

Section 15C deals with penalty for failure to redress investors' grievances. It states that, if any listed company or any person who is registered as an intermediary, after having been called upon by SEBI in writing to redress the grievances of investors, fails to redress such grievances within the time specified by SEBI, such company or intermediary shall be liable to a penalty which shall not be less than one lakh rupees, but which may extend to one lakh rupees for each day during which such failure continues subject to a maximum of one crore rupees.

#### **4.2.2 Penalty for Failure to enter into an agreement with clients**

Section 23B of the SCRA and 15B of SEBI Act states that, if any person, who is required under this Act or any bye-laws of a recognised stock exchange made thereunder, to enter into an agreement with his client, fails to enter into such an agreement, he shall be liable to a penalty, which shall not be less than one lakh rupees but which may extend

to one lakh rupees for each day during which such failure continues subject to a maximum of one crore rupees for every such failure.

#### **4.2.3 Maintenance of different types of Books as prescribed under SC(R)R 1957 and SEBI Stock Broker Regulations, 1992**

We have already discussed the maintenance of different types of books under different regulations in the previous chapter under section 3.4.5.1.

#### **4.2.4 Submission of various periodic reports**

The stock broker has to provide/disclose/submit various information/ report to Exchanges/Clearing Corporation on periodic (daily, weekly, monthly, quarterly, half-yearly, yearly etc.) basis. These details pertain to day-to-day operation and other compliance. The stock exchanges have prescribed details of these periodic reports to be submitted by the brokers in their compliance calendars. Some of the major reports are given below, for other details participants can refer the compliance calendar of respective Exchanges:

<b>Sr. No.</b>	<b>Reports</b>	<b>National Stock Exchange<sup>65</sup></b>	<b>Metropolitan Stock Exchange of India Ltd.<sup>66</sup></b>	<b>Bombay Stock Exchange<sup>67</sup></b>
1	System Audit Report – Half yearly, annual or once in 2 years depending on the nature of business carried out by the broker	Half yearly, annual, or once in 2 years depending on the nature of business carried out by the broker		
		Preliminary report, corrective action report, Follow on report within time period specified by Exchange based on the nature of business carried out by broker		
2	Annual Returns (Audited Financial Statements) - Annually	By October 31st of every year	By September 30th	By October 31st of every year
3	Client wise Funding Report – Monthly	Within seven days from the end of the month		
4	Internal Audit Report Half yearly basis	Within 2 months from half year ended March and September	Within 60 days from half year ended March and September	Within 2 months from half year ended March and September
5	Net worth certificate Half yearly basis	Within 2 months from half year ending March and September	Within 2 months from half year ended March and September	Within 2 months from half year ending

<sup>65</sup> <https://www.nseindia.com/trade/members-compliance-calendar>

<sup>66</sup> <https://www.msei.in/members/compliance/compliance-calendar>

<sup>67</sup> <https://www.bseindia.com/static/members/compliancecalendar.aspx>

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6	Net worth 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	Members with validity ending on May 31st: By July 31st  Members with any other due date: Within one month from the expiry of validity period	Members with validity ending on May 31st: By July 31st  Members with any other due date: Within one month from the expiry of validity period	Within 30 days from the date of expiry of the Insurance policy
8	Quarterly Compliance Report			Within 15 Calendar days from end of calendar quarter
9	Risk Based Supervision	Half Yearly	Half-yearly. Within 2 months.	Within 2 months from half year ending
10	Cyber Security Incident reporting	Within 15 days from the end of quarter		
11	Cyber Security & Cyber Resilience framework	Preliminary report, corrective action report, Follow on audit report within time period specified by Exchange based on the nature of business carried out by broker		
12	Disclosures by trading members (Capital market segment) regarding their holdings in listed companies.	Within 45 days from the end of quarter		
13	Reporting of Artificial Intelligence and Machine Learning applications used by the members.	Within 15 days from the end of quarter		
14	Enhance Supervision reporting	Various details of client funds, holding statement, etc. on periodic basis.		

SEBI vide circular dated June 07, 2022, has advised the Stock Brokers / Depository Participants to conduct comprehensive cyber audit at least once in a financial year. All Stock Brokers / Depository Participants shall submit with Stock Exchange/Depository a declaration from the MD/ CEO/ Partners/ Proprietors certifying compliance by the Stock Brokers / Depository Participants with all SEBI Circulars and advisories related to Cyber security from time to time, along with the Cyber audit report.

#### **4.2.5 Settlement of accounts (funds) & Statement of accounts<sup>68</sup>**

SEBI, vide circular no. MIRSD/SE/Cir-19/2009 dated December 03, 2009 and SEBI/HO/MIRSD/MIRSD2/CIR/P/2016/95 dated September 26, 2016, issued the guideline for settlement of running account of client's funds / securities. The settlement of funds and / or securities shall be done within 1 working day of the pay-out, unless client specifically authorizes the stock broker in writing to maintain a running account. As specified by SEBI, the actual settlement of funds and securities shall be done by the member depending on the mandate of the client and there must be a gap of maximum 90 / 30 days (as per the choice of client viz. Quarterly / Monthly) between two settlements of running account. Vide SEBI circular no. CIR/HO/MIRSD/DOP/CIR/P/2019/75 dated June 20, 2019, settlement of running account for securities has been discontinued and therefore, SEBI circulars dated December 03, 2009 and September 26, 2016, are now applicable for settlement of running account of client's "funds" only.

While settling the account, the member should simultaneously 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.

SEBI has given direction for handling of client securities by trading member/clearing member and also issued following advice with respect to a TM/CM maintaining a running account for client securities and pledging the client securities with Banks/NBFCs.<sup>69</sup>

- The securities received in pay-out against which payment has been made by clients, shall be transferred to the demat account of the respective clients within one working day of the pay-out. Such securities shall be transferred directly from the pool account of the TM/CM to the demat account of the respective client.
- With regard to securities that have not been paid for in full by the clients (unpaid securities), a separate client account titled – "client unpaid securities account" shall be opened by the TM/CM. Unpaid securities shall be transferred to such "client unpaid securities account" from the pool account of the concerned TM/CM.
- The securities kept in the 'client unpaid securities account' shall either be transferred to the demat account of the respective client upon fulfilment of client's funds obligation or shall be disposed of in the market by TM/CM within five trading days after the pay-out. The unpaid securities shall be sold from the Unique Client Code (UCC) of the respective client. Profit/loss on the sale transaction of the unpaid securities, if any, shall be transferred to/adjusted from the respective client account.
- In case the clients' securities are kept in the 'client unpaid securities account' beyond seven trading days after the pay-out, the depositories shall under their bye-laws levy

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<sup>68</sup>Refer SEBI circular no. MIRSD/SE/Cir-19/2009 dated December 03, 2009.

<sup>69</sup> SEBI circular CIR/HO/MIRSD/DOP/CIR/P/2019/75 dated June 20, 2019

appropriate penalties upon such TM/CM which shall not be permitted to be recovered from the client.

- Further, SEBI has restricted broker to pledge client securities to the Banks/NBFCs for raising funds, even with authorization by client as the same would amount to fund-based activity by TM/CM which is in contravention of Rule 8(1)(f) & 8(3)(f) of Securities Contracts (Regulation) Rules, 1957.

SEBI, vide circular no. SEBI/HO/MIRSD/DOP/CIR/P/2020/28 dated February 25, 2020, discontinued title transfer of securities to the demat account of TM for margin purposes and TM shall accept collateral from the clients in the form of securities only by way of 'margin pledge' created in the Depository system.

Further, SEBI vide circular SEBI/HO/MIRSD/DOP/P/CIR/2021/57 dated June 16, 2021<sup>70</sup>, revised guideline for "Settlement of Running Account of Client's Funds lying with Trading Member (TM)". Some of the details are given below:

- The settlement of running account of funds of the client shall be done by the TM after considering the End of the day (EOD) obligation of funds as on the date of settlement across all the Exchanges, at least once within a gap of 30 / 90 days between two settlements of running account as per the preference of the client.
- In case of client having any outstanding trade position on the day on which settlement of running account of funds is scheduled, a TM may retain funds calculated in the manner specified in this circular.
- Client's running account shall be considered settled only by making actual payment into client's bank account and not by making any journal entries. Journal entries in client account shall be permitted only for levy / reversal of charges in client's account.
- For the clients having credit balance, who have not done any transaction in the 30 calendar days since the last transaction, the credit balance shall be returned to the client by TM, within next three working days irrespective of the date when the running account was previously settled.
- The Authorized person is not permitted to accept client's funds and securities. The TM should keep a proper check. Proprietary trading by Authorized person should be permitted only on his own funds and securities and not using any of the client's fund.
- Once the TM settles the running account of funds of a client, an intimation shall be sent to the client by SMS on mobile number and also by email.

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<sup>70</sup> [https://www.sebi.gov.in/legal/circulars/jun-2021/settlement-of-running-account-of-client-s-funds-lying-with-trading-member-tm-\\_50570.html](https://www.sebi.gov.in/legal/circulars/jun-2021/settlement-of-running-account-of-client-s-funds-lying-with-trading-member-tm-_50570.html)

- Client shall bring any dispute on the statement of running account, to the notice of TM within 30 working days from the date of the statement.

#### **4.2.6 Sending account statements to clients**

The stock broker shall send a complete 'Statement of Accounts' for both funds and securities in respect of each of its clients containing extract of from the client ledger for funds, an extract from the register of securities displaying all receipts and deliveries of securities and a statement explaining the retention of funds and / or securities in such periodicity and format within such time, as may be prescribed by the relevant Exchange, from time to time, where the trade is executed. The Statement shall also state that the client shall report errors, if any, in the Statement within such time as may be prescribed by the relevant Exchange from time to time where the trade was executed, from the receipt thereof to the Stock broker.

Further, SEBI, vide its letter dated November 27, 2017 has directed that all members shall issue an **Annual Global Statement** to their clients<sup>71</sup>. The statement shall be issued within 30 days from the end of the financial year and shall contain details of all transactions executed by the client in the financial year.

Stock Brokers should daily send margin related information across all segment to their clients, which shall, inter-alia, include:

- Client code and name, Trade day (T)
- Margin deposit available for the client on day T (with break-up in terms of cash, FDRs, BGs and securities)
- Margin adjustments (including MTM losses) for day T after adjusting MTM profit if any.
- Margin status (balance with the member / due from the client) at the end of T day.

Such margin related information (Daily margin statement) should be issued by Stock Brokers to clients on a daily basis at the end of the trade day (T-Day) itself or by such timelines as may be specified from time to time.

#### **4.2.7 Risk Based Supervision of Market Intermediaries**

In order to help better regulate the marketplace and strengthen its supervision system, SEBI has initiated a process of formalizing its risk based approach towards supervision of market intermediaries, including stock brokers, in alignment with the global best practices. Risk Based supervision is a process of assessment of members by the Exchanges on a half yearly basis. It is forward looking and preventive mechanism which aims at assessing the various business areas of the Stock broker, and the associated quality of their management and

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<sup>71</sup>NSE Cir No. NSE/INSP/36731 dated January 11, 2018.

internal controls, to identify the areas of risks and concern and directing the supervisory focus to these areas.

The Risk Based Supervision model follows four distinct steps:

- a. Risk Assessment
- b. Assigning Risk & Impact Rating
- c. Determining Supervisory Risk Rating Score
- d. Supervisory Approach

Under the new model, various market entities would be divided into four groups — very low risk, low risk, medium risk and high risk — and the quantum of supervision and number of inspections would vary as per the risk level of each intermediary. The risk based supervisory model is expected to facilitate a more focused regulatory supervision.

SEBI has formulated a Risk Assessment template in consultation with Stock Exchanges and various Member Associations, which requires most of the inputs from Exchange as well as some from the Members. It is a half yearly process and the timeline for submission of data by broker to Exchange is as under:

Sr. No.	Period	Due date
1.	Half year ending September 20xx	2 months from the end of period
2.	Financial year ending March 20xx	2 months from the end of period

#### **4.2.8 Suspicious Transaction Reporting (STR) to Financial Intelligence Unit (FIU)**

SEBI Intermediaries including brokers shall monitor transactions of the client to ensure that those are not suspicious from money laundering or tax evasion point of view. The trades like reversal trade, profit transfer trades or trades associated with dabba trades are some of the examples of suspicious trades. FIU is a separate intelligence arm under finance ministry. The brokers are expected to report such transactions to FIU through online mechanism provided by FIU. Though, the Exchange through its surveillance mechanism raise a suspicion about a client's transactions, it is the duty of concerned broker to identify those suspicious transactions through its regular monitoring and report them to FIU. The brokers are not supposed to inform the client about this reporting, as it will lead to tipping-off information to client, which is illegal and not allowed. At the same time, members should not depend solely upon the direction from Exchanges' surveillance mechanism but are required to have their own robust controls and procedures.

Intermediaries shall carefully go through all the reporting requirements and formats that are available on the website of FIU – IND under the Section Obligation of Reporting Entity – furnishing information–reporting format.

([https://fiuindia.gov.in/files/downloads/Filing\\_Information.html](https://fiuindia.gov.in/files/downloads/Filing_Information.html)). These documents contain detailed directives on the compilation and manner/procedure of submission of the reports to FIU-IND. The Suspicious Transaction Report (STR) shall be submitted within 7 days of arriving at a conclusion that any transaction, whether cash or non-cash, or a series of



transactions integrally connected are of suspicious nature. The Principal Officer shall record his reasons for treating any transaction or a series of transactions as suspicious. It shall be ensured that there is no undue delay in arriving at such a conclusion. The Non-Profit Organization Transaction Reports (NTRs) for each month shall be submitted to FIU-IND by 15th of the succeeding month.

### **4.3 Core Settlement Guarantee Fund**

Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2018, inter-alia, state the following:

#### **Fund to guarantee settlement of trades**

- 1) Every recognized clearing corporation shall establish and maintain a Fund by whatever name called, for each segment, to guarantee the settlement of trades executed in respective segment of a recognized stock exchange.
- (2) In the event of a clearing member failing to honour his settlement obligations, the Fund shall be utilized to complete the settlement.
- (3) The corpus of the Fund shall be adequate to meet the settlement obligations arising on account of failure of clearing member(s).
- (4) The sufficiency of the corpus of the Fund shall be tested by way of periodic stress tests, in the manner specified by SEBI.
- (5) The utilization of the Fund shall be in accordance with the norms specified by SEBI.

Further, SEBI has directed clearing corporation to have a fund called Core SGF (Settlement Guarantee Fund) for each segment of each Recognized Stock Exchange (SE) to guarantee the settlement of trades executed in respective segment of the Stock Exchange.<sup>72</sup> In the event of a clearing member (member) failing to honour settlement commitments, the Core SGF shall be used to fulfill the obligations of that member and complete the settlement without affecting the normal settlement process.

#### **4.3.1 Corpus of Core SGF**

The corpus of the fund should be adequate to meet out all the contingencies arising on account of failure of any member(s). The risk or liability to the fund depends on various factors such as trade volume, delivery percentage, maximum settlement liability of the members, the history of defaults, capital adequacy of the members, the degree of safety measures employed by the CC/SE etc. 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)

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<sup>72</sup> [https://www.sebi.gov.in/sebi\\_data/attachdocs/1409136206919.pdf](https://www.sebi.gov.in/sebi_data/attachdocs/1409136206919.pdf)

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

- i. The MRC shall be fixed for a month.
- ii. 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.
- iii. 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.
- iv. 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.
- v. Average of all the daily worst case loss numbers determined in (iv) above shall be calculated.
- vi. The MRC for next month shall be higher of the average arrived at as (v) above and the segment MRC as per previous review.

#### **4.3.2 Contribution to Core SGF**

Contributions of various contributors to Core SGF of generally in various 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 (can be against transfer of profits by Exchange as per Regulation 33 of SECC Regulations).
- c) *Clearing Member Primary Contribution:* The total contribution from members to core SGF for each segment will not be more than 25% of MRC of the respective segment. No exposure shall be available to CMs on their contribution to core SGF. The required contributions of individual CMs shall be assessed 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.  
As per SEBI circular no SEBI/HO/MRD/DRM/NP/CIR/P/2016/54 dated May 04, 2016, the clearing member contribution to core SGF shall be met to the extent available from the amount received from Exchange.
- 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

#### **Further contribution to / Recoupment of Core SGF<sup>73</sup>**

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<sup>73</sup> SEBI Circular Ref. No. SEBI/HO/MRD2/DCAP/CIR/P/2020/01 Dated January 03, 2020.

In the event of usage of Core SGF during a calendar month, contributors shall, as per usage of their individual contribution, immediately replenish the Core SGF to MRC. However, such contribution towards replenishment of Core SGF by the members would be restricted to only once during a period of 30 calendar days regardless of the number of defaults during the period. The period of 30 calendar days shall commence from the date of notice of default by Clearing Corporation to market participants. In case there is failure on part of some contributor(s) to replenish its (their) contribution, same shall be immediately met, on a temporary basis during the month, in the following order: (i) By CC (ii) By SE  
CC shall ordinarily accept cash collateral for Core SGF contribution. However, CC may accept CM contribution in the form of bank FDs, Central Government securities or as specified by SEBI from time to time in this regard.

#### **Access to Core SGF**

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

#### **4.3.3 Default waterfall**

In the event of a default, the utilization of the Settlement Guarantee Fund shall generally be in 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.
- e) Proportion of remaining CC resources (excluding CC contribution to core SGFs of other segments and Rs. 100 Crore) equal to ratio of segment MRC to sum of MRCs of all segments. Rs. 100 Crore to be excluded only when remaining CC resources (excluding CC contribution to core SGFs of other segments) are more than Rs. 100 Crore.
- f) 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.
- g) Capped additional contribution by non-defaulting members of the segment.<sup>74</sup>
- h) Any remaining loss to be covered by way of pro-rata haircut to pay-outs.

#### **4.3.4 Stress testing and back testing**

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<sup>74</sup> For further details, refer SEBI Circular Ref. No. SEBI/HO/MRD2/DCAP/CIR/P/2020/01 Dated January 03, 2020. The maximum capped additional contribution by non-defaulting members shall be lower of 2 times of their primary contribution to Core SGF or 10% of the Core SGF of the segment on the date of default in case of equity/ debt segments. The maximum capped additional contribution by non-defaulting members shall be lower of 2 times of their primary contribution to Core SGF or 20% of the Core SGF of the segment on the date of default in case of derivatives segment.

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.

**Stress test for credit risk:** CC shall carry out daily stress testing for credit risk using at least the standardized stress testing methodology prescribed for each segment viz. equity, equity derivatives and currency derivatives. Apart from the stress scenarios prescribed for cash market and derivatives market segments, 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. Such scenarios should include relevant peak historic price volatilities, shifts in other market factors such as price determinants and yield curves, multiple defaults over various time horizons and a spectrum of forward looking stress scenarios in a variety of extreme but plausible market conditions.

**Liquidity stress test and adequacy of liquidity arrangements:** CC shall ensure that it maintains sufficient liquid resources to manage liquidity risks from members, settlement banks and those generated by its investment policy.

**Reverse stress test:** CC shall periodically carry out reverse stress tests designed to identify under which market conditions and under what scenarios the combination of its margins, Core SGF and other financial resources prove insufficient to meet its obligations (e.g., simultaneous default of top N members or N% movement in price of top 2 scrips by turnover or 20% movement in price of top N scrips by turnover etc.)

Back testing for adequacy of margins: CC shall daily conduct back testing of the margins collected vis-à-vis the actual price changes for the contracts being cleared and settled in every segment to assess appropriateness of its margining models

Adequacy of financial resources: CC shall continuously monitor the adequacy of financial resources (as available in its default waterfall) against the uncovered loss estimated by the various stress tests conducted by the CC and take steps to beef up the same in case of shortfall.

At least on a monthly basis, CC shall perform a comprehensive and thorough analysis of stress testing scenarios, models, and underlying parameters and assumptions used to ensure they are appropriate for determining the CCP’s required level of default protection in light of current and evolving market conditions. CC shall perform this analysis of stress testing more frequently when the products cleared or markets served display high volatility, become less liquid, or when the size or concentration of positions held by a CC’s participants increases significantly. A full validation of CC’s risk-management model shall be performed at least annually. The results of tests carried out above shall be monitored by the Risk Management Committee of the CC and the same should be communicated for discussion and review by the Board of the CC.

### **Sample Questions**

Questions to assess your learning:

1. Risk containment measures includes which of the following:
  - (a) Checking Margin requirements**
  - (b) Checking net worth of the client /investor
  - (c) Checking whether the order placed is genuine
  
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
  
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 up to 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
  
4. SEBI prescribes brokers/members to send a Global statement to its clients on which periodicity?
  - (a) Annual**
  - (b) Quarterly

## **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. General Clearing process in Cash Segment for T+2 rolling settlement.

1. At the end of the day's trade (T day), 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/custodians and informs them about the transactions of their respective clients.
3. The clearing members/custodians then confirm back institutional/Custodian Participant 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 for funds and securities by 2.30 p.m. on T+1 and downloaded to them so that they can settle their obligations on the settlement day (T+2).

General Clearing process in Cash Segment for T+1 rolling settlement

1. At the end of the day's trade (T Day), 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/custodians and informs them about the transactions of their respective clients.
3. The clearing members/custodians then confirm back institutional/Custodian Participant trades by 7:30 p.m. or time specified by clearing corporation on same day (T+0 day).
4. The clearing house/corporation then performs multilateral netting and determines the final obligations of all clearing members for funds and securities on end of the same day (T+0) and downloaded to them so that they can settle their obligations on the settlement day (T+1)

### **5.2 Role of the Clearing Corporation**

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.

Clearing Corporation 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 becomes the buyer to every seller and seller to every buyer. If there is a default in this scenario, Clearing Corporation being counter party, is responsible for ensuring the settlement, thus managing risk and guaranteeing settlement to both the parties.

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 “novation<sup>75</sup>” addresses this risk.

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 has sufficient funds from the defaulter to cover the loss. The Clearing Corporation also provides core clearing and settlement services apart from settlement guarantee. The clearing function of the clearing corporation is designed to work out a) what members are due to deliver and b) what members are due to receive on the settlement date. Settlement is a two-way process which involves transfer of funds and securities on the settlement date. Clearing corporation has also devised mechanism to handle various exceptional situations like security shortages, bad delivery, company objections, auction settlement etc. 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 for capital market segment is T+2 days (i.e., trade day + 2 days). T+2 means the transactions done on Stock Exchanges on the trade day (T day) will be settled by the Clearing Corporation on the second business day (excluding Saturday, Sundays, Bank holidays, Exchange Trading holidays and clearing holidays). Pay-in and Pay-out for securities settlement is done on T+2 basis. SEBI vide circular dated September 07, 2021<sup>76</sup>, provided guideline for “Introduction of T+1 rolling settlement on an optional basis. All Exchanges, clearing corporations and depositories has decided to introduced T+1 rolling settlement in phased manner. The first list of securities with T+1 settlement were introduced in end of February 2022. It is proposed to fully implement the T+1 rolling settlement by the end of FY 2022-23. In case of T+1 rolling settlement, the trades executed on Wednesday, has to be settled on Thursday (provided no holiday in between) with pay-in and pay-out of funds and securities being completed on that day.

Thus, the clearing agency is the main entity managing the clearing and settlements of transactions and settlement guarantee for transaction done on a Stock Exchange. It

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<sup>75</sup> As per the definition given in the SEBI Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2018 "novation" means the act of a clearing corporation interposing itself between both parties of every trade, being the legal counterparty to both.

<sup>76</sup>[https://www.sebi.gov.in/legal/circulars/sep-2021/introduction-of-t-1-rolling-settlement-on-an-optional-basis\\_52462.html](https://www.sebi.gov.in/legal/circulars/sep-2021/introduction-of-t-1-rolling-settlement-on-an-optional-basis_52462.html)

interacts with the Stock Exchange, clearing banks, clearing members, custodians and depositories through an electronic connection.

As a central counterparty, the clearing corporation:

- 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 corporation 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.
- Provides less risk to investors trading on the stock exchanges, as the clearing corporation assumes the role of counterparty agency.
- Calculates and controls the margining mechanism

In India, in cash segment there are three clearing corporations, viz., the NSE Clearing Limited (NCL), Indian Clearing Corporation Limited (ICCL) and Metropolitan Clearing Corporation of India Ltd. (MCCIL).

### ***Interoperability among Clearing Corporations<sup>77</sup>***

SEBI introduced the concept of Interoperability among Clearing Corporations which necessitates linking of multiple Clearing Corporations. Inter-operability among Clearing Corporation (CC) will enable a Clearing Member to select the Clearing Corporation of its choice to clear and settle trades executed in multiple exchanges. It allows market participants to consolidate their clearing and settlement functions at a single Clearing Corporation, irrespective of the stock exchange on which the trade is executed. It is expected that the interoperability among Clearing Corporations would lead to efficient allocation of capital for the market participants, thereby saving on costs as well as provide better execution of trades.

The interoperability framework shall be applicable to all the recognised clearing corporations excluding those operating in International Financial Services Centre (IFSC) and all the products available for trading on stock exchanges, except commodity derivatives. The recognised clearing corporations shall establish peer-to-peer link for ensuring interoperability. A clearing corporation shall maintain special arrangements with another clearing corporation and shall not be subjected to normal participant (membership) rules. Risk management between the clearing corporations shall be based on a bilaterally approved framework and shall ensure coverage of inter-clearing corporation exposures.

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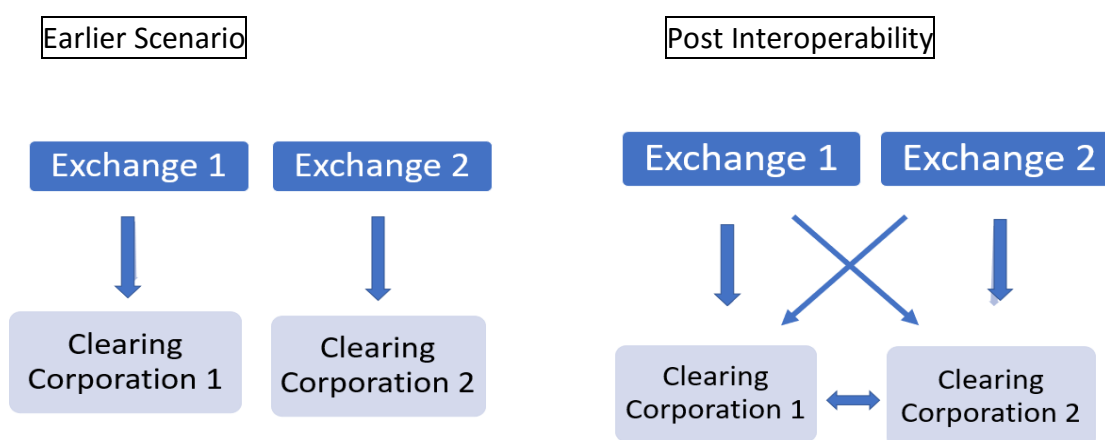
<sup>77</sup> SEBI circular CIR/MRD/DRMNP/CIR/P/2018/145 dated November 27, 2018



Clearing corporations shall exchange margins and other financial resources on a reciprocal basis based on mutually agreed margining models.

To manage the inter-Clearing Corporation exposure in the peer-to-peer link, Clearing Corporations shall maintain sufficient collateral with each other so that any default by one Clearing Corporation, in an interoperable arrangement, would be covered without financial loss to the other non-defaulting Clearing Corporation. The inter-Clearing Corporation collateral shall comprise two components, viz. (a) Margins as per the existing Risk Management Framework (initial margin, extreme loss margin, calendar spread margin, etc.) prescribed by SEBI; and (b) Additional capital, to be determined by each Clearing Corporation, based on the credit risk from the linked Clearing Corporation, on which no exposure shall be granted to the linked Clearing Corporation.

Pictorial representation of Interoperability among clearing corporations



Following are some of the benefits of Interoperability among clearing corporations

- Choice to participants to choose the clearing corporation
- Better capital utilization
- Reduce trading disruption
- Reduce aggregate exposure
- Reduced operational complexity
- Enhanced market competition and lower cost of clearing
- Execution risk can be decoupled from settlement risk as there can be an 'arm's length' relationship between the exchange and adjunct clearing corporation.

### 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 any of the empanelled clearing banks at the designated clearing bank branches. The clearing accounts are to be used exclusively for clearing & settlement operations. 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 funds obligations. In case of a pay-out clearing member receives the amount on pay-out day.

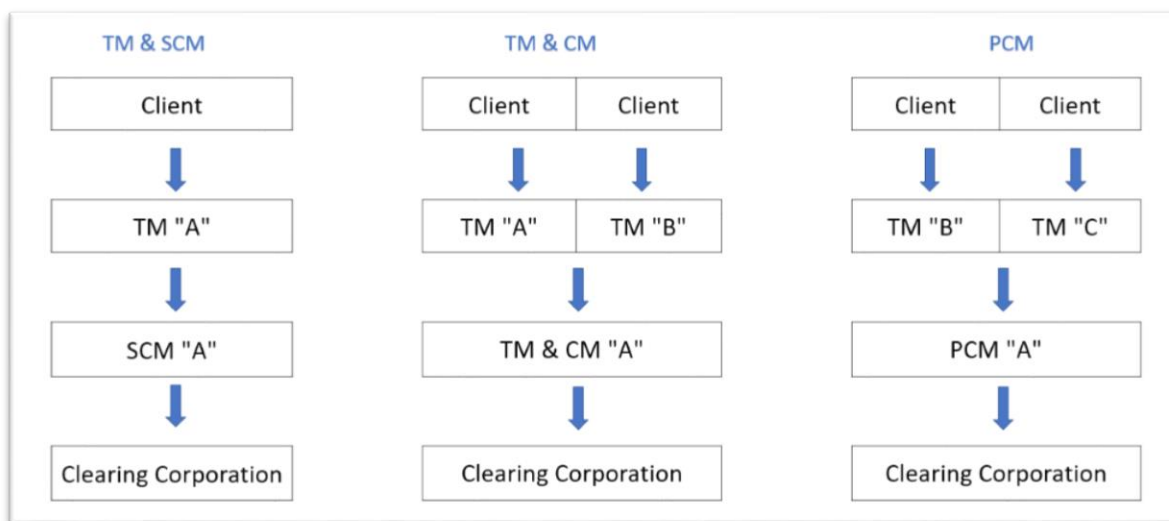
All transactions of pay-in/pay-out of funds are carried out by these clearing banks. The pay-in obligation details are passed on to the clearing banks by clearing corporation, who then debit the clearing member account and based on pay-out instruction from clearing corporation the clearing bank will credit the receiving member clearing account. In case of cash market this happens on T+2 and / or T+1 day.

The clearing banks are required to provide the minimum services as specified by Clearing Corporation to clearing members.

#### 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 namely, professional clearing member (PCM), trading cum clearing member (TCM) and trading cum self-clearing member (SCM). The clearing members need to take membership of the clearing corporation/s. They then get a unique member ID number from the clearing corporation. Custodians act as clearing members but not trading members. They settle trades on behalf of their clients that are executed through other trading members.

Pictorial representation of various kind of clearing member is given below:



Clearing Members/Custodian handle the responsibility of clearing and settlement of all deals executed by Trading Members, who clear and settle such deals through them. Clearing Members/Custodian perform the following important functions:

- Clearing: Computing obligations of all his trading members i.e., determining positions to settle.
- Settlement: Performing actual settlement.

- Risk Management: Setting limits based on upfront deposits / margins for each trading member/client and monitoring positions on a continuous basis.
- Confirmation of custodian participant trade.

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) through depository participant. These accounts are known as clearing member settlement pool account. 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. The benefits related to shares are received in the pool account, from where they are distributed to the beneficiaries. A pool account is a settlement account of broker / exchange member from where broker deliver securities to exchange's clearing corporation against pay-in obligation and receive pay-out of securities from clearing corporation. Client can transfer share directly in members pool account.

It is mandatory for clearing member to open separate and distinct clearing bank account with the designated clearing bank. This account is used for clearing and settlement operation i.e. for settlement of fund obligation, payment of margins, release and enhancement of collateral, EPI of funds, penal charges etc. Clearing members shall irrevocably authorize to Clearing Bank for operation of clearing account, the clearing banks to access their clearing accounts for debiting and crediting their clearing accounts as per the instructions of the Clearing Corporation, reporting of balances and other information as may be required by the Clearing Corporation from time to time. Clearing member can deposit fund in these accounts in any form but withdraw funds from these accounts only in self-name.

The clearing corporation provides details of all transaction of members and their clients which are linked to its clearing member. Wherever applicable, the clearing member shall confirm the transaction (about the genuineness of the transactions). In cash market, trades which are allocated for settlement by Custodians are indicated with a Custodian Participant (CP) code and the same is subject to confirmation by the respective Custodian. Once this is done, the clearing agency then determines the net obligations of the clearing members/custodian through multilateral netting.

### **5.5 Depositories & Depository Participants**

A "Depository" is an entity facilitating holding securities in electronic form and enables transfer of securities by book entry. The main objective of depository is to provide maintenance of ownership or transfer records of securities in an electronic book entry form resulting in paper-less trading rather than paper-based trading and to ensure transferability of securities with speed, accuracy and safety. In clearing and settlement process, the depositories facilitate transfer of securities from one account to another at the instruction of the account holder.

The Depository provides its services to clients through its agents called depository participants (DPs). For trading in Cash Market, it is mandatory for buyer and seller to open demat (beneficiary) account with the depository participant in either of the depositories. 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. . The transferee has to submit Receipt Instruction to received securities into his account. However, for the convenience of investor 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:

- a. Transfer due to a transaction done on a person-to-person basis i.e. 'off-market'<sup>78</sup> transaction.
- b. Transfer arising out of a transaction done on a recognised Stock Exchange.
- c. 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 Slip' (DIS) in the prescribed form. The DIS 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. Further, both the depositories also facilitate for electronic delivery instruction slip facility to clients of DPs over internet. SEBI has introduced concept of 'Demat Debit and Pledge Instruction'(DDPI), under which the clients shall explicitly agree to authorize the stock broker/stock broker and depository participant to access their BO account for the limited purpose of meeting pay-in obligations for settlement of trades executed by them. The DDPI shall serve the same purpose of PoA and significantly mitigate the misuse of PoA.

Trades done on the Exchange is one that is settled through participation of a Clearing Corporation. 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 pool account.
- Securities are transferred from broker's pool account to Clearing Agency settlement pool account on the basis of a delivery out instruction.
- On pay-out, based on clearing corporation pay-out instruction, depositories will move securities from Clearing Corporation pool account to the buying broker's pool account. A facility is provided to the members to directly credit the pay-out to investor's beneficiary account from clearing corporation pool account.

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<sup>78</sup> A trade which is not done on a recognised stock exchange is known as off-market trade.

- Buying broker gives instructions and securities move to the buyer's beneficiary account.

## **5.6 Clearing Process**

The clearing function of the clearing corporation is designed to work out a) what members are due to deliver and b) what members are due to receive on the settlement date.

In the clearing corporation 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.

Clearing is the process of determination of obligations, after which the obligations are discharged by settlement. A multilateral netting procedure is adopted to determine the net settlement obligations (delivery/receipt positions) of the clearing members. Accordingly, a clearing member would have either pay-in or pay-out obligations for funds and securities separately. Settlement is a two-way process which involves transfer of funds and securities on the settlement date. Clearing corporation also devised mechanism to handle various exceptional situations like security shortages, bad delivery, company objections, auction settlement etc.

For certain transactions / securities the settlement is done on Gross basis i.e. trade for trade basis and there is no netting of transactions.

***The following is the summary Clearing and Settlement process in India for cash market/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 to clearing members and custodians.
- The delivering member shall complete delivery instructions for transfer of securities to CM Clearing Pool Account on settlement day before time specified by clearing corporation.
- The paying member shall ensure that clear funds are available in his clearing bank settlement account.
- Pay-in of securities: Clearing Corporation advises depository to debit pool account of custodians/Clearing members and credit its (Clearing Corporation's) settlement pool 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 general time line followed for the custodian settled trade for institutional clients is as follows for T+2 rolling settlement:

- T is trade date by broker
- By T+1 morning, trade confirmation by custodian to Clearing Corporation (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 funds / Securities pay-in and pay-out between clearing corporation and custodian
- On T+2/T+3 credit of shares /funds to client account

The general time line followed for the custodian settled trade for institutional clients is as follows for T+1 rolling settlement:

- T is trade date by broker
- By T+0 End of Day (EOD), trade confirmation by custodian to Clearing Corporation (Obligations move from broker to custodian)
- Payment of margins or early pay-in of securities and/ or funds as per regular procedure
- On T+1 funds / Securities pay-in and pay-out between clearing corporation and custodian
- On T+1/T+2 credit of shares /funds to client account

For institutional like Mutual Funds, Insurance Companies, FPIs etc. 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 who are registered as “Custodians” with SEBI provides clearing member related services. Even if the clients don’t meet their obligations clearing members are required to meet their obligations to the clearing corporations.

#### **5.6.1 Clearing Process for Derivatives**

The clearing mechanism essentially involves working out open positions<sup>79</sup> and obligations of clearing members. This position is considered for exposure and daily margin purposes.

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<sup>79</sup> Outstanding/ unsettled either long (buy) or short (sell) position in various derivative contracts is called “Open Position.”

The open positions of clearing members are arrived at by aggregating the open positions of all the brokers/trading members and all custodial participants<sup>80</sup> clearing through them. A trading member's open position is arrived at by summing up his proprietary and client's open positions.<sup>81</sup> Proprietary positions are calculated on net basis (buy - sell) for each contract<sup>82</sup>. Clients' positions are arrived at by summing together net (buy - sell) positions of each individual client. Please note that positions are only netted for each client at contract level and not netted across clients and are rather added up across clients. A TM's open position is the sum of proprietary open position, client open long position and client open short position. All derivatives contracts irrespective of whether it is index futures, stock futures, index options, stock options, currency futures & options, interest rate futures & option are either cash settled or physically 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, premium settlement, and final settlement. The settlement process would be discussed in chapter 6 of this workbook.

### **5.6.2 Balancing / Netting of Clients accounts within the broker's firm**

The stock brokers are allowed to net the clients 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.

### **5.6.3 Broker netting with Clearing Corporation**

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. 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

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<sup>80</sup> Custodial participants (CP) are those clients who are eligible for trading through trading members and clearing and settling deals through clearing members. Such CP registered with clearing corporation through Clearing Members.

<sup>81</sup> 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.

<sup>82</sup> The contract will be distinguished based on futures and option, underlying instrument, expiry date, option type, strike price.

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**Broker X**

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

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
<b>350</b>	<b>200</b>		<b>-1825</b>

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
<b>0</b>	<b>150</b>		<b>1575</b>

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

Net Value to receive pay = 1575 (to receive)

	Quantity to Deliver	Quantity 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
<b>Total</b>	<b>150</b>	<b>150</b>	<b>1825</b>	<b>1825</b>



### **Sample 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
  
2. 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
  
3. Which procedure is adopted to determine the net settlement obligations (delivery/receipt positions) of the clearing members?
  - (a) Multilateral Netting**
  - (b) Novation
  - (c) Auto Netting
  - (d) Pay-in
  
4. The stock brokers are allowed to net the client account within the firm. State whether True or False?
  - (a) True**
  - (b) False

## **Chapter 6: Settlement Process**

### **LEARNING OBJECTIVES:**

After studying this chapter, you should know about:

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

### **6.1 Introduction**

In the Indian equities market SEBI has given option to Exchanges/Clearing Corporations to settled trades on T+1/T+2 basis. In case of T+2 rolling settlement, a transaction entered into on Day 0 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/clearing corporation holidays, Saturdays and Sundays are excluded.

All Exchanges, clearing corporations and depositories has decided to introduced T+1 rolling settlement in phased manner. The first list of securities with T+1 settlement were introduced in end of February 2022. It is proposed to fully implement the T+1 rolling settlement by the end of FY 2022-23. In case of T+1 rolling settlement, the trades executed on Wednesday, has to be settled on Thursday (provided no holiday in between) with pay-in and pay-out of funds and securities being completed on that day. From a settlement cycle taking a week, the Exchanges have now moved to a faster and efficient mode of settling trades within T+1 Days.

In case of exchange-traded equity derivatives contracts in India, some of the derivatives contracts (such as those based on the Indices) are cash-settled and some of the contracts (such as those based on individual securities) are physically settled. Cash settlement is a settlement method where upon expiration or exercise of the derivatives contract, the counterparties to the contract settle their position through exchange of the price differentials and do not deliver the actual (physical) underlying asset. In case of Physical settlement, the counterparties settle their position through the exchange of the underlying security.

The daily & final settlement of derivative trades is done on T+1 working day basis except for final settlement of equity derivatives contracts which are settled by delivery and are effected

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on Expiry+2 days (This may change with introduction of T+1 settlement in equity/cash segment). The final settlement in currency derivatives segment take place on a T+2 basis. The funds pay-in and pay-out of daily mark to market settlement, final settlement of futures contracts which are cash settled, premium settlement and the final exercise settlements of options contracts which are cash settled are typically effected before start of market hours on the next day i.e. around 8:30 a.m. The Clearing Corporations announces the settlement schedule for various segments/products on a periodic basis.

Activity Schedule for T+2 Rolling Settlement in cash market<sup>83</sup>:

Sr. No	Day	Time	Description of activity
1	T		Trade Day
2	T+1	By 1.00 pm	Completion of custodial confirmation of trades to CC/CH.
		By 2.30 pm	Completion of process and download obligation files to brokers/ custodians by the CC/CH.
3	T+2	Upto 10.30 am	Accept Pay-in instructions from investors into pool account
		By 10.30 am	Submit final pay-in files to the depository and the clearing bank.
		By 1.30 pm	Pay-out of securities and funds.

Typical activity schedule for T+1 Rolling Settlement in Cash Market

Sr. No	Day	Time	Description of activity
1	T		Trade Day
2	T+0	By EOD	Completion of custodial confirmation of trades to CC/CH.
		By EOD	Completion of process and download obligation files to brokers/ custodians by the CC/CH.
3	T+1	Upto 10.30 am	Accept Pay-in instructions from investors into pool account
		By 10.30 am	Submit final pay-in files to the depository and the clearing bank.
		By 1.30 pm	Pay-out of securities and funds.

### 6.2 Determination of settlement obligations

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:

<sup>83</sup> [https://www.sebi.gov.in/sebi\\_data/commondocs/jul-2021/Chapter%203%20-%20Settlement\\_p.pdf](https://www.sebi.gov.in/sebi_data/commondocs/jul-2021/Chapter%203%20-%20Settlement_p.pdf)

- i. **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 buy and sell transactions under netted settlement.
- ii. **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.
- iii. **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.
- iv. **Final settlement for futures contract which are cash settled** (in equity F&O – Index Futures): All positions (brought forward, created during the day, closed out during the day) of a clearing member in futures contracts, at the close of trading hours on the last trading day of the contract which are cash settled, shall be marked to market at final settlement price (for final settlement) and settled.
- v. **Premium settlement for option contracts:** Premium settlement in respect of admitted deals in options contracts shall be cash settled by debit/ credit of the clearing accounts of clearing members with the respective clearing bank. The premium payable or receivable value of clearing members shall be computed after netting the premium payable or receivable positions at trading member/Custodial Participant level, for each option contract, at the end of each trading day.
- vi. **Exercise settlement for cash settled option contracts** (In equity F&O applicable for index options): Long positions at in-the money contracts shall be assigned to short positions in option contracts with the same series on a random basis. For option contracts that are to be cash settled shall be by debit/ credit of relevant clearing accounts of relevant clearing members with the respective clearing bank towards the exercise settlement value for each unit of the option contract.
- vii. **Delivery Settlement in equity F&O** (applicable for individual stock derivatives): In respect of contracts to be settled through delivery the following positions shall be considered:
  - All open futures positions after close of trading on expiry day
  - All in-the-money option contracts which are exercised and assigned

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The final deliverable/receivable positions at a clearing member shall be arrived after netting the obligations of all clients/constituent/trading members clearing through the respective clearing member. Delivery settlement of securities shall be done only in dematerialized mode through the depositories.

Note: All in-the-money contract get exercised automatically. However, in equity F&O segment, Clearing Corporations may provide a facility to specify 'Do not Exercise' instruction on expiry day in options contracts. In this facility, on the expiry day, members have been given an option to specify not to exercise in respect of Close to Money (in-the-money options near the final settlement price) option strikes.

Settlement Price for derivatives is given in the following table:

Product	Settlement	Price
Futures Contracts on Index or Individual Security	Daily Settlement	<p>a. Index- Closing price of the futures contracts on the index on the trading day. (The closing price for a futures contract shall be calculated on the basis of the last half an hour weighted average price of such contract on the given Exchange).</p> <p>b. Individual Security- Closing price of the futures contracts on Individual security on the trading date. (The closing price for a futures contract shall be calculated on the basis of the last half an hour weighted average price across Exchanges of such contract)</p>
Un-expired illiquid futures contracts	Daily Settlement	<p>Theoretical Price computed as per formula</p> $F = S * e^{rt}$
Futures and Options Contracts on Index or Individual Securities	Final Settlement	<p>a. Index- Closing price of the relevant underlying index on the last trading day of the futures or options contract on the given exchange.</p> <p>b. Individual Securities- Closing price of the relevant underlying security in the Capital Market Segment across exchanges on the last trading day of the futures or options contract.</p>

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Currency Futures	Daily Settlement	Closing price of the futures contracts for the trading day. (The closing price for a futures contract shall be calculated on the basis of the last half an hour weighted average price across Exchanges of such contract).
Un-expired illiquid futures contracts	Daily Settlement	Theoretical Price computed as per formula $F = S * e^{(r-r_f)t}$
Currency Futures and Options	Final Settlement	FBIL reference rate / Rate derived from FBIL reference rate.
Cash Settlement GOI Bond Futures	Daily Settlement	Closing price of the futures contracts for the trading day. (The closing price for a futures contract shall be calculated on the basis of the last half an hour weighted average price across Exchanges of such contract).
Un-expired illiquid futures contracts	Daily Settlement	Theoretical Price computed as per formula Cash Price + Financing cost – Income on cash position
Cash Settlement GOI Bond Futures & Options	Final Settlement	Weighted average price of the underlying bond based on the process during the last two hours of the trading on NDS-OM <sup>84</sup> subject to minimum of 5 trades otherwise, the FIMMDA / FBIL price is applicable.

### 6.3 Settlement of Funds

Every clearing member shall maintain and operate a separate and distinct primary clearing account with one of the designated clearing banks. Every clearing member shall maintain and operate a separate and distinct primary clearing account for each segment. Clearing members having funds obligation to pay should have clear balance of requisite funds in the clearing accounts on or before the stipulated funds pay-in day and the stipulated time. The clearing banks shall debit/credit the clearing accounts of clearing members as per instructions received from the Clearing Corporation from time to time. Clearing members can deposit funds into these accounts in any form and can withdraw funds from these accounts only in self-name.

<sup>84</sup> NDS-OM is a screen based electronic anonymous order matching system for secondary market trading in Government securities owned by RBI.

### **6.3.1 Mode of Payment and Delivery from Clients**

All payments shall be received / made by the brokers from / to the clients strictly by account payee crossed cheques / demand drafts or by way of direct credit into the bank account through EFT, or any other mode allowed by RBI. The brokers shall accept cheques drawn only by the clients and also issue cheques in favour of the clients only, for their transactions. Similarly, in the case of securities giving / taking delivery of securities in “demat mode” should be directly to / from the “beneficiary accounts” of the clients except delivery of securities to a recognized entity under the approved scheme of the stock exchange and / or SEBI.

Unless otherwise specifically agreed to by a client, the settlement of funds/securities shall be done within 24 hours/1 working day of the pay-out. However, a client may specifically authorize the stock broker to maintain a running account subject to the following conditions. Vide SEBI circular no. CIR/HO/MIRSD/DOP/CIR/P/2019/75 dated June 20, 2019, settlement of running account for securities has been discontinued and therefore, SEBI circulars dated December 03, 2009 and September 26, 2016, are now applicable for settlement of running account of client’s “funds” only.

- a. The authorization shall be dated and revocable.
- b. The authorization shall be signed by the client only and not by any Authorized 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. The actual settlement of funds shall be done by the broker, at least once in a calendar quarter or month, depending on the preference of the client.
- e. 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.
- f. For the clients having an outstanding obligations on the settlement date, the stock broker may retain the requisite funds towards such obligations in the manner specified by SEBI /Stock Exchanges.
- g. The client shall bring any dispute arising from the statement of running account to the notice of the broker within 30 working days from the date of statement.
- h. Such periodic settlement of running account may not be necessary:
  - for clients availing margin trading facility (MF) as per SEBI circular, to the extent of funds/securities relating to MTF used by client.
  - for funds received from the clients towards collaterals/margin in the form of bank guarantee (BG)/fixed deposit receipts (FDR).
  - In case of institutional clients settling trades through “custodians”.
- i. 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.
- j. There is no inter-client adjustment for the purpose of settlement of running account.

### **6.3.2 Margin Payment**

The clearing member is required to pay upfront margin to the clearing corporation as specified by clearing corporation / SEBI from time to time. Clearing members shall provide for margin in any one or more of the eligible collaterals as specified by clearing corporation from time to time. The margins shall be collected /adjusted from the liquid assets of a clearing member on a real time basis. SEBI vide circular dated July 20, 2021, advised Segregation and Monitoring of Collateral at Client Level. With a view to providing visibility of client-wise collateral (for each client) at all levels, viz., TM, CM and Clearing Corporation (CC), a reporting mechanism, covering both cash and non-cash collateral, shall be specified by the CCs. TM shall report disaggregated information on collaterals up to the level of its clients to the CM. CM shall report disaggregated information on collaterals up to the level of clients of TM and proprietary collaterals of the TMs to the Stock Exchanges (SEs) and CCs in respect of each segment. On receipt of a trade from a client account by the CC, the margin shall first be blocked from the value of the client collateral. If the client collateral is not sufficient, the residual margin shall be blocked from the TM proprietary collateral of the TM of such client. If the TM proprietary collateral is also not sufficient, then the residual margin shall be blocked from the CM proprietary collateral of the CM of such TM.

Non-fulfilment of either whole or part of the margin obligations by clearing member 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 transactions / positions. In turn, the clearing agency shall pay to the clearing members and custodians moneys payable to them for every settlement for their transactions / 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 client should issue delivery instructions slip to the DP with whom client maintains his demat account. Securities are transferred to the broker's clearing pool account, as advised by his broker. Clients can give 'Demat Debit and Pledge Instruction'(DDPI) under which the clients shall explicitly agree to authorize the stock broker/stock broker and depository participant to access their BO account for the limited purpose for transferring securities from their individual demat account to broker's pool account for the purpose of meeting their pay-in obligation.

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, the client may choose to issue separate receipt instruction to his DP every time the client makes any purchase of securities.

The securities which the client has purchased will be first delivered in the brokers pool account by the Clearing Corporation. The broker will subsequently transfer the securities in clients demat (beneficiary) account. The broker may give request to the Clearing Corporation to deliver the securities directly in the purchaser's demat account.

### **6.4.1 Settlement through the Depository Clearing System**

In the Cash segment the securities pay-in takes place on the T+1 and / or T+2 day based on settlement cycle. Members shall maintain settlement accounts at both depositories viz. NSDL and CDSL and provide specific pay-in instructions to depositories for effecting pay-in. For pay-in through NSDL / CDSL broker can avail facility wherein delivery-out instructions can be generated automatically by the Clearing Corporation based on the net delivery obligations of its Clearing Members. Securities pay-out is done by 1:30 p.m. in member's pool account. A facility is provided to the members to directly credit the pay-out to investor's beneficiary account. Members are required to provide information regarding their client's beneficiary accounts to clearing corporation within the time specified by clearing corporation to receive the pay-out of securities directly by client.

## **6.5 Auction of Securities**

An auction is resorted to when there are shortages in delivery by a seller broker. The clearing corporation conducts a buy-in auction through Exchange system to buy shares from open market for delivering to buyer broker. Securities shortages occurs generally 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. Once shortages are identified, the members are debited by an amount equivalent to the securities not delivered and valued at a valuation price. This is known as valuation debit. For all such short deliveries clearing corporation conducts a buying-in auction on the day of pay-out.

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

An auction is a mechanism utilized by the clearing corporation to fulfill its obligation towards the buying trading members. Thus, when the selling broker fails to deliver the shares, the clearing corporation through stock exchanges system 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.

#### **6.5.1 Auction of securities on Exchanges/Clearing Corporation**

An auction tender notice is issued by Exchanges/CCs 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 Exchanges.

The auction for the undelivered quantities is conducted on settlement day after completion of payout between 2:00 p.m. and 2.45 p.m. for all the scrips under compulsory rolling settlements other than scrips which are directly close-out (e.g., trade for trade securities etc.) and securities are under corporate action.

The members participating in the auction session, will receive the obligation for securities pay-in 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., subsequent day (within the time specified by clearing corporation). Pay-out of auction shares and funds is also done on the same day.

##### **6.5.1.1 Self Auction / Auction for Internal Shortages**

In some cases, a selling client has failed to deliver the shares sold in a settlement to a member. However, this may not result in failure of the Member to deliver the shares to the Clearing House as there was a purchase transaction by his other buying client in the same security and the same was netted off for the purpose of settlement. In such a case, the 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. These shortages are called internal shortages.

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 and other client of same member has bought the similar quantity of shares of company 'X'. Due to netting, there is no security obligation for member from clearing corporation. As selling client is not able to deliver the shares, member is not able to make delivery to buying client. To provide shares to the trading members in such cases, member have been given an option by clearing corporation to submit the details of such internal shortages on pay-in day for conducting self-auction. 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.

#### **6.5.2 Close Out Procedure**

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 across 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.

In certain delivery shortages, clearing corporation directly does the close-out without conducting an auction. For e.g., Securities under trade for trade category, securities under corporate action, trades done on block deal window etc.

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 across 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.

### **6.6 Corporate Actions Adjustment**

Corporate actions like Bonus, Rights, Extra-ordinary dividends, Merger/Demerger, Amalgamation, Splits and Consolidations etc. will result in adjustments in the futures & options contracts of the underlying stock which is undergoing the corporate action. 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.

#### **6.6.1 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

### **6.6.2 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.

### **6.6.3 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

In a lot of cases, adjustments may result in the change in date of expiry of the contract as well i.e., contract will be force closed before the expiry date and the adjusted contracts will trade instead. 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.

### **6.6.4 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:

#### **6.6.4.1 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 : $A/B$

#### **6.6.4.2 Rights**

##### **Strike Price:**

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

##### **Market Lot / Multiplier:**

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

##### **Position:**

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

##### **Rights**

Rights Entitlement = A

Number of Existing shares = B

Total Entitlement = A+B

Underlying close price on the last cum date = P

Issue price of the rights = S

Benefit per Right Entitlement =  $(P - S) * A$

Benefits per share = E

$E = (P-S)*A/(A+B)$

Adjustment Factor is =  $(P-E)/P$

Dividend if any, declared by the company along with rights shall be adjusted as per the prevailing dividend adjustment policy in Equity F&O Segment.

#### **Adjustment in case of Fraction**

The above methodology may result in fractions due to the corporate action e.g., a bonus ratio of 3:7. With a view to minimizing 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 to the nearest tick size and Market Lot to nearest integer.
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.

#### **6.6.4.3 Dividends**

For the purpose of adjustments in equity F&O, dividends which are below 2 percent of the market value of the underlying stock, would be deemed to be ordinary dividends and no adjustment in Equity F&O would be made for ordinary dividends.

For extra-ordinary dividends i.e., at and above 2 percent<sup>85</sup> of the market value of the underlying security or all cases of dividends, where the listed entity has sought exemption from the timeline prescribed under the provisions of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 there would be adjustment in Equity F&O.

To decide whether the dividend is "extra-ordinary" (i.e. 2 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. All open positions shall be carried forward at the daily settlement price less dividend amount for the respective futures contract.

#### **6.6.4.4 Mergers / Demergers**

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/demerger.

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.

Demerger:

All the following conditions shall be met in the case of shares of a company undergoing restructuring through any means for eligibility to re-introduce derivative contracts on that company from the first day of listing of the post restructured company's stock (herein referred to as post restructured company) in the underlying market.

a. the futures and options contracts on the stock of the original (pre restructure) company were traded on any Exchange prior to its restructuring;

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<sup>85</sup> SEBI/HO/MRD2/MRD2\_DCAP/P/CIR/2022/90.

- b. the pre restructured company had a market capitalization of at least Rs.1000 crores prior to its restructuring;
- c. the post restructured company would be treated like a new stock and if it is, in the opinion of the Exchange, likely to be at least one-third the size of the pre restructuring company in terms of revenues, or assets, or (where appropriate) analyst valuations; and
- d. in the opinion of the Exchange, the scheme of restructuring does not suggest that the post restructured company would have any characteristic (for example extremely low free float) that would render the company ineligible for derivatives trading,

If the above conditions are satisfied, then the following course of action in dealing with the existing derivative contracts on the pre-restructured company and introduction of fresh contracts on the post restructured company:

- a) All existing contracts of the security shall be expired on the last cum date.
- b) The Exchange shall introduce near month, middle month and far month derivative contracts on the stock of the restructured company from the ex-date of the demerger.

#### **6.6.4.5 Other Corporate Actions**

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.

### **Sample 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.
2. Corporate action adjustments are done on all \_\_\_\_\_ positions.  
  
**(a) Open**  
(b) Closed  
(c) Past  
(d) Executed
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
4. In case of declaration of "extra-ordinary" dividend by any company, the total dividend amount would be \_\_\_\_\_ from all the strike prices of the option contracts on that stock.  
  
**(a) Reduced**  
(b) Increased



## **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) 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 take 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 securities 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:

#### **Grievance Redressal Mechanism:**

Level 1 – Approach the Stock Broker at the designated Investor Grievance e-mail ID of the stock broker. The Stock Broker will strive to redress the grievance immediately, but not later than 30 days of the receipt of the grievance.

Level 2 – Approach the Stock Exchange using the grievance mechanism mentioned at the website of the respective exchange.

Level 3 – The complaint not redressed at Stock Broker / Stock Exchange level, may be lodged with SEBI on SCORES (a web based centralized grievance redressal system of SEBI) at: <https://scores.gov.in>

### **7.2.1 Investor Grievance handling at the trading member level**

All the trading firms have a designated cell/person for redressing investor grievances. When a complaint is filed by the investor, matter has to be resolved at the branch level or the firm level depending upon the nature of the complaint. All the registered brokers shall designate an e-mail ID of the grievance redressal division/compliance officer exclusively for the purpose of registering complaints by investors. The broker shall also display the email ID and other relevant details prominently on their websites and in the various materials/pamphlets/advertisement campaigns initiated by them for creating investor awareness. Further, for information of all investors who deal/ invest/ transact in the market, the offices of all stock brokers (its registered authorized person(s)) shall prominently display basic information, as provided in Exhibit 7.1 below, about the grievance redressal mechanism available to investors.

#### **Exhibit 7.1**

Dear Investor,

In case of any grievance / complaint against the stock broker / Depository Participant:

Please contact compliance officer of the Stock Broker / Depository Participant (Name) / email-id (xxx.@email.com) and Phone No. 91-XXXXXXXXXX

You may also approach CEO / Partner/ Proprietor (Name) / e-mail id (xxx.@email.com ) and Phone No. – 91 – XXXXXXXXXX

If not satisfied with the response of the Stock Broker / Depository Participant, you may contact the concerned Stock Exchange / Depository at the following:

	Web Address	Contact No.	Email-id
BSE	<a href="http://www.bseindia.com">www.bseindia.com</a>	XXXXXXXXXX	xxx@bseindia.com
NSE	<a href="http://www.nseindia.com">www.nseindia.com</a>	XXXXXXXXXX	xxx@nse.co.in
MSEI	<a href="http://www.msei.in">www.msei.in</a>	XXXXXXXXXX	xxx@msei.in

	Web Address	Contact No.	Email-id
CDSL	<a href="http://www.cdslindia.com">www.cdslindia.com</a>	XXXXXXXXXX	xxx@cdslindia.com
NSDL	<a href="http://www.nsdl.co.in">www.nsdl.co.in</a>	XXXXXXXXXX	xxx@nsdl.co.in

You can also lodge your grievance with SEBI at <http://scores.gov.in>. For any queries, feedback or assistance, please contact SEBI Office on Toll Free Helpline at 1800 22 7575 / 1800 266 7575.

The stock broker shall endeavor to redress investor grievances promptly within the time specified by the SEBI/Exchanges from time to time. The stock broker shall maintain records regarding investor grievances received by it and redressal of such grievances.

SEBI has issued circular<sup>86</sup> for “Publishing Investor Charter and disclosure of Investor Complaints by Stock Brokers on their websites”. SEBI has prepared an Investor Charter for Stock Brokers inter-alia detailing the services provided to Investors, Rights of Investors, various activities of Stock Brokers with timelines, DOs and DON'Ts for Investors and Grievance Redressal Mechanism. SEBI has advised member to provide investor grievance redressal within 30 days from the receipt of complaints from investor. Stock Exchanges are directed to advise Stock Brokers to bring the Investor Charter to the notice of their clients (existing as well as new clients) through disclosing the Investor Charter on their respective websites, making them available at prominent places in the office, provide a copy of Investor Charter as a part of account opening kit to the clients, through e-mails/ letters etc. Further, in order to bring about transparency in the Investor Grievance Redressal Mechanism, it has been decided that all the Stock Brokers shall disclose on their respective websites, the data on complaints received against them or against issues dealt by them and redressal thereof, latest by 7th of succeeding month, as per the format provided in the above circular. According to SEBI (Intermediaries) Regulations 2008, the stock broker shall at the end of each quarter of a financial year ending on 31st March upload information about the number of investor grievances received, redressed and those remaining unresolved beyond three months of the receipt thereof by the stock broker on the website.

### ***7.2.2 Investor Grievance handling at the Stock Exchanges and SEBI***

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

#### ***7.2.2.1 SEBI Complaints Redressal System (SCORES)***

SEBI handles the investor grievances through a system called SEBI Complaints Redress System (SCORES). SCORES is a web based centralized system to capture investor complaints against listed companies and registered intermediaries and is available 24x7. Salient features of SCORES are:

- Centralized database of all complaints.
- Online movement of complaints to the concerned entities.
- Online upload of Action Taken Reports (ATRs) by the concerned entities.
- Online tracking of status of complaints by investors.

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<sup>86</sup>[https://www.sebi.gov.in/legal/circulars/dec-2021/publishing-investor-charter-and-disclosure-of-investor-complaints-by-stock-brokers-on-their-websites\\_54402.html](https://www.sebi.gov.in/legal/circulars/dec-2021/publishing-investor-charter-and-disclosure-of-investor-complaints-by-stock-brokers-on-their-websites_54402.html)

It allows the investors to lodge their complaints and track the status online. Investors who wish to lodge a complaint on SCORES are requested to register themselves on [www.scores.gov.in](http://www.scores.gov.in).<sup>87</sup> 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. SEBI encourages the investors to lodge complaints through electronic mode in SCORES. However, if an investor submits a manual complaint, the same is digitized by SEBI and uploaded on SCORES. Thereafter, follow-up actions of the complaint are done in electronic form only i.e., through SCORES. Investors can easily access, retrieve and preserve the complaints lodged by them in electronic mode. Further, it enhances the turnaround time and speed of redressal of a complaint.

Investors may contact the Investor Associations (IAs) recognized by SEBI for any assistance in filing complaints on SCORES. The lists of Investor Associations are available on SEBI website ([www.sebi.gov.in](http://www.sebi.gov.in)). Investors may also seek assistance in filing complaints on SCORES from SEBI's toll free helpline numbers. SEBI has received inputs from listed companies and intermediaries that investor grievances can be resolved faster if the grievance been taken up directly with the entity at the first instance. Accordingly, it appears to be prudent and time saving if the investors approach the concerned listed company or registered intermediary first with all the requisite details to redress the complaints. In case, the listed company or registered intermediary fails to redress the complaint to the investor's satisfaction, the investor may file a complaint in SCORES.

The investor grievances received by SEBI against stock brokers will be taken up electronically with the concerned stock exchange(s) through SCORES (<https://scores.gov.in/Admin>). The stock exchange(s) shall, in turn, take up the matter with the concerned stock brokers. With a view to make complaint redressal mechanism through SCORES more efficient, all stock brokers are directed to address/redress the complaint within a period of 15 days from the receipt of the complaint. In case of additional information is required from complainant, the same shall be sought within 7 days from the receipt of the complaint. In such case the period of 15 days shall run from the receipt of additional information.

SEBI has advised Stock Exchanges to put in place a suitable mechanism to follow up with the stock broker, wherever necessary; devise a system to levy penalty on its members for any non-compliance with the requirements related to SCORES, update the status of the complaints in SCORES, at every stage, along with supporting documents and ensure that the status of investor complaints disclosed on their websites is in conformity with the status updated in SCORES.

The complaints received by SEBI against Stock Exchanges and Depositories shall be electronically sent through SCORES. Stock Exchanges and Depositories advised to view the pending complaints at <http://scores.gov.in/admin> and submit the Action Taken Report (ATR) along with supporting documents electronically in SCORES. Stock Exchanges and Depositories indicate a contact person in case of SCORES, who is an employee heading the complaint services division/cell/department. Address/redress the

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<sup>87</sup>[https://www.sebi.gov.in/legal/circulars/mar-2018/investor-grievance-redress-mechanism-new-policy-measures\\_38481.html](https://www.sebi.gov.in/legal/circulars/mar-2018/investor-grievance-redress-mechanism-new-policy-measures_38481.html)

complaints within a period of 15 working days upon receipt of complaint on SCORES. In case additional information is required from the complainant, the same shall be sought within 7 working days of receipt on SCORES. In such case, the period of 15 working days will be counted upon the receipt of additional information. Maintain a monthly record of the complaints which are not addressed/redressed within 15 working days from the date of receipt of the complaint/information, along with the reason for such pendency. Exchanges/depositories has to upload/update the ATR on the SCORES. Failure to do so shall be considered as non-redressal of the complaint and the complaint shall be shown as pending. Presently, the limitation period for filing an arbitration reference with stock exchanges is three years. In line with the same and in order to enhance ease, speed & accuracy in redressal of investor grievance, the investor may lodge a complaint on SCORES within three years from the date of cause of complaint;

- where Investor has approached the listed company or registered intermediary for redressal of the complaint **and**,
- The concerned listed company or registered intermediary rejected the complaint **or**,
- The complainant does not receive any communication from the listed company or intermediary concerned **or**,
- The complainant is not satisfied with the reply given to him or redressal action taken by the listed company or an intermediary.

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.

It is pertinent to note here that at present following types of complaints are not dealt through SCORES

- i. Complaints against the companies which are unlisted/delisted, in dissemination board of Stock Exchanges,
- ii. Complaints those are sub-judice i.e., relating to cases which are under consideration by court of law, quasi-judicial proceedings etc.
- iii. Complaints falling under the purview of other regulatory bodies viz. RBI, IRDAI, PFRDA, CCI, etc., or under the purview of other ministries viz., MCA, etc.
- iv. Complaints against a sick company or a company where a moratorium order is passed in winding up / insolvency proceedings.
- v. Complaints against the companies where the name of company is struck off from RoC or a vanishing company as per list published by MCA.
- vi. Companies under liquidation / BIFR / etc.

Following matters cannot be considered as complaints under SCORES:

- a. Complaint not pertaining to investment in securities market
- b. Anonymous Complaints (except whistleblower complaints)
- c. Incomplete or un-specific complaints
- d. Allegations without supporting documents
- e. Suggestions or seeking guidance/explanation

- f. Not satisfied with trading price of the shares of the companies
- g. Non-listing of shares of private offer
- h. Disputes arising out of private agreement with companies/intermediaries
- i. Matter involving fake/forged documents
- j. Complaints on matters not in SEBI purview
- k. Complaints about any unregistered/ un-regulated activity

To enhance investor satisfaction on complaint redressal, SEBI has put in place a 'Complaint Review facility' under SCORES wherein an investor if unsatisfied with the redressal may within 15 days from the date of closure of his complaint in SCORES opt for review of the complaint and the complaint shall be escalated.

In order to increase the awareness regarding online grievance redressal mechanisms, all Recognized Stock Exchanges / Depositories / Clearing Corporations are advised to display the following on the home page of their websites and mobile apps.

- Link / option to lodge complaint with them directly.
- Link to SCORES website/ link to download SCORES mobile app

#### **7.2.2.2 Resolution of complaints by Stock Exchanges<sup>88</sup>**

Stock Exchange shall ensure that the investor complaints shall be resolved within 15 working days from the date of receipt of the complaint. Additional information, if any, required from the complainant, shall be sought within 7 working days from the date of receipt of the complaint. The period of 15 working days shall be counted from the date of receipt of additional information sought. Stock Exchange shall maintain a record of all the complaints addressed/redressed within 15 working days from the date of receipt of the complaint/additional information. If complaint is not resolved within stipulated time frame, then the reason for non-redressal in given time frame shall also be recorded.

Stock Exchange shall resolve service related complaints at its end. However, in case the complainant is not satisfied with the resolution, the same may be referred to the Investor Grievance Redressal Committee ("IGRC")/ Grievance Redressal Committee (GRC)<sup>89</sup>, after recording the reasons in writing by the Chief Regulatory Officer of the Stock Exchange or any other officer of the Stock Exchange authorized in this behalf by the Managing Director. Service related complaints shall include non-receipt/ delay of Account statement, non-receipt/ delay of bills, closure of account/branch, technological issues, shifting/closure of branch without intimation, improper service by staff, freezing of account, alleged debit in trading account, contact person not available in Trading member's office, demat account transferred without permission etc. For Complaints related to trade, settlement and 'deficiency in services', resulting into any financial loss, the stock exchange shall resolve the complaint on its own as per the time lines prescribed. However, if complaint is not resolved amicably, the same shall be referred to the IGRC, after recording the reasons in writing by

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<sup>88</sup> [https://www.sebi.gov.in/legal/circulars/nov-2020/investor-grievance-redressal-mechanism\\_48105.html](https://www.sebi.gov.in/legal/circulars/nov-2020/investor-grievance-redressal-mechanism_48105.html)

<sup>89</sup> SEBI vide circular SEBI/HO/MRD/DDAP/CIR/P/2020/16 dated January 28, 2020 has advised following: "Investor grievance redressal committee" shall be read as "Grievance redressal committee"

the Chief Regulatory Officer of the Stock Exchange or any other officer of the Stock Exchange authorized in this behalf by the Managing Director. It shall be the responsibility of the Stock Exchange to provide documents/ necessary information after collecting the same from the member and/ or the complainant and provide necessary assistance to IGRC/GRC to ensure resolution of complaints in a timely manner.

All Stock exchanges have an investor grievance department/Investor services department which looks into all the complaints/matters against the trading members registered with the Exchange. To facilitate early redressal of investor grievances, it is mandated to stock exchanges having nationwide terminals, functional stock exchanges having trading volumes, stock exchanges entering into MOUs with other exchanges and stock exchanges intending to recommence trading operations shall constitute Investor Grievance Redressal Committee (IGRC/GRC) at every investor service Centre. With a view to assist investors engaged in dispute resolution process, Stock Exchanges shall set up facilitation desks at all investor services centres as specified by SEBI from time to time. These facilitation desks would inter alia also assist investors in obtaining documents/details from Stock Exchanges wherever so required for making application to Investor Grievance Redressal Committee (IGRC/GRC) and filing arbitration.

To enable investors to lodge and follow up on their complaints and track the status of redressal of complaints from anywhere, all Recognized Stock Exchanges including Commodity Derivatives Exchanges / Depositories are advised by SEBI to design and implement an online web based complaints redressal system of their own, which will facilitate investors to file complaints and escalate complaints for redressal through Grievance Redressal Committee (GRC), arbitration, appellate arbitration etc. in accordance with their respective byelaws, rules and regulations. The above redressal mechanism shall be implemented within 6 months from the issuance of the circular<sup>90</sup>.

### **7.2.3 Handling of complaint by Investor Grievance Redressal Committee**

IGRC shall have a time of 15 working days to amicably resolve the investor complaint. IGRC shall adopt a two-fold approach i.e., for proceedings leading to direction to the Member to render required service in case of service related complaints and proceedings leading to an order concluding admissibility of the complaint or otherwise in case of trade related complaints. In case the matter is not resolved through the conciliation process, IGRC shall decide claim value admissible to the complainant. Upon conclusion of the proceedings of IGRC i.e. in case claim is admissible to the complainant, Stock Exchanges shall block the admissible claim value from the deposit of the member as specified in this regard.

The Stock Exchange shall give a time of 7 days to the member from the date of receipt of IGRC directions as mentioned above to inform the Stock Exchange whether the member intends to pursue the next level of resolution i.e., Arbitration. In case, the Member opts for an Arbitration within 7 days but does not file Arbitration reference within specified time or the member does not opt for arbitration, the Stock Exchange shall, release the blocked amount to the investor after the afore mentioned 7 days.

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<sup>90</sup> SEBI circular SEBI/HO/MRD1/ICC1/CIR/P/2022/94 dated July 04, 2022.

In case, awards is in favour of client and the Member opts for arbitration and where the claim value admissible to the investor/client is not more than Rs. 20 lakhs, the following steps shall be undertaken by the Stock Exchange:

- a. 50% of the admissible claim value or Rs. 2.00 lakhs, whichever is less, shall be released to the investor from IPF of the Stock Exchange.
- b. In case the arbitration award is in favour of the investor and the Member opts for appellate arbitration then a positive difference of 50% of the amount mentioned in the arbitration award or Rs. 3.0 lakhs, whichever is less, and the amount already released to the client at clause (a) above, shall be released to the client from IPF of the Stock Exchange.
- c. In case the appellate arbitration award is in favour of the investor and the Member opts for making an application under section 34 of the Arbitration and Conciliation Act, 1996 to set aside the appellate arbitration award, then a positive difference of 75% of the amount determined in the appellate arbitration award or Rs. 5 lakhs, whichever is less and the amount already released to the client at clause (a) and (b) above, shall be released to the client from IPF of the Stock Exchanges.
- d. Total amount released to the client through the facility of interim relief from IPF in terms of this circular shall not exceed Rs. 10.00 lakhs (Ten lakhs) in a financial year.
- e. Before release of the said amounts from the IPF to the investor, the Stock Exchange shall obtain appropriate undertaking/ indemnity from the investor against the release of the amount from IPF, to ensure return of the amount so released to the investor in case the proceedings are decided against the investor.
- f. If it is observed that there is an attempt by investor/client either individually or through collusion with Member(s) or with any other stakeholders, to misuse the provision, then without prejudice to the powers of the SEBI to take action, appropriate action in this regard shall be taken against any such person, by the Stock Exchange, including disqualification of the person so involved from henceforth accessing the benefits under this provision.
- g. In case the complaint is decided in favour of the investor after conclusion of the proceedings, then the amount released to the investor shall be returned to IPF from the blocked amount of the Member by the Stock Exchange and the rest shall be paid to the investor.
- h. Stock Exchanges will devise a detailed procedure with regard to release of funds from IPF and recovery thereof and necessary formats of documentation.
- i. In case the investor loses at any stage of the proceedings and decides not to pursue further, then the investor shall refund the amount released from IPF, back to the IPF. In case the investor fails to make good the amount released out of IPF then investor (based on PAN of the investor) shall not be allowed to trade on any of the Stock Exchanges till such time the investor refunds the amount to IPF. Further, the securities lying in the demat account(s) of the investor shall be frozen till such time as the investor refunds the amount to the IPF.



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- j. The Stock Exchanges may also resort to displaying the names of such investors on their websites if considered necessary.

With a view to address complaints regarding 'unauthorized trades' Stock Exchanges are advised to direct the Members to put in place the following:

- a) In case the Member has made margin calls to the client and the client has failed to comply with these margin calls, then the contract notes issued by Member for transactions owing to non-compliance of such margin calls would bear a remark specifying the same.
- b) The Member shall maintain a verifiable record of having made such margin calls and that the clients have not complied with the same.

The composition of the IGRC/GRC shall be as follows:

- The IGRC/GRC shall comprise of a single person for claims up to Rs. 25 Lakh, whereas, for claims above Rs. 25 Lakh, the IGRC/IGRP shall comprise of three persons.
- The IGRC/GRC shall comprise of independent persons with qualifications in the area of law, finance, accounts, economics, management or administration and experience in financial services, including securities market.
- Further, the three members Committee shall comprise of at least one technical expert for handling complaints related to technology issues (such as internet-based trading, algorithmic trading, etc.).
- The members of IGRC/GRC shall not be associated with a trading member in any manner.
- The disclosures and code of conduct prescribed under para 3.4 and 4 of SEBI circular Ref. No CIR/MRD/DSA/24/2010 dated August 11, 2010, shall be applicable, as far as may be, to members of IGRC/IGRP also.

Stock Exchanges shall empanel Grievance Redressal Committee members and no arbitrator/appellate arbitrator shall be empaneled as IGRC/GRC member.

Timelines for complaint resolution process at Stock Exchanges against stock brokers<sup>91</sup>

S. No.	Type of Activity	Timelines for activity
1	Receipt of Complaint	Day of complaint (C Day).
2	Additional information sought from the investor, if any, and provisionally forwarded to stock broker.	C + 7 Working days
3	Registration of the complaint and forwarding to the stock broker.	C+8 Working Days i.e. T day
4	Amicable Resolution	T+15 Working Days
5	Refer to Grievance Redressal Committee (GRC), in case of no amicable resolution.	T+16 Working Days
6	Complete resolution process post GRC	T + 30 Working Days

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<sup>91</sup>[https://www.sebi.gov.in/legal/circulars/dec-2021/publishing-investor-charter-and-disclosure-of-investor-complaints-by-stock-brokers-on-their-websites\\_54402.html](https://www.sebi.gov.in/legal/circulars/dec-2021/publishing-investor-charter-and-disclosure-of-investor-complaints-by-stock-brokers-on-their-websites_54402.html)

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7	In case where the GRC Member requires additional information, GRC order shall be completed within.	T + 45 Working Days
8	Implementation of GRC Order.	On receipt of GRC Order, if the order is in favour of the investor, debit the funds of the stock broker. Order for debit is issued immediately or as per the directions given in GRC order.
9	In case the stock broker is aggrieved by the GRC order, will provide intention to avail arbitration	Within 7 days from receipt of order
10	If intention from stock broker is received and the GRC order amount is upto Rs.20 lakhs	Investor is eligible for interim relief from Investor Protection Fund (IPF). The interim relief will be 50% of the GRC order amount or Rs.2 lakhs whichever is less. The same shall be provided after obtaining an Undertaking from the investor.
11	Stock Broker shall file for arbitration	Within specified time from the date of GRC recommendation
12	In case the stock broker does not file for arbitration within specified period	The GRC order amount shall be released to the investor after adjusting the amount released as interim relief, if any.

**Handling of Investor's claims / complaints in case of default of a Trading Member / Clearing Member (TM/CM)**

**Default of TM/CM**

Following steps are carried out by Stock Exchange for benefit of investor, in case stock broker defaults:

- Circular is issued to inform about declaration of Stock Broker as Defaulter.
- Information of defaulter stock broker is disseminated on Stock Exchange website.
- Public Notice is issued informing declaration of a stock broker as defaulter and inviting claims within specified period.
- Intimation to clients of defaulter stock brokers via emails and SMS for facilitating lodging of claims within the specified period.

Following information is available on Stock Exchange website for information of investors:

- Norms for eligibility of claims for compensation from IPF.
- Claim form for lodging claim against defaulter stock broker.

- FAQ on processing of investors' claims against defaulter stock broker.
- Provision to check online status of client's claim.

In order to bring about transparency in the Investor Grievance Redressal Mechanism, it has been decided that all the Stock Exchanges / Depositories / Clearing Corporations shall disclose on their websites, the data on complaints received against them and redressal thereof, latest by 7th of succeeding month, as per the format specified by SEBI.

### **7.3 Investor Protection Fund**

The Central Government, vide notification No. F. No. 14/4/SE/85 dated August 22, 1985, has stipulated the setting up of the Investor Protection Fund (IPF) by Stock Exchanges. This fund should take care of legitimate investment claims which are not of speculative nature of the clients of defaulting member(s). The Investor's Protection Fund is a fund established and maintained by the Exchanges with an aim to protect the interests of the clients of the trading members of the Exchange, who may have been declared defaulters or who may have been expelled, under the provisions of the Rules, Bye-laws and Regulations of the Exchange. The Investor Protection Fund/Customer Protection Fund (hereinafter referred to as IPF/CPF) shall be administered by way of a Trust created for the purpose.

The Investors' Protection Fund may provide compensation against a genuine and bonafide claim made by any client, who has either not received the securities bought from a trading member for which the payment has been made by such client to the trading member or has not received the payment for the securities sold and delivered to the trading member or has not received any amount or securities which is/are legitimately due to such client from the trading member, who is either declared a defaulter or expelled by the Exchange or where the trading member, through whom such client has dealt, is unable to get the securities rectified or replaced for the reason that the introducing trading member at the Exchange is either declared a defaulter or expelled by the Exchange, under the relevant Rules, Bye-laws and Regulations of the Exchange.

The claims of the investors/clients against the defaulter members during the specified period shall be eligible for compensation from the IPF/CPF and in no case the claims of a broker or an associate of the member broker of the Stock Exchange shall be eligible for compensation out of the IPF/CPF. The claims of the investors/clients arising out of speculative transactions shall not be eligible for compensation from the IPF/CPF. The claim should not be a sham or collusive. The IPF/CPF Trust may adopt the arbitration mechanism at the Stock Exchange to determine the legitimacy of the claims received from the claimants. The IPF/CPF Trust may also seek the advice of the Defaulters Committee to sanction and ratify the payments to be made to the investors.

Stock Exchanges are required to adhere to the guidelines provided by SEBI with regards to Constitution and Management of the IPF/CPF, Contribution to IPF/CPF, Eligibility of claims, Determination of Legitimate Claims, Threshold limits of claims, Disbursements of claims from the IPF/CPF, Utilization of investor protection fund etc. SEBI also through various had

specified the Standard Operating Procedure enumerating the steps to be taken by the Stock Exchanges (“SEs”), Clearing Corporations (“CCs”) and Depositories in cases where SE / CC is of the view that Trading Member/ Clearing Member is likely to default in repayment of funds or securities to its clients.

#### **7.4 Arbitration**

For any dispute between the member and the client relating to or arising out of the transactions in Stock Exchange, which is of civil nature, the complainant/ member shall first refer the complaint to the IGRC and/ or to arbitration mechanism provided by the Stock Exchange before resorting to other remedies available under any other law. For the removal of doubts, it is clarified that the sole arbitrator or the panel of arbitrators, as the case may be, appointed under the Stock Exchange arbitration mechanism may consider any claim relating to any dispute between a stock broker and client arising out of the transactions in stock exchange, as per law, and shall always be deemed to have the competence to rule on its jurisdiction. A complainant/member, who is not satisfied with the recommendation of the IGRC shall avail the arbitration mechanism of the Stock Exchange for settlement of complaints within three months from the date of IGRC recommendation. The time period of three months mentioned above for filing arbitration shall be applicable only for the cases where the IGRC recommendation is being challenged. For any arbitration application received without going through IGRC mechanism, the above time period of three months shall not apply, and for such cases the limitation period for filing arbitration shall be governed by the law of limitation, i.e., The Limitation Act, 1963.”

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. A stock exchange shall provide an arbitration mechanism for settlement of disputes between a client and a member through arbitration proceedings in accordance with the provisions of this Circular read with Section 2(4) of the Arbitration and Conciliation, Act, 1996. Stock Exchange should comply with SEBI guidelines with regards to Arbitration mechanism. 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 identified around 16 such centers where investor services as well arbitration facility are to be provided by stock Exchanges. In case the award amount is more than Rs. 50 lakh (Rs. Fifty lakh), the next level of proceedings (arbitration or appellate arbitration) may take place at the nearest metro city, if desired by any of the party involved. The additional statutory cost for arbitration, if any, is to be borne by party desirous of shifting the place of arbitration..

The stock exchange shall have a set of fair and transparent criteria for inclusion of names in the panel of arbitrators. While deciding to include a particular person in the panel of arbitrators, the stock exchange shall take into account the factors like age, qualification in the area of law, finance, accounts, economics, management, or administration and

experience in financial services, including securities market. There shall be separate panels for arbitration and appellate arbitration. Further, for appellate arbitration, at least one member of the panel should be a Retired Judge. In order to enhance transparency and also to provide choice to parties, Stock Exchanges/ Depositories shall disseminate information w.r.t. brief profile, qualification, areas of experience/ expertise, number of arbitration matters handled, pre-arbitration experience, etc. of the arbitrators on their website.

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 randomized computer-generated selection process. The 'Automatic Process' will send a system generated, real time alert (sms, email etc.) to all entities involved in the particular case. Further, the communication for the appointment of the Arbitrator will be sent immediately and, in any case, not later than the next working day from the day of picking of the Arbitrator. This communication will be sent by the stock exchange on which the dispute had taken place, to all concerned entities including clients, arbitrators, members, stock exchanges etc. In case of any probable conflict of interest in an arbitration reference being assigned to any Arbitrator, the Arbitrator will have to upfront decline the arbitration reference. After the said arbitrator declines, the 'automatic process' will pick the name of another Arbitrator.

Along with an arbitration application the claimant may need to submit necessary document / record as given below:

- 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.
- Margin Statement
- Member Constituent Agreement
- Risk Disclosure Document etc.

In order to assist the arbitrators in pronouncing comprehensive and speedy awards, Stock Exchanges/ Depositories shall make necessary arrangements in terms of hardware viz., computer, scanner, printer, etc. and required software’s at exchange offices/ Investor Service Centers (ISCs) to facilitate the clients to type/ convert their documents into

electronic format/ soft copy. Such electronic format/ soft copies shall be provided to the arbitrators along with original submissions in physical copies.

The limitation period (currently three years) for filing an arbitration reference shall be governed by the law of limitation, i.e., The Limitation Act, 1963. 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. As per the Code of Conduct for Arbitrators specified by SEBI, Arbitrator shall pass reasoned and speaking arbitral awards.

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. In order to safeguard the interest of the parties involved in arbitration and to ensure speedy implementation of the arbitration award, the rate of interest on the award passed by arbitrators shall be in compliance with Arbitration and Conciliation Act, 1996.

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

Stock Exchanges/ Depositories shall create a common database of defaulting clients accessible to members/ depository participants across the Stock Exchanges/ Depositories. For this purpose, a client may be identified as defaulter if the client does not pay the award amount to the member/ depository participant as directed in the IGRC/arbitration/ appellate arbitration order and also does not appeal at the next level of redressal mechanism within the timelines prescribed by SEBI or file an application to court to set aside such order in accordance with Section 34 of the Arbitration and Conciliation Act, 1996 (in case of aggrieved by arbitration/ appellate award).

### **Arbitration Fees**

In order to have faster implementation of award and to discourage delayed filing of arbitrations by members, the fee structure (exclusive of statutory dues – stamp duty, GST etc.) for filing arbitration reference shall be as follows:

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**Table 7.1: Arbitration Fees<sup>92</sup>**

<b>Amount of claim /counter claim (whichever is higher)</b>	<b>If claim is filed within six months from the date of dispute</b>	<b>If claim is filed after six months from the date of dispute or after one month from the date of IGRC order, whichever is later</b>	<b>If the claim is filed beyond the timeline prescribed in column 3 (only for member)</b>
≤ Rs. 10,00,000	1.3% subject to a minimum of Rs. 10,000	3.9% subject to a minimum of Rs. 30,000	Additional fee of Rs. 3,000/- per month over and above fee prescribed in column 3
>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	Additional fee of Rs. 6,000/- per month over and above fee prescribed in column 3
≥ 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	Additional fee of Rs. 12,000/- per month over and above fee prescribed in column 3

The filing fee will be utilized to meet the fee payable to the arbitrators. A client, who has a claim / counter claim upto Rs.20 lakh(Rs. Twenty lakh) and files arbitration reference, will be exempted from payment of the fees specified above. Excess of filing fee over fee payable to the arbitrator, if any, to be deposited in the IPF of the respective stock exchange. In all cases except the additional fees charged from the trading members, if the claim is filed beyond the timeline prescribed in column 3, (only for member), on issue of the arbitral award the stock exchange shall refund the deposit to the party in whose favour the award has been passed. The additional fees charged from the trading members, if the claim is filed beyond the timeline prescribed in column 3, (only for member), if any, to be deposited in the IPF of the respective Stock Exchange. A party filing an appeal before the appellate panel shall pay a fee not exceeding Rs. 54,000, as may be prescribed by the stock exchange, in addition to statutory dues (stamp duty, GST, etc.) along with the appeal. In case the party filing the appeal is a client, the additional expenses shall be borne by the client and Exchange equally.

<sup>92</sup> SEBI Circular Ref. No. SEBI/HO/DMS/Cir/P/2017/15 Dated February 23, 2017.

### **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. There shall be separate panels for arbitration and appellate arbitration. Further, for appellate arbitration, at least one member of the panel should be a Retired Judge. 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. Members shall convey their intention to Stock Exchanges within 7 days of receipt of the award, as regards whether such Members desire to challenge the arbitration award/appellate arbitration award in Court or not.

SEBI has advised Stock Exchanges to use hybrid mode (i.e., online and offline) for conducting GRC and arbitration / appellate arbitration process.



### **Sample 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
  
2. Arbitration aims at \_\_\_\_\_ legal resolution for the disputes.
  - (a) Slower
  - (b) Quicker**
  - (c) Routine
  
3. A client, who has a claim / counter claim upto \_\_\_\_\_ and files arbitration reference, will be exempted from payment of the fees specified by SEBI..
  - (a) Rs. 10 lakh
  - (b) Rs. 15 lakh
  - (c) Rs. 5 lakh
  - (d) Rs. 20 lakh**
  
4. Arbitration for claims up to \_\_\_\_\_ is decided by a sole arbitrator.
  - (a) Rs. 25 Lakh**
  - (b) Rs. 5 Lakh
  - (c) Rs. 20 Lakh
  - (d) Rs. 50 Lakh

## **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
- Internet Based Trading etc.

### **8.1 Introduction**

The brokers 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. However, for all the other services, the brokers need to be separately registered with SEBI.

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 net worth 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:

- Investment advice & Research reports and market review
- Depository services
- Direct Market Access (DMA)
- Mobile trading & Smart Order Routing (SOR)
- Algorithmic trading
- IPOs & Mutual Funds Distribution
- Internet-based Online Trading (IBT)
- 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 list of trading members who are appointed as syndicate/sub-syndicate member to participate in the book building process to the Exchange.<sup>93</sup> Exchange provides platform to trading members to submit the IPO application online. To enable on IPO platform, member has to comply with the registration procedure specified by Exchanges from time to time. 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. In ASBA the application money remains blocked in the investor's account till finalization of basis of allotment in the issue. The application money to the extent of allotment value is debited from the bank account only if the investors application is selected for allotment after the basis of allotment is finalized and the non-allotted amount is unblocked. As per SEBI circular no CIR/CFD/POLICY CELL/11/2015 dated November 10, 2015. All the investors shall mandatorily use only Application Supported by Blocked Amount (ASBA) facility for all issues opening from 01 January 2016 onwards. SEBI further advised that, the ASBA applications in public issues shall be processed only after the application monies are blocked in the investor's bank accounts. Accordingly, all intermediaries / market infrastructure institutions are advised to ensure that appropriate systemic and procedural arrangements are made within three months from the date of issuance of this circular.<sup>94</sup>

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<sup>93</sup>The 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.

<sup>94</sup>[https://www.sebi.gov.in/legal/circulars/may-2022/processing-of-asba-applications-in-public-issue-of-equity-shares-and-convertibles\\_59338.html](https://www.sebi.gov.in/legal/circulars/may-2022/processing-of-asba-applications-in-public-issue-of-equity-shares-and-convertibles_59338.html)

To further streamline the process of IPO, SEBI had decided the use of Unified Payment Interface (UPI) as a payment mechanism with Application Supported by Block Amount (ASBA) for application in public issues by retail investors through intermediaries (Syndicate members, Registered Stock Brokers, Registrar and Transfer agent and Depository Participants).<sup>95</sup> SEBI vide circular dated April 05, 2022, decided that all Individual Investors applying in Public issues where the application amount is upto 5 Lakhs shall use UPI and shall also provide their UPI ID in the bid-cum-application form submitted with any of the entities mentioned herein below:

- i. a syndicate member
- ii. a stock broker registered with a recognised stock exchange (and whose name is mentioned on the website of the stock exchange as eligible for this activity) ('broker')
- iii. a depository participant ('DP') (whose name is mentioned on the website of the stock exchange as eligible for this activity)
- iv. a registrar to an issue and share transfer agent ('RTA') (whose name is mentioned on the website of the stock exchange as eligible for this activity)

The process increases efficiency, eliminates the need for manual intervention at various stages, and thereby reduces the time duration from issue closure to listing by up to 3 working days. Considering the time required for making necessary changes to the systems and to ensure complete and smooth transition to UPI payment mechanism, it is proposed to be introduced in a phased manner.

### **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 Exchanges provides platform (e.g. Mutual Fund Service System of NSE and BSE Star MF) to trading member and mutual fund distributors for trading in open ended mutual fund scheme. 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. Regulation 4 (g) of SEBI (Investment Advisers) Regulations, 2013, stock brokers are required to comply with general obligations and responsibilities specified in Chapter III of SEBI (Investment Advisers) Regulations, 2013, which, inter-alia, provide that client level segregation of advisory and distribution activities needs to be ensured at the entity and group level.

Asset Management Companies (AMC) desirous of providing this alternate mechanism through Exchange platform to their potential customers shall enter into an agreement with

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<sup>95</sup> vide Circular no SEB/HO/CFD/DIL2/CIR/P/2018/138 dated November 01, 2018

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.

The Exchange system facilitate purchase, redemption, SIP etc. for MF schemes. 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. 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.

Following some of the 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.

SEBI vide its various circular<sup>96</sup> has issued guideline for “Discontinuation of usage of pool accounts for transactions in units of Mutual Funds on the Stock Exchange Platforms”. Following are some of the important guidelines of this circulars.

- SEBI has advised member that pooling of funds and/or units by stock brokers / clearing members in any form or manner shall be discontinued for mutual fund transactions.
- Funds pay-in is directly received by the clearing corporation from the investor account and funds pay-out is directly made to the investor account. Pay-in / pay-out of funds shall not be handled by the stock brokers / clearing members.
- In the same manner, for both demat and non-demat mode transactions, the units shall be credited and debited directly to/from the investors’ demat account/ folio account without routing it through the pool account of the stock brokers / clearing members. However, for redemption of units held in dematerialised mode, the practice of issuance of Delivery Instruction Slip (‘DIS’) (physical or

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<sup>96</sup>[https://www.sebi.gov.in/legal/circulars/oct-2021/discontinuation-of-usage-of-pool-accounts-for-transactions-in-units-of-mutual-funds-on-the-stock-exchange-platforms\\_53104.html](https://www.sebi.gov.in/legal/circulars/oct-2021/discontinuation-of-usage-of-pool-accounts-for-transactions-in-units-of-mutual-funds-on-the-stock-exchange-platforms_53104.html),  
[https://www.sebi.gov.in/legal/circulars/mar-2022/discontinuation-of-usage-of-pool-accounts-for-transactions-in-the-units-of-mutual-funds-two-factor-authentication-2fa-for-redemption-and-other-related-requirements-extension-of-timeline\\_57471.html](https://www.sebi.gov.in/legal/circulars/mar-2022/discontinuation-of-usage-of-pool-accounts-for-transactions-in-the-units-of-mutual-funds-two-factor-authentication-2fa-for-redemption-and-other-related-requirements-extension-of-timeline_57471.html)  
[https://www.sebi.gov.in/legal/circulars/mar-2022/discontinuation-of-usage-of-pool-accounts-for-transactions-in-the-units-of-mutual-funds-clarifications-with-respect-to-circulars-dated-october-4-2021\\_56887.html](https://www.sebi.gov.in/legal/circulars/mar-2022/discontinuation-of-usage-of-pool-accounts-for-transactions-in-the-units-of-mutual-funds-clarifications-with-respect-to-circulars-dated-october-4-2021_56887.html)

electronic) to the Depository Participant to debit the units for delivery to clearing corporation may continue.

- Stock Exchanges and AMFI shall jointly, in consultation with SEBI, issue Operating Guidelines to stock brokers/ clearing members and AMCs respectively, to facilitate the mutual fund transactions on stock exchange platforms. The Operating Guidelines shall include, inter-alia, roles and responsibilities of various stakeholders, timelines with respect to activities specified in this circular, sharing of system generated information among various stakeholders at relevant stage of the transaction in a secured environment, sharing of relevant information with concerned entities to perform functional, tax and regulatory obligations, etc. All the concerned intermediaries shall comply with the aforesaid Operating Guidelines<sup>97</sup>

All requests for subscription and redemption are settled on individual basis and only to the extent of the funds/units paid in by participants/clients on the settlement day. Funds pay-in for subscription are done on a T+0 day basis and securities/units pay-out done on T+0 basis for liquid funds and T+1 basis for other funds. Securities pay-in for mutual fund units for redemption is done on T+0 day and is conducted for units in dematerialized form only. The transfer of funds for redemption is carried out on a T+1, T+2, T+3, T+4, T+5, T+6 and T+7 basis depending upon the category of scheme.

#### **8.4 Portfolio Management Service**

Many stock brokers also offer Portfolio Management Services (PMS) to their clients. For this, a separate PMS license has to be obtained by them from SEBI. This is normally offered to the High Net worth 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 (Portfolio Managers) Regulation, 2020, "portfolio manager" means a body corporate, which pursuant to a contract 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 goods or funds of the client, as the case may be: Provided that the Portfolio Manager may deal in goods received in delivery against physical settlement of commodity derivatives. Portfolio manager can be discretionary or non-discretionary. The discretionary portfolio manager means a portfolio manager who under a contract relating to portfolio management, exercises or may exercise, any degree of discretion as to the investment of funds or management of the portfolio of securities of the client, as the case may be. whereas the non-discretionary portfolio manager manages the funds in accordance with the directions of the client.

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<sup>97</sup> <https://archives.nseindia.com/content/circulars/NMF51746.zip>

Co-investment Portfolio Manager” means a Portfolio Manager who is a Manager of a Category I or Category II Alternative Investment Fund(s); and:(i)provides services only to the investors of such Category I or Category II Alternative Investment Fund(s); and(ii)makes investment only in unlisted securities of investee companies where such Category I or Category II Alternative Investment Fund(s) make investments: Provided that the Co-investment Portfolio Manager may provide services to investors from any other Category I or Category II Alternative Investment Fund(s) which are managed by them and are also sponsored by the same Sponsor(s)

To act as a portfolio manager, broker must obtain certificate of registration as per the provision of SEBI (Portfolio Manager) Regulation, 2020. For considering the grant of certificate of registration to the applicant, the SEBI takes into account all matters, including given below, it deems relevant to the activities relevant to portfolio management:

- the applicant is a body corporate;
- the applicant has the necessary infrastructure like adequate office space, equipment and the manpower to effectively discharge the activities of a portfolio manager;
- the applicant has appointed a compliance officer;
- the principal officer of the applicant has– (i) a professional qualification in finance, law, accountancy or business management from a university or an institution recognized by the Central Government or any State Government or a foreign university or a professional qualification by completing a Post Graduate Program in the Securities Market (Portfolio Management) from NISM of a duration not less than one year or a professional qualification by obtaining or a CFA charter from the CFA institute; (ii) experience of at least five years in related activities in the securities market including in a portfolio manager, stock broker, investment advisor, research analyst or as a fund manager; and (iii) the relevant NISM certification as specified by the Board from time to time. Provided that at least 2 years of relevant experience is in portfolio management or investment advisory services or in the areas related to fund management.

Provided further that a fresh NISM certification shall be obtained before expiry of the validity of the existing certification to ensure continuity in compliance with the certification requirements.

(“principal officer” means an employee of the portfolio manager who has been designated as such by the portfolio manager and is responsible for: -

- (i) the decisions made by the portfolio manager for the management or administration of portfolio of securities or the funds of the client, as the case may be; and
- (ii) all other operations of the portfolio manager.)

- In addition to the Principal Officer and Compliance Officer, the applicant has in its employment at least one person with the following qualifications :- (i) graduation

from a university or an institution recognized by the Central Government or any State Government or a foreign university; and (ii) an experience of at least two years in related activities in the securities market including in a portfolio manager, stock broker, investment advisor or as a fund manager:

- Any disciplinary action has been taken against a person directly or indirectly connected with the applicant under the Act or the rules or the regulations made there under.
- The applicant fulfils the net worth requirement (Should not be less than five crore rupees. however, portfolio managers granted registration before the commencement of SEBI (Portfolio Managers) Regulations, 2020 shall increase their net worth to not less than Rs. 5 crores within 36 months from the date of commencement of the regulations which is January 16, 2020.)
- The applicant, its director or partner, principal officer, compliance officer or the employee is involved in any litigation connected with the securities market that has an adverse bearing on the business of the applicant.
- The applicant, its director or partner, principal officer, compliance officer or the employee has at any time been convicted for any offence involving moral turpitude or has been found guilty of any economic offence; .
- The applicant is a fit and proper person as per the criteria specified in Schedule II of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008.

**Fees:**

An applicant for 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. A portfolio manager who has been granted a certificate of registration, to keep its registration in force, shall pay fee of five lakh rupees every three years, from the date of grant of certificate of registration or from the date of grant of certificate of registration, within three months before expiry of the block period for which fee has been paid<sup>98</sup>.

**Content of Agreement between Portfolio Manager and Client:**

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, 2020. The portfolio manager shall provide to the client, the Disclosure Document as specified in Schedule V of the SEBI (Portfolio Managers) Regulations, 2020.

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<sup>98</sup> Registration granted prior to the commencement of the SEBI (Change in Conditions of Registration of Certain Intermediaries) (Amendment) Regulations, 2016, as the case may be.



**Disclosure Document:**

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 including risk specific to each investment approach offered by the portfolio manager,
- 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,
- details of conflicts of interest related to services offered by group companies or associated of the portfolio manager,
- the performance of the portfolio manager and
- the audited financial statements of the portfolio manager for the immediately preceding three years.

**Code of Conduct:**

The portfolio manager shall abide by the Code of Conduct as specified in Schedule III of the SEBI (Portfolio Managers) Regulations, 2020.

**General Responsibilities of a Portfolio Manager:**

Further, portfolio manager should adhere to general obligation and responsibilities specified in the SEBI (Portfolio Managers) Regulations, 2020.

- The discretionary portfolio manager shall individually and independently manage 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 shall manage the funds in accordance with the directions of the client.
- The portfolio manager shall not accept from the clients, funds or securities worth less than Rs.50 lakh. Provided further that subject to appropriate disclosures in the disclosure document and the terms agreed between the client and the portfolio manager, the requirement of minimum investment amount per client shall not apply to an accredited investor. Provided further that the requirement of minimum investment amount per client shall not apply to the Co-investment Portfolio Manager.
- The portfolio manager shall act in a fiduciary capacity with regard to the client's funds and shall segregate each client's holding in securities in separate accounts.
- The portfolio manager shall keep the funds of all clients in a separate account to be maintained by it in a Scheduled Commercial Bank.

- The portfolio manager shall transact in securities within the limitation placed by the client himself with regard to dealing in securities under the provisions of the Reserve Bank of India Act, 1934 (2 of 1934).
- The portfolio manager shall not derive any direct or indirect benefit out of the client's funds or securities and not borrow funds or securities on behalf of the client.
- The portfolio manager shall not borrow funds or securities on behalf of the client.
- The portfolio manager shall not lend securities held on behalf of the clients to a third person except as provided under regulation.
- The portfolio manager shall ensure proper and timely handling of complaints from his clients and take appropriate action immediately.
- The portfolio manager shall ensure that any person or entity involved in the distribution of its services is carrying out the distribution activities in compliance with the regulations and circulars issued thereunder from time to time.

**Management or administration of clients' portfolio:**

SEBI (Portfolio Managers) Regulations, 2020 specified details about “Management or administration of clients' portfolio” by portfolio manager. Some of them are given below:

- The money or securities accepted by the portfolio manager shall not be invested or managed by the portfolio manager except in terms of the agreement between the portfolio manager and the client.
- The discretionary portfolio manager shall invest funds of his clients in the securities listed or traded on a recognized stock exchange, money market instruments, units of Mutual Funds and other securities as specified by Board from time to time, on behalf of their clients.
- The portfolio manager offering non-discretionary or advisory services to clients may invest or provide advice for investment up to 25% of the assets under management of such clients in unlisted securities, in addition to the securities permitted for discretionary portfolio management. The portfolio manager may offer discretionary or non-discretionary or advisory services for investment up to hundred percent of the assets under management of the large value accredited investors in unlisted securities, subject to appropriate disclosures in the disclosure document and the terms agreed between the client and the portfolio manager. The Co-investment Portfolio Manager shall invest hundred percent of the assets under management in unlisted securities of investee companies where Category I and Category II Alternative Investment Funds managed by it as Manager, make investment;
- Portfolio Managers may invest in units of Mutual Funds only through direct plan.
- The portfolio manager shall not leverage the portfolio of its clients for investment in derivatives.

- The portfolio manager shall not deploy the clients' funds in bill discounting, badla financing or for the purpose of lending or placement with corporate or non-corporate bodies.
- The portfolio manager shall not invest client's fund based on the advice of any other entity.
- The portfolio manager shall not while dealing with clients' funds indulge in speculative transactions i.e., it shall not enter into any transaction for purchase or sale of any security which is periodically or ultimately settled otherwise than by actual delivery or transfer of security except the transactions in derivatives.

**Other Responsibilities of a Portfolio Manager:**

The portfolio manager shall maintain separate client-wise accounts. The funds received from the clients, investments or disinvestments, all the credits to the account of the client like interest, dividend, bonus, or any other beneficial interest received on the investment and debits for expenses, if any, shall be properly accounted for and details thereof shall be properly reflected in the client's account. The portfolio manager shall furnish periodically a report to the client, as agreed in the contract, but not exceeding a period of three months and as and when required by the client. The fees on such accounts must be distinguished and accounted for separately. The books of account will be audited yearly by qualified auditor to ensure that the portfolio manager has followed proper accounting methods and procedures and that the portfolio manager has performed his duties in accordance with the law. Every portfolio manager has to appoint a custodian in respect of securities managed or administered by it. However, if the portfolio manager provides only advisory services, then the provision does not apply. All the books of account and other records and documents shall be maintained for a period of 5 years.

## **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. Brokerage house should also comply with the relevant guidelines provided under SEBI (Research Analysts) Regulation, 2014.

## **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. Through DP, Depositories interface with the investor and provides depository services. The SEBI (Depository & Participants) Regulations, 2018 and the bye-laws of depositories prescribe the eligibility criteria to become a DP.

On satisfying the conditions/completion of procedure of registration as laid down by the SEBI and the depositories, the certificate of registration is given to the DP for commencement of DP related activities. Every DP shall abide by the Code of Conduct as specified in Part A of Third Schedule of SEBI (Depository Participant) Regulation, 2018 and other guidelines specified by SEBI/Depository from time to time. The depository participant act as intermediaries between the depository and the investors. The Depository Participant can act as participant for both depositories subject to fulfillment of certain conditions. Every depository participant shall enter into an agreement with a beneficial owner/client before acting as a participant on his behalf, in a manner specified by the depository in its bye-laws. For any investor / client, to avail the services provided by the Depository, has to open Depository account, known as Demat A/c, with any of the DPs. The main activity of the DP is to open a demat account for an investor. *The main activity being the settlement and transfer of securities from one beneficiary account to another pursuant a trading activity of an investor.* A participant shall register the transfer of securities to or from a beneficial owner's account only on receipt of instructions from the beneficial owner and thereafter confirm the same to the beneficial owner. There are other services also which a DP can engage into such as:

- Opening a demat account
- Dematerialisation<sup>99</sup>
- Maintaining record of securities held by the beneficial owners in the electronic form
- Settlement of trades by delivery or receipt of securities from / in BO accounts
- Receiving electronic credit in respect of securities allotted by issuers under IPO or otherwise on behalf of demat account holders

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<sup>99</sup> Dematerialisation is the process of converting securities held in physical form into holdings in book entry form

- Receiving non cash corporate benefits such as allotment of bonus and rights shares or any other non-cash corporate benefits given by the issuers in electronic form on behalf of its demat account holders
- Pledging of dematerialized securities & facilitating loans against shares
- Freezing of the demat account for debits, credits, or both.

## **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, by brokers to their clients, from time to time.

### *Eligibility Requirement*

Only corporate brokers with net worth of at least Rs.3 crore are eligible for providing margin trading facility to their clients. The stock brokers wishing to extend margin trading facility to their clients shall be required to obtain prior permission from the exchange where the margin trading facility is proposed to be offered.

### *Securities eligible for margin trading*

The facility of margin trading is available for those securities which are classified as Group 1 securities according to the SEBI circular no. SEBI/HO/MRD/DP/CIR/P/2016/135 dated December 16, 2016. In order to avail margin trading facility, initial margin required shall be as under:

Category of Stocks	Applicable margin
Group 1 stocks available for trading in the F&O segment	VaR + 3 times of applicable Extreme Loss Margin
Group 1 stocks other than F&O stocks	VaR + 5 time of applicable Extreme Loss Margin

For aforesaid purpose the applicable VaR and ELM shall be as in the cash segment for a particular stock.

The initial margin payable by the client to the Stock Broker shall be in the form of cash, cash equivalent or Group I equity shares, with appropriate haircut.

Stock brokers shall ensure maintenance of the aforesaid margin at all times during the period that the margin trading facility is being availed by the client. In case of short fall, stock broker shall make necessary margin calls.

The Stock brokers shall be required to comply with the following conditions:

- i. The stocks deposited as collateral with the stock broker for availing margin trading facility (Collaterals) and the stocks purchased under the margin trading facility (Funded stocks) shall be identifiable separately and no co-mingling shall be permitted for the purpose of computing funding amount.

- ii. Collateral and Funded stocks shall be marked to market on a daily basis.
- iii. In case of increase in the value of Collaterals, stock brokers may have the option of granting further exposure to their clients subject to applicable haircuts.
- iv. However, no such exposure shall be permitted on the increased value of Funded stocks.

**Liquidation of Securities by the Stock Broker in case of default by the client**

The stock broker shall list out situations/conditions in which the securities may be liquidated and such situations/conditions shall be included in the "Rights and Obligations Document" but not exceeding 5 working days from the day of margin call. The broker shall liquidate the securities, if the client fails to meet the margin call to comply with the conditions as mentioned in this circular or specified in the "Rights and Obligations Document" specified by exchange. However, the broker shall not liquidate or use in any manner the securities of the client in any situation other than the conditions stated above.

**Sources of Funds**

For the purpose of providing the margin trading facility, a stock broker may use own funds or borrow funds from scheduled commercial banks and/or NBFCs regulated by RBI. Stock brokers may borrow funds by way of issuance of CP and by way of unsecured long term loans from their promoters and directors. The borrowing by way of issuance of CPs shall be subject to compliance with appropriate RBI Guidelines. The borrowing by way of unsecured long term loans from the promoters and directors shall be subject to the appropriate provisions of Companies Act. The broker shall not use the funds of any client for providing the margin trading facility to another client, even if the same is authorized by the first client. A stock broker shall not be permitted to borrow funds from any other source, except the sources stated in the SEBI circular.

**Leverage and Exposure Limits**

At any point of time, the total indebtedness of a broker for the purpose of margin trading shall not exceed 5 times of his net worth and the maximum allowable exposure of the broker towards the margin trading facility shall be within the self-imposed prudential limits and shall not, in any case, exceed the borrowed funds and 50% of his "net worth". While providing the margin trading facility, the broker shall ensure that:

- a) Exposure to any single client at any point of time shall not exceed 10% of the broker's maximum allowable exposure.
- b) Exposure towards stocks purchased under margin trading facility and collateral kept in the form of stocks are well diversified. Stock brokers shall have appropriate Board approved policy in this regard.

**Rights and Obligations for Margin Trading**

The stock exchanges shall frame a Rights and Obligations document laying down the rights and obligations of stock brokers and clients for the purpose of margin trading facility. The Rights and Obligations document shall be mandatory and binding on the Broker/Trading Member and the clients for executing trade in the Margin Trading framework.

The broker/exchange may modify the Rights and Obligations document only for stipulating any additional or more stringent conditions, provided that no such modification shall have the effect of diluting any of the conditions laid down in the circular or in the Rights and Obligations document.

*Maintenance of Records*

- The stock broker shall maintain separate client-wise ledgers for funds and securities of clients availing margin trading facility.
- The stock broker shall maintain a separate record of details of the funds used and sources of funds for the purpose of margin trading.
- The books of accounts, maintained by the broker, with respect to the margin trading facility offered by it, shall be audited on a half yearly basis. The stock broker shall submit an auditor's certificate to the exchange, within one month from the date of the half year ending 31st March and 30th September of a year certifying, inter alia, the extent of compliance with the conditions of margin trading facility. The certificate shall be in addition to the certificate on net worth.

*Disclosure Requirements*

The stock broker shall disclose to the Stock Exchanges details on gross exposure towards margin trading facility including name of the client, Category of holding (Promoter/promoter group or Non-promoter), clients' Permanent Account Number ("PAN"), name of the scrips (Collateral stocks and Funded stocks) and if the stock broker has borrowed funds for the purpose of providing margin trading facility, name of the lender and amount borrowed, on or before 12 noon on the following trading day.

The Stock Exchanges shall disclose on their websites 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, through its website.

*Other Conditions*

- A broker shall take adequate care and exercise due diligence before providing margin trading facility to any client.
- Any disputes arising between the client and the stock broker in connection with the margin trading facility shall have the same treatment as normal trades and should be covered under the investor grievance redressal mechanism, arbitration mechanism of the Stock Exchange.
- SGF and IPF shall be available for transactions done on the exchange, whether through normal or margin trading facility. However, any losses suffered in connection with the margin trading facility availed by the client from the stock broker shall not be covered under IPF.
- The stock brokers wishing to extend margin trading facility to their clients shall be required to obtain prior permission from the exchange where the margin trading

facility is proposed to be offered. The exchange shall have right to withdraw this permission at a later date, after giving reasons for the same.

Funded stocks held by the TM / CM under the margin trading facility shall be held by the TM / CM only by way of pledge. For this purpose, the TM / CM shall be required to open a separate demat account tagged 'Client Securities under Margin Funding Account' in which only funded stocks in respect of margin funding shall be kept/ transferred, and no other transactions shall be permitted. The securities lying in 'Client Securities under Margin Funding Account' shall not be available for pledge with any other Bank/ NBFC.

### **8.8 Internet Based Trading (IBT) & Securities Trading Using Wireless Technology (STWT)**

Internet Based trading can take place through order routing systems, which will route client orders, to exchange trading systems, for execution of trades on the existing stock exchanges. SEBI Registered Brokers can introduce this service after obtaining permission from respective Stock Exchanges. The stock exchange should grant approval or reject the application as the case may be and communicate its decision to the member within 30 calendar days of the date of completed application submitted to the exchange. Exchanges while giving permission will be required to ensure minimum conditions specified by SEBI from time to time. SEBI registered brokers who provide Internet Based Trading shall be eligible to provide securities trading using wireless technology. All relevant requirements applicable to internet based trading shall also be applicable to securities trading using wireless technology. Securities Trading using Wireless technology shall include devices such as mobile phone, laptop with data card, etc., that use Internet Protocol (IP).

The stock exchange, before giving permission to brokers to start Internet based services shall ensure the fulfilment of the minimum conditions as specified by SEBI from time to time. Some of them are given below:

- **Net worth Requirement:** The broker must have a minimum net worth of Rs.50 lacs if the broker is providing the Internet based facility on his own. However, if some brokers collectively approach a service provider for providing the internet based trading facility, net worth criteria as stipulated by the stock exchange will apply.
- **Operational and System Requirements:** The Stock Exchange must ensure that the system used by the broker has provision for security, reliability and confidentiality of data through use of encryption technology. The Stock Exchange must ensure that the brokers maintain adequate backup systems and data storage capacity. The Stock Exchange must also ensure that the brokers have adequate system capacity for handling data transfer, and arranged for alternative means of communications in case of Internet link failure. The Stock Exchange must lay down the minimum qualification for personnel to ensure that the broker has suitably qualified and adequate personnel to handle communication including trading instructions as well as other back office work which is likely to increase because of higher volumes.
- **Client Broker Relationship:** Additional rights & obligations provided to client in case of internet / wireless technology-based trading. The broker web site providing the internet



based trading facility should contain information meant for investor protection such as rules and regulations affecting client broker relationship, arbitration rules, investor protection rules etc. The broker web site providing the Internet based trading facility should also provide and display prominently, hyper link to the web site/ page on the web site of the relevant stock exchange(s) displaying rules/ regulations/circulars. Ticker/quote/order book displayed on the web-site of the broker should display the time stamp as well as the source of such information against the given information. Order/Trade confirmation should also be sent to the investor through email at client's discretion at the time period specified by the client in addition to the other mode of display of such confirmations on real time basis on the broker web site.

- **Risk Management:** Exchanges must ensure that brokers have a system-based control on the trading limits of clients, and exposures taken by clients. Brokers must set pre-defined limits on the exposure and turnover of each client. The broker systems should be capable of assessing the risk of the client as soon as the order comes in. Reports on margin requirements, payment and delivery obligations, etc. should be informed to the client through the system.
- **Cross Trades:** As in the case of existing system, brokers using Internet based systems for routing client orders will not be allowed to cross trades of their clients with each other. All orders must be offered to the market for matching.
- **Standards for Web Interfaces and Protocols:** Between a Trading Web Server and Trading Client Terminals, Interfaces Standards as per recommendations of IETF (Internet Engineering Task Force) and W3C (World Wide Web Consortium) may be adopted. E.g.: HTTP Ver 4 or above HTML Ver 4/XML.
- **System Operations:** Brokers should follow the similar logic/priorities used by the Exchange to treat client orders. Brokers should maintain all activities/ alerts log with audit trail facility. Broker Web Server should have internally generated unique numbering for all client order/trades.
- **Network Security:** 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.

The stock exchange shall ensure that the broker complies with the following:

- There shall be secure access, encryption and security of communication for internet-based trading and securities trading using wireless technology. DOT policy and regulation shall govern the level of encryption.

- Adequate measures should be taken for user identification, authentication and access control using means such as user-id, passwords, smart cards, biometric devices or other reliable means, to prevent misuse of facility by unauthorized persons.
- Unique identification number as given in case of internet-based trading shall be made applicable for securities trading using wireless technology.
- In case of failure of the wireless network, alternative means of communication for placing orders should be available.
- Additional provisions specifying possible risks, responsibilities and liabilities associated with securities trading using wireless technology should be incorporated in the Broker-Client agreement as an addendum or by bringing to the notice of clients, who are desirous of availing such facility, and taking their concurrence on the same.
- As it may not be possible to give detailed information to the investor on a hand-held device e.g. mobile phones, it may be ensured that minimum information may be given with addresses of the Internet web site/web page where detailed information would be available.
- Order confirmation should be provided to the user on submitting the order. Order modification / cancellation facilities should also be provided. Trade confirmation should be provided to the user, along with history of trades for the day.
- Session login details should not be stored on the devices used for internet-based trading and securities trading using wireless technology.
- Network security protocols and interface standards should be as per prevalent industry standards and sound audit trails should be available for all transactions conducted using wireless devices.
- The broker's server routing orders to the exchange trading system shall be located in India.
- Stock exchanges shall arrange for periodic systems audits of broker systems to ensure that requirements specified in the circulars are being met.
- Stock exchange shall also include securities trading using wireless technology in their ongoing investor awareness and educational programme

**Additional Requirements for Internet Based Trading (IBT) and Securities trading using Wireless Technology (STWT)**

- 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
- Two-factor authentication for login session may be implemented for all orders emanating using Internet Protocol. Public Key Infrastructure (PKI) based implementation using digital signatures, supported by one of the agencies certified by the government of India, is advisable. Further the two factors in the Two-factor authentication framework should not be same.
- Further to the above, the following practice is advisable: The back-up and restore systems implemented by the broker should be adequate to deliver sustained performance and high availability. The broker system should have on-site as well as remote site back-up capabilities.

Testing of software used in or related to Trading and Risk Management: The term ‘software’ shall mean electronic systems or applications used by stock brokers / trading members for connecting to the stock exchanges and for the purposes of trading and real-time risk management, including software used for Internet Based Trading (IBT), Direct Market Access (DMA), Securities Trading using Wireless Technology (STWT), Smart Order Routing (SOR), Algorithmic Trading (AT) etc. The stock broker / trading member shall undertake UAT of the software to satisfy itself that the newly developed / modified software meets its requirements. Stock brokers / trading members shall engage system auditor(s) to examine reports of mock tests and UAT in order to certify that the tests were satisfactorily undertaken.

As part of compliance, stock brokers would be required to submit the System Audit Report on periodic basis to the Exchange after getting the facility audited from CISA / CISSP / ISA / DISA certified auditor as specified by the Exchange from time to time.

Stock Broker can also provide facility like Direct Market Access, facility for algorithmic trading, Smart Order Routing etc. to clients as specified by SEBI/Exchanges from time to time.

### **Sample 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
  
2. ASBA is the acronym for \_\_\_\_\_.  
  
**(a) Application Supported by Blocked Amount**  
  
(b) Applying Sponsoring Brokers Amounts  
  
(c) Application Supports for Brokers Amount
  
3. Only corporate brokers with net worth of at least \_\_\_\_\_ are eligible for providing margin trading facility.  
  
**(a) Rs. 3 crores**  
  
(b) Rs. 1 crores  
  
(c) Rs. 5 crore  
  
(d) Rs. 50 lakh
  
4. Portfolio Managers may invest in units of Mutual Funds only through direct plan. State TRUE or FALSE.  
  
**(a) TRUE**  
  
(b) FALSE

## **Annexure 1: Code of Conduct for Stock Brokers**

### **General:**

A Stock Broker shall:

1. Maintain high standards of integrity, promptitude and fairness in the conduct of all his business.
2. Act with due skill, care and diligence in the conduct of all his business.
3. Not indulge in manipulative, fraudulent or deceptive transactions or schemes or spread rumours with a view to distorting market equilibrium or making personal gains.
4. 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.
5. Not involve himself in excessive speculative business in the market beyond reasonable levels not commensurate with his financial soundness.
6. Abide by all the provisions of the Act and the rules, regulations issued by the Government, SEBI and the Stock Exchange from time to time as may be applicable to him.

### **Duty towards the Investor**

1. A 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 and not refuse to deal with a Small Investor merely on the ground of the volume of business involved.
2. A stock-broker shall promptly inform his client about the execution or non-execution of an order, and make prompt payment in respect of securities sold and arrange for prompt delivery of securities purchased by clients.
3. A stock-broker shall issue without delay to his client a contract note for all transactions in the form specified by the stock exchange.

4. A stock-broker shall not disclose or discuss with any other person or make improper use of the details of personal investments and other information of a confidential nature of the client which he comes to know in his business relationship.
5. A stock-broker shall not encourage sales or purchases of securities with the sole object of generating brokerage or commission. He shall not furnish false or misleading quotations or give any other false or misleading advice or information to the clients with a view of inducing him to do business in particular securities and enabling himself to earn brokerage or commission thereby.
6. A stock-broker shall not deal or transact business knowingly, directly or indirectly or execute an order for a client who has failed to carry out his commitments in relation to securities with another stock-broker.
7. A stock-broker, when dealing with a client, shall disclose whether he is acting as a principal or as an agent and shall ensure at the same time that no conflict of interest arises between him and the client. In the event of a conflict of interest, he shall inform the client accordingly and shall not seek to gain a direct or indirect personal advantage from the situation and shall not consider clients' interest inferior to his own.
8. A stock-broker shall not make a recommendation to any client who might be expected to rely thereon to acquire, dispose of, retain any securities unless he has reasonable grounds for believing that the recommendation is suitable for such a client upon the basis of the facts, if disclosed by such a client as to his own security holdings, financial situation and objectives of such investment.
9. A stock broker or any of his employees shall not render, directly or indirectly, any investment advice about any security in the publicly accessible media, whether real-time or non-real-time, unless a disclosure of his interest including the interest of his dependent family members and the employer including their long or short position in the said security has been made, while rendering such advice.

In case an employee of the stock broker is rendering such advice, he shall also disclose the interest of his dependent family members and the employer including their long or short position in the said security, while rendering such advice.

10. A stock-broker should have adequately trained staff and arrangements to render fair, prompt and competence services to his clients.

**Duty towards Other Stock-Brokers**

1. A stock-broker shall co-operate with the other contracting party in comparing unmatched transactions. A stock-broker shall not knowingly and wilfully deliver documents which constitute bad delivery and shall co-operate with other contracting party for prompt replacement of documents which are declared as bad delivery.
2. A stock-broker shall extend fullest co-operation to other stock-brokers in protecting the interests of his clients regarding their rights to dividends, bonus shares, right shares and any other right related to such securities.
3. A stock-broker shall carry out his transactions with other stock-brokers and shall comply with his obligations in completing the settlement of transactions with them.
4. A stock-broker shall not advertise his business publicly unless permitted by the stock exchange.
5. A stock-broker shall not resort to unfair means of inducing clients from other stock-brokers.
6. A stock-broker shall not neglect or fail or refuse to submit the required returns and not make any false or misleading statement on any returns required to be submitted to the SEBI and the stock exchange.

## About NISM

National Institute of Securities Markets (NISM) is an educational institution established by the Securities and Exchange Board of India (SEBI), the securities market regulator, in 2006. The Institute was established in pursuant to the Union Finance Minister's proposal, in his 2005-06 Budget Speech, to set up an institution 'for teaching and training intermediaries in the securities markets and promoting research'.

NISM is committed to its vision 'to lead, catalyze and deliver educational initiatives to enhance the quality of securities markets'. The Institute conducts a wide range of capacity building programmes in securities markets - from basic financial literacy to full-time post-graduation programmes. The Institute's six Schools of Excellence, viz., School for Certification of Intermediaries, School for Securities Education, School for Investor Education and Financial Literacy, School for Regulatory Studies and Supervision, School for Corporate Governance and School for Securities Information and Research upholds NISM's vision and works in synergy towards professionalizing the markets.

NISM is mandated by SEBI (Certification of Associated Persons in the Securities Markets) Regulations, 2007 to conduct certification examinations and continuing professional education programs for associated persons engaged by an intermediary. NISM also conducts certification examinations for other regulators like IBBI and PFRDA. NISM's certifications establish a single market-wide knowledge benchmark for different functions in the Indian securities market and enable the associated persons to advance their knowledge and skills.

## About the 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. NISM-Series-VII: Securities Operations and Risk Management Certification 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.

The book covers 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. It also deals with the trade life cycle (TLC), the steps and participants involved in the TLC, the functions of the Front Office, Middle Office and Back Office in a Securities Broking Firm, the Risk management practices, clearing and settlement of trades.

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