

NiSM

National Institute of Securities Markets
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Workbook for

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

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

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

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About NISM

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

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

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

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

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

Acknowledgement

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

About the Author

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

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

How to register and take the examination

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

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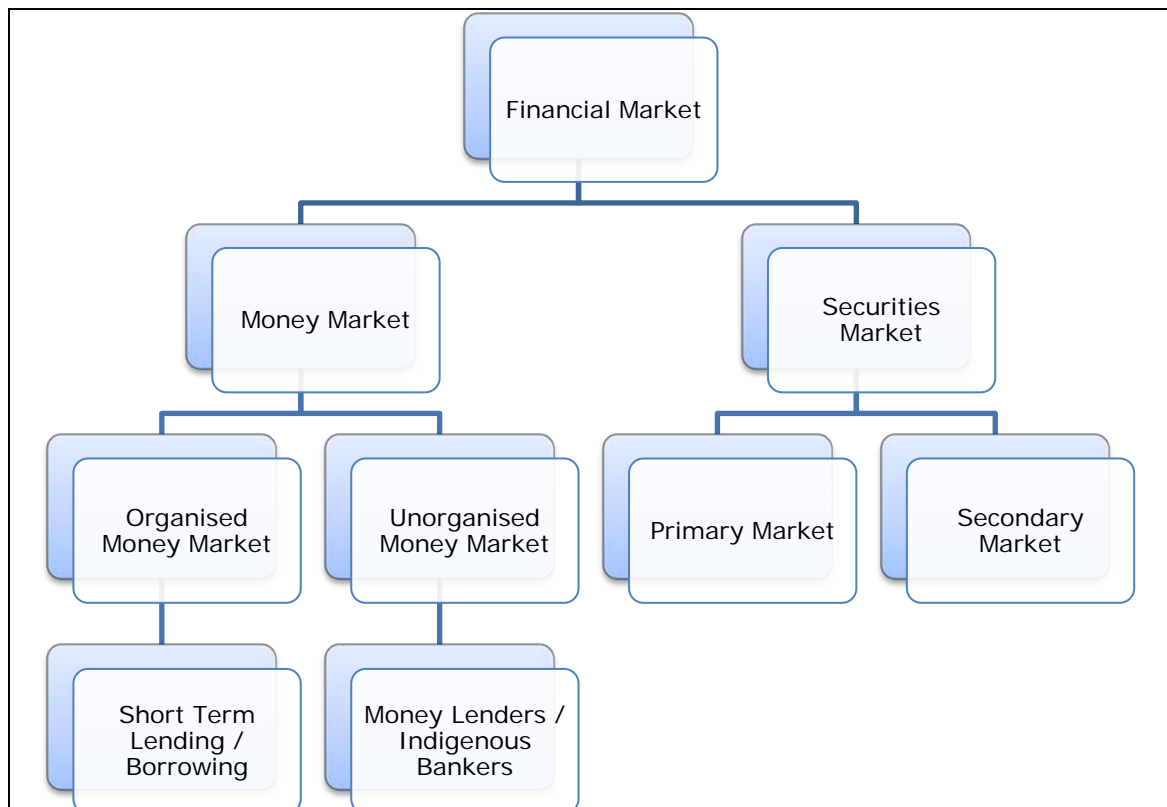
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Chapter 1: Introduction to the Securities Market

1.1 Introduction

Securities market help in transfer of resources from those with idle resources 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 invest and save respectively, which inevitably enhances savings and investment in the economy. A financial market consists of investors (buyers of securities), users of funds (sellers of securities), intermediaries and regulatory bodies.

The Indian financial market can be best illustrated in the figure below. In this book however, we are going to understand the securities market in specific.



1.2 Securities Market

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

The **primary market** is used by issuers for raising fresh capital from the investors by making initial public offers or rights issues or offers for sale of equity or debt; on the other hand the **secondary market** provides liquidity to these instruments, through trading and settlement on the stock exchanges. An active secondary market promotes the growth of the primary market and capital formation, since the investors in the primary market are assured of a continuous market where they have an option to liquidate their investments. Thus, in the primary market, the issuer has direct contact with the investor, while in the secondary market, the dealings are between two investors and the issuer does not come into the picture.

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**.

The secondary market on the other hand operates through two mediums, namely, the Over-The-Counter (OTC) market and the Exchange Traded Market. **OTC markets** are the informal type of markets where trades are negotiated. In this type of market, the securities are traded and settled bilaterally over the counter. Indian markets have recognized OTC exchanges like the OTCEI, however they do not give much volumes. 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 done as per a fixed time schedule. The trades executed on the exchange are settled through the clearing corporation, who acts as a counterparty and guarantees settlement.

There are several major players in the primary market. These include the merchant bankers, mutual funds, financial institutions, foreign institutional investors (FIIs), individual investors; the issuers including companies, bodies corporate; lawyers, bankers to the issue, brokers, and depository participants. The stock exchanges are involved to the extent of listing of the securities. In the secondary market, there are the stock exchanges, stock brokers (who are members of the stock exchanges), the mutual funds / asset management companies (AMCs), financial institutions, foreign institutional investors (FIIs), investment companies, individual investors, depository participants and banks. The Registrars and Transfer Agents, Custodians and Depositories are capital market intermediaries which provide important infrastructure services to both the primary and secondary markets. These would be discussed in detail in the later sections of this workbook.

1.3 Money markets

Money market is a market for financial assets that are close substitutes for money. It is a market for short term funds and instruments having a maturity period of one or less than one year. Money market provides short term debt financing and investment. The money market deals primarily in short-term debt securities and investments, such as banker's acceptances, negotiable certificates of deposit (CDs), repos and Treasury Bills (T-bills), call/notice money market, commercial papers. Government securities are also a part of the money market.

1.4 Products Traded in the Indian Market

The investors in the Indian securities market have a wide choice of product base to choose depending upon a person's risk appetite and needs. Broadly, however the products available can be categorized as Debt and Equity. We here discuss the different products available in the different types of market in India.

Equity Markets and its Products

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

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

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

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

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

Exchange Traded Fund is a fund that can invest in either all of the securities or a representative sample of securities included in the index. Importantly, the ETFs offer a one-stop

exposure to a diversified basket of securities that can be traded in real time like individual stock.

Derivative Market and its Products

Derivative is a product whose value is derived from the value of one or more basic variables, called bases (underlying asset, index, or reference rate), in a contractual manner. The underlying asset can be equity, forex, commodity or any other asset. The derivatives segment in India allows trading in the equities, currency, commodities. There are two types of derivatives instruments viz., Futures and Options that are traded on the Indian stock exchanges.

Index/Stock Future is an agreement between two parties to buy or sell an asset at a certain time in the future at a certain price. Futures contracts are special types of forward contracts in the sense that the former are standardized exchange-traded contracts. Futures contracts are available on certain specified stocks and indices.

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

Currency Derivatives trading was introduced in the Indian financial markets with the launch of currency futures trading in the USD-INR pair at the National Stock Exchange of India Limited on August 29, 2008. Few more currency pairs have also been introduced thereafter. It was subsequently introduced in the BSE on October 1, 2008, and MCX, On October 7, 2008. As at end October 2010, currency futures are traded on the USD-INR, GBP-INR, EUR-INR and JPY-INR at the NSE.

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

Interest Rate Futures trading is based on notional 10 year coupon bearing GOI security. These contracts are settled by physical delivery of deliverable grade securities using electronic book entry system of the existing depository's viz., NSDL and CDSL and the Public Debt Office of the Reserve Bank unlike the cash settlement of the other derivative products.

Debt Market and its Products

Debt market consists of Bond markets, which provide financing through the issuance of Bonds, and enable the subsequent trading thereof. Instruments like bonds/debentures are traded in this market. These instruments can be traded in OTC or Exchange traded mar-

kets. In India, the debt market is broadly divided into two parts government securities (G-Sec) market and the corporate bond market.

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

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

Corporate Bond Market: Corporate bonds are bonds issued by firms and are issued to meet needs for expansion, modernization, restructuring operations, mergers and acquisitions. The corporate debt market is a market wherein debt securities of corporates are issued and traded therein. The investors in this market are banks, financial institutions, insurance companies, mutual funds, FIs etc. Corporates adopt either the public offering route or the private placement route for issuing debentures/bonds.

Other instruments available for trading in the debt segment are Treasury Bills, Commercial Papers and Certificate of Deposits.

Box 1.1: Trading of Derivative Products

Since a number of derivatives products (as discussed in section 1.4) are traded on the exchange, it would be beneficial to understand the trading of these products, as the clearing and settlement mechanism is also dealt with in the later section of this workbook.

The trading in derivative products such as index futures and index options, stock futures and stock options are very similar to that of trading in equities. Various functionalities, like time and price related conditions can be built in an order.

At any point in time there are only three (3) contract months available for trading, with 1 month, 2 months and 3 months to expiry. These contracts expire on the last Thursday of the expiry month and have maximum of 3 month expiration cycles. Quarterly contracts however have been introduced only for index futures for 5 years. 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 these derivative trades are settled in cash.

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

The underlying bond in case of interest rate futures contracts is a notional 10 year, 7% coupon-bearing GOI bond. The lot size, which is the minimum amount that can be traded on the Exchange is 2000 bonds at the rate of Rs. 100 per bond. New contracts can be introduced by the Exchange on any day of a calendar month. At the time of introduction, the duration of any contract can vary from 1 month to 12 months. The expiry has to be on one of the four specific days of a year, as specified by the regulator. Expiry cannot happen on any other date. The set of expiry dates available in a year constitute the expiry cycle or contract cycle. The last trading day for a futures contract is two business days before the expiry date.

Review Questions

Questions to assess your learning:

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

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

Ans: (b)

2. State which of these statements is true?

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

Ans: (a)

3. Interest rate futures trading is based on _____.

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

Ans: (b)

4. Derivative contracts expire on the _____.

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

Ans: (b)

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Chapter 2: Market Participants in the Securities Market

2.1 Introduction

As already discussed in the previous chapter, in every economic system, there are savers (who are surplus-generating) and there are spenders (deficit-generating). Securities Market provides a platform wherein the savers place their surplus funds in financial claims or securities at the disposal of the spenders and in turn get benefits like 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 is 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 mobilisation of resources is carried out under the supervision and overview of the regulators. The regulators develop fair market practices and regulate the conduct of issuers of securities and the intermediaries. They are also in charge of protecting the interests of the investors. The regulator ensures a high service standard from the intermediaries and supply of quality securities and non-manipulated demand for them in the market.

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

2.2 Investors

An investor is the backbone of the securities market in any economy, as the investor is the one lending surplus resources for funding, setting up of or expansion of companies, in return for financial gain. Investors in securities market can be broadly classified into Retail Investors and Institutional Investors.

Retail Investors are individual investors who buy and sell securities for their personal account, and not for another company or organization. This category also includes High Networth Individuals (HNI) which comprise of people who invest above rupees two lakh in a single transaction.

Institutional Investors comprise domestic Financial Institutions, Banks, Insurance Companies, Mutual Funds and FIIs (A Foreign Institutional investor is an entity established or incorporated outside India that proposes to make investments in India).

2.3 Issuers

Both the public sector undertakings (PSUs) and private companies tap the securities market to finance capital expansion activity and growth plans. Even banks and other financial institutions raise resources from securities market. Other important issuers are the mutual

funds (MFs) which are important investment intermediaries which mobilize the savings of the small investors. Funds can be raised in the primary market from the domestic market as well as from international markets. After the reforms initiated in 1991, one of the major policy change was allowing Indian companies to raise resources by way of equity issues in the international markets. Indian companies have raised resources from international capital markets through Global Depository Receipts (GDRs)/American Depository Receipts (ADRs), Foreign Currency Convertible bonds (FCCBs) and External Commercial Borrowings (ECBs). GDRs are essentially equity instruments issued abroad by authorized overseas corporate bodies against the shares/bonds of Indian companies held with nominated domestic custodian banks. ADRs are negotiable instruments, denominated in dollars and issued by the US Depository Bank. FCCBs are bonds issued by Indian companies and subscribed to by a non-resident in foreign currency. They carry a fixed interest or coupon rate and are convertible into a certain number of ordinary shares at a preferred price. ECBs are commercial loans (in the form of bank loans, buyers credit, suppliers credit, securitised instruments, floating rate notes and fixed rate bonds) availed from any internationally recognised 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. Latest development on reforms has allowed foreign companies to raise capital from Indian markets. They can issue IDR (Indian Depository Receipts). This will be in rupee term and in similar nature of IDR. Standard Chartered Bank is the first entity to raise capital through issuing IDR.

2.4 Intermediaries

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

2.4.1 Stock Exchanges

The stock exchanges provide a trading platform where the buyers and sellers (investors) can meet to transact in securities. In the olden days it (meeting of investors) used to happen in the trading hall or the “Ring” of the Stock Exchanges where the Stock Brokers used to meet and transact whereas, in the modern world the trading takes place online through computer connected through VSATs & Internet. The Securities Contract (Regulation) Act, 1956 (SCRA) defines ‘Stock Exchange’ as a body of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities. Stock exchange could be a regional stock exchange whose area of operation/jurisdiction is specified at the time of its recognition or national exchanges, which are permitted to have nationwide trading since inception.

2.4.2 Clearing Corporation/Agency

A Clearing Corporation / Agency is a part of an exchange or it can also be a separate entity, which performs three main functions, namely, clearing and settling 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, providing financial guarantee for all transactions executed on the exchange and providing risk management functions. This process is called novation.

The clearing agency determines fund/security obligations and arranges for pay-in of the same. It collects and maintains margins, processes for shortages in funds and securities. In this process of settling the trades, the clearing corporation is helped by the clearing members, clearing banks, custodians and depositories.

2.4.3 Trading member /Clearing Member

Trading member means a member of a Stock Exchange and Sub-broker means any person not being a member of Stock Exchange who acts on behalf of a trading member as an agent or otherwise for assisting the investors in buying, selling or dealing in securities through such trading members. Trading members can be individuals (sole proprietor), Partnership Firms, Corporates and Banks¹. However, SEBI registered Custodians and Banks registered by the Exchange are eligible as Professional Clearing Members (PCMs).

Clearing Members are those who help in clearing of the trades. There are Professional Clearing Members (PCM), Trading Cum Clearing Member (TCM) and Self Clearing Member (SCM).

Professional Clearing Members (PCM) and Trading cum Clearing Members (TCM)

PCM has the right only to clear trades. The PCM does not have any trading rights. These types of members can clear trades of all members. The TCM has both trading and clearing rights. He can clear his own trades as well as the trades of others.

Any member of the equity segment of the Exchange is eligible to become trading cum clearing member of the Derivatives Segment also.

Custodians

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

¹ Banks are permitted to become trading and clearing members of the currency futures market of recognized stock exchanges subject to fulfillment of minimum prudential requirements.

Self Clearing Members (SCM)

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

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

2.4.3.1 Eligibility Criteria of a Trading Member

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

Capital Adequacy Requirements

The capital adequacy requirements by a trading member comprises of the following two components viz., Base Minimum Capital and the Additional or Optional capital related to the volume of business. An absolute minimum of Rs. 5 lakh as a deposit is required to be kept with the Exchange, which is irrespective of the volume of the business of the trading member. SEBI regulation also prescribes the form in which the base minimum capital is to be maintained. 25% of the base minimum capital is to be maintained in cash with the exchange; another 25% in the form of long term (3years or more) fixed deposit with the bank with which the stock exchange has given complete lien; the remaining shall be in form of securities with 30% margin (the securities should be in the name of members). The additional capital required at any point of time shall be such that the base minimum capital is not less than 8% of the gross outstanding business in the Exchange.

Eligibility Criteria

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

Criteria	
Age	Minimum Age: 21 years
Status	Indian Citizen
Education	At least HSC or Equivalent qualification
Experience	Applicant should have an experience of not less than two years as a partner with, or an authorized assistant or authorized remisier or apprentice to a member

Fit and Proper person

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

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

2.4.4 Depository and Depository Participants (DPs)

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

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

Besides providing custodial facilities and dematerialisation, depositories are offering various transactional services to its clients to effect buying, selling, transfer of shares etc. Through a system of paperless securities, depositories have made the going easier to other institutions as well such as Stock Exchanges and its clearing houses, stock broking firms, equity issuing companies, share transfer agents etc.

2.4.6 Custodian

A Custodian is an entity that helps register and safeguard 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 issue of securities, having a bearing on the benefits or rights accruing to the client.

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

2.5 Regulators

The regulators in the Indian securities market ensures that the market participants behave in a desired manner so that securities market continue to be a major 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 Industry.
- Reserve Bank of India (RBI) is the authority to regulate and monitor the Banking sector.
- Insurance Regulatory and Development Authority (IRDA) regulates the Insurance sector.
- Pension Fund Regulatory and Development Authority (PFRDA) regulate the pension fund sector.
- Ministry of Finance (MOF)
- Ministry of Corporate Affairs (MCA)

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

Most of the powers under the SCRA are exercisable by DEA while a few others by SEBI. The powers of the DEA under the SCRA are also con-currently 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 mostly 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 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 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 and to regulate the securities market, by measures it thinks fit.

Role of SEBI:

- Protecting the interests of investors in securities.

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

2.5.2 Regulatory Framework for Securities Market

The process of liberalization of the Indian securities market started in 1992. The aim was to liberalise the securities market, ensure protection of the interests of the investor, to have a regulated market and to develop the securities market. There was a concerted move from a control / merit based frame work to a disclosure based regime. 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, 1956.

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

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

SEBI Act, 1992

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

- (a) protecting the interests of investors in securities,
- (b) promoting the development of the securities market, and
- (c) regulating the securities market.

Its regulatory jurisdiction extends over corporates in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with securities market. It can conduct enquiries, audits and inspection of all concerned and adjudicate offences under the Act. It has powers to register and regulate all market intermediaries and also to penalise them in case of violations of the provisions of the Act, Rules and Regulations

made there under. SEBI has full autonomy and authority to regulate and develop an orderly securities market.

Securities Contracts (Regulation) Act, 1956

It provides for direct and indirect control of virtually all aspects of securities trading and the running of stock exchanges and aims to prevent undesirable transactions in securities.

It gives Central Government regulatory jurisdiction over

- (a) stock exchanges through a process of recognition and continued supervision,
- (b) contracts in securities, and
- (c) listing of securities on stock exchanges.

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

Depositories Act, 1996

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

Companies Act, 1956

The Companies Act of 1956 deals with issue, allotment and transfer of securities and various aspects relating to company management. It provides for standard of disclosure in public issues of capital, particularly in the fields of company management and projects, information about other listed companies under the same management, and management perception of risk factors. It also regulates underwriting, the use of premium and discounts on issues, rights and bonus issues, payment of interest and dividends, providing annual reports and other information.

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

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

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

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

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

Prevention of Money Laundering Act, 2002

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

The Prevention of Money-Laundering Act, 2002 (PMLA), is an act to prevent money-laundering and to provide for confiscation of property derived from, or involved in, money-laundering and for related matters. Chapter II, section 3 of this act describes the offence of money-laundering thus: Whoever directly or indirectly attempts to indulge, or knowingly assists or knowingly is a party or is actually involved, in any process or activity connected with the proceeds of crime and projecting it as untainted property shall be guilty of the offence of money-laundering.

The offences are classified under Part A, Part B and Part C of the Schedule of the Act. Under Part A, offences include counterfeiting currency notes under the Indian Penal Code (IPC) to punishment for unlawful activities under the Unlawful Activities (Prevention) Act, 1967. Under Part B, offences are considered as money laundering if the total value of such offences is Rs 30 lakh or more. Such offences include dishonestly receiving stolen property under the Indian Penal Code to breaching of confidentiality and privacy under the Infor-

mation Technology Act, 2000. Part C includes all offences under Part A and Part B (without the threshold) that has cross-border implications.

Section 6 of the PMLA confers powers on the Central Government to appoint Adjudicating Authorities to exercise jurisdiction, powers and authority conferred by or under the Act. According to section 9, in the event of an order of confiscation being made by an Adjudicating Authority (AA) in respect of any property of a person, all the rights and title in such property shall vest absolutely in the Central Government without any encumbrances.

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

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

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

Section 12 of PMLA stipulates that every banking company, financial institution and intermediary shall maintain a record of all transactions, the nature and value of which may be prescribed, whether such transactions comprise a single transaction or a series of transactions integrally connected to each other, and where such series of transactions take place within a month and furnish information of transactions and verify and maintain the records of the identity of all its clients. Such transactions include:

- *All cash transactions of the value of more than Rs. 10 lakh or its equivalent in foreign currency.*
- *All series of cash transactions integrally connected to each other which have been valued below Rs. 10 lakh or its equivalent in foreign currency where such series of transactions take place within one calendar month and the aggregate value of such transaction exceeds Rs. 10 lakh.*
- *All suspicious transactions whether or not made in cash.*

Provided that where the principal officer² of a banking company or financial institution or intermediary, as the case may be, has reason to believe that a single transaction or series of transactions integrally connected to each other have been valued below the prescribed

² Principal Officer's are designated officers of the intermediaries, who would be responsible for ensuring compliance of the provisions of the PMLA.

value so as to defeat the provisions of this section, such officer shall furnish information in respect of such transactions to the Director within the prescribed time.

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

Sections 16 and 17 lay down the powers of the authorities to carry out surveys, searches and seizures. Section 24 makes it clear that when a person is accused of having engaged in money-laundering, the burden of proving that the proceeds of the alleged crime are untainted shall be on the accused. Sections 25 and 26 relate to the establishment of an Appellate Tribunal and the procedures for filing an appeal to the same. Section 42 deals with appeals against any decision or order of the Appellate Tribunal. Section 43 empowers the Central Government to designate Courts of Session as Special Courts for the trial of the offence of money-laundering.

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

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

SEBI (Prohibition of Insider Trading) Regulations, 1992

Insider Trading is considered as an offence and is hence prohibited as per the SEBI (Prohibition of Insider Trading) Regulations, 1992. The same was amended in the year 2003. The act prohibits an insider from dealing (on his behalf or on behalf of any other person) in securities of a company listed on any stock exchange, when in possession of any unpublished price sensitive information. Further, it also prohibits any insider from communicating, counseling or procuring directly or indirectly any unpublished price sensitive information to any outside person. Price sensitive information means any information which is related directly or indirectly to a company and which if published is likely to materially affect the price of securities of a company. It includes information like periodical financial results of the company, intended declaration of dividends (both interim and final), issue of securities or buy-back of securities, any major expansion plans or execution of new projects, amalgamation, merger or takeovers, disposal of the whole or substantial part of the undertaking and significant changes in policies, plans or operations of the company. SEBI is empowered to investigate on the basis of any complaint received from the investors, intermediaries or any other person on any matter having a bearing on the allegations of insider trading.

Regulation 12(1) of the SEBI (Prohibition of Insider Trading) Regulations, 1992 requires listed companies and organizations associated with the securities market to frame a code of internal procedures and conduct, in line with the Model Code specified in Schedule I of the regulations. According to the Model Code, the compliance officer shall be responsible

for setting forth policies, procedures, monitoring adherence to the rules for the preservation of price-sensitive information and other related critical tasks.

Schedule I, Part B of the Insider Trading Regulations incorporates the Model Code of Conduct for connected persons (including brokers and sub-brokers). The Compliance Officer in Stock-broking and sub-broking firms is responsible for enforcement of the Model Code of Conduct, viz. preservation of price-sensitive information, prevention of misuse of information, and restriction of information. Effective procedures such as pre-clearance of trades and reporting requirements and a penalty system shall be laid down by the Compliance Officer.

Guidelines for trading by employees/directors/partners of the stock broking firms

An employee when rendering an investment advice should disclose if he or any of his dependent family members and employer has any holdings in the security.

No employee/director/partner of the stock broking firm can engage in purchase or sale of a security when he is in possession of unpublished material information. The stock is typically placed on a restricted list till the company publishes the information. Further, any purchase or sale in the securities of a client company (above a minimum threshold limit to be determined by the organisation/firm) shall be pre-cleared by the firm. Additionally an undertaking shall be executed in favour of the organization/firm by such designated employee/partners/directors incorporating, inter alia, that the designated employee/director/partner does not have any access or has not received any “Price Sensitive Information” up to the time of signing the undertaking.

Further, all such trades must be executed within one week after the approval of pre-clearance is given. If the order is not executed within one week after approval is given the employee/director/partners must [pre] clear the transaction again. All directors/officers/designated employees/partners shall hold their investments for a minimum period of 30 days in order to be considered as being held for investment purposes.

Additionally, to prevent the misuse of confidential information, the firm has to adopt a “Chinese wall” policy, which separates those areas of the firm which has access to confidential information (considered *insider areas*) from those areas which the sale / marketing /investment advice or other front dealing departments providing support services (considered *public areas*). The employees in the inside area should not communicate any price sensitive information to anyone in the public area.

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

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

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

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

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

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

- m) An intermediary not disclosing to his client transactions entered into on his behalf including taking an option position
- n) Circular transactions in respect of a security entered into between intermediaries in order to increase commission to provide a false appearance of trading in such security or to inflate, depress or cause fluctuations in the price of such security
- o) Encouraging the clients by an intermediary to deal in securities solely with the object of enhancing his brokerage or commission
- p) An intermediary predating or otherwise falsifying records such as contract notes
- q) An intermediary buying or selling securities in advance of a substantial client order or whereby a futures or option position is taken about an impending transaction in the same or related futures or options contract
- r) Planting false or misleading news which may induce sale or purchase of securities

We here describe the act of front running as an example of unfair trade practices. Front – running can be described as an illegal act on part of a dealer / stock broker in which the broker places his own / firm’s order ahead of client’s order or when client’s order is pending. This act of dealer / broker gives him / her 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 ground to believe that the transaction in securities are being dealt with in a manner detrimental to the investor or the securities market in violation of these regulations and when any intermediary has violated the rules and regulations under the act then it can order to investigate the affairs of such intermediary or persons associated with the securities market. Based on the report of the investigating officer, SEBI can initiate action for suspension or cancellation of registration of an intermediary.

SEBI (Custodian of Securities) Regulation, 1996

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

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

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

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

Review Questions

Questions to assess your learning:

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

Ans: (a)

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

Ans: (c)

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

Ans: (b)

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

Ans: (a)

Chapter 3: Introduction to Securities Broking Operations

3.1 Introduction to the Trade Life Cycle

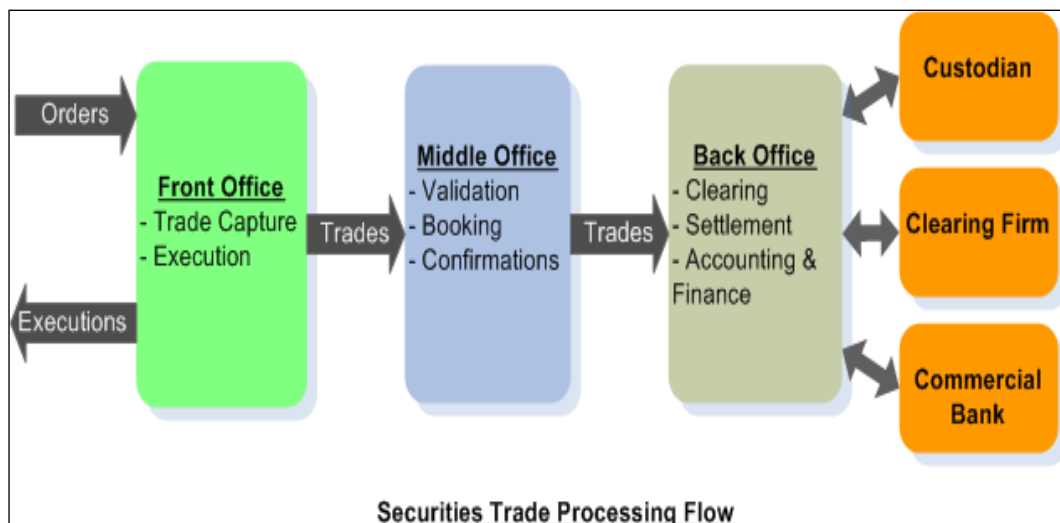
In financial market, “trade” means to buy and / or sell securities / financial products. To explain it further, *a trade is the conversion of an order placed on the exchange which results into pay-in and pay-out of funds and securities. Trade ends with the settlement of the order placed.* Every trade has its own cycle and can be broken down into pre-trade and post-trade events. Trading of securities also involves many participants like the investors, brokers, exchange, clearing agency /corporation, clearing banks, depository participants, custodians etc.

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

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

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

Figure 3.1: Securities Trade Life Cycle



3.1.1 Placing of order

The Broker accepts orders from the client and sends the same to the Exchange after performing the risk management checks. Clients have the option of placing their orders through various channels like internet, phone etc.

In the year 2008, SEBI permitted the facility of Direct Market Access for institutional clients³. DMA is a facility which allows brokers to offer its institutional clients direct access to the exchange trading system through the broker's infrastructure. This does not involve any manual intervention of the broker. This facility can be extended to the institutional clients provided the broker satisfies the operational specifications; risk management measure and other details as prescribed by SEBI.

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 & Order Routing

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

- Cash: The broker should ensure that there is enough balance in the clients account to honor the trade. Should have sufficient margin else the trade cannot be entered into the system.
- In case a buy order is entered by the client, the broker's system queries to find the available balance in the clients bank account and whether it is sufficient to meet the stipulated margin requirements. This is as per the agreed upon terms and conditions of risk management with the client. If the available balance satisfies the risk management parameters then the order is routed to the exchange. In cases where the balance is not sufficient the order gets rejected. A rejection message is shown in the system, which then is conveyed to client.

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

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

³ Vide SEBI Circular MRD/DoP/SE/Cir -7/2008 Dated April 03, 2008.

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 orders and are executed. The order matching in an exchange is done on a price time priority. 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 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. 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. These generally occur due to errors by the system and are not a common practice.

3.1.4 Affirmation and Confirmation (*For Institutional Clients*)

FIs trading in the Indian securities market use the services of a custodian to assist them in the clearing and settlement of executed trades. Custodians are clearing members of the exchange and not brokers who trade on behalf of them. On behalf of their clients, they settle trades that have been executed through other brokers. A broker assigns a particular trade to a custodian for settlement. The custodian needs to confirm whether he is going to settle that trade. Upon confirmation 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 submits to the custodian for providing this service.

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

It has been decided by SEBI (vide circular no. DNPD/Cir- 22 /04 dated April 1, 2004) that all the institutional trades executed on the stock exchanges would be mandatorily processed through the Straight through Processing System (STP) w. e. f. July 01, 2004. 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.

Box 3.1: Contract Notes

A contract note is a confirmation of trade done on a particular day for and on behalf of a client. A contract note is issued in the format and manner prescribed by the exchanges. It establishes a legally enforceable relationship between the stock broker and the client in respect of settlement of trades executed on the exchange as stated in the contract note. Every trade executed by a stock broker on behalf of his client should be supported by a contract note. Contract note should be issued within 24 hours and in the format prescribed by exchanges/SEBI. These should be issued in physical form or electronic form depending on the mode chosen by client.

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

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

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

Contract should also mention all statutory charges like Securities Transaction Tax (STT), Service Tax (ST), Education Cess, SEBI & Exchange charges, etc. Contract notes should be affixed with the brokers note stamps, as a percentage of the total value of the contract, as per the respective state government stamp acts / rules. Contract note also should clearly specify the complete address, phone numbers, e-mail IDs, fax numbers, Depository Participant ID (DP-ID), Pool A/C details, etc of the broker alongwith 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. It then notifies the consummated trade details to the clearing members / custodians who affirm back. Based on the affirmation, the clearing corporation applies multilateral netting and determines obligations. The settlement process begins as soon as member's obligations are determined through the clearing process. The settlement process is carried out by the clearing corporation with the help of clearing banks and the depositories. The clearing corporation provides a major link between the clearing banks

and the depositories. This link ensures actual movement of funds as well as securities on the prescribed pay-in and pay-out day.

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

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

3.2 Front Office Operations

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

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

3.2.1 Client On-Boarding and Registration

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

3.2.1.1 Sales

In market making, traders will 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, then communicate their clients' orders to the appropriate trading desks, who can price and execute trades. The job of the sales team also includes getting of 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. The client has to fill an account opening form (Refer Annexure I). After that, certain documents are to be submitted. These 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.

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 (refer to Annexure II). Brokers must also ensure that the following documents are submitted along with the KYC forms by the clients.

- PAN Card: The photocopy of the PAN card with original. The original PAN card is for verification only and will be returned to the client immediately.
- Proof of Address Document: (one for each distinct address). These should be either original and photocopies or self attested photocopies. The documents may include one of the following: Latest Telephone/Electricity Bill, Passport, Driving License, Latest Bank Passbook or A/c Statement, Voter Identity Card, Ration Card, Latest Demat Account Statement, Registered Lease / Sale Agreement of residence, and the details of registration and proof of address of registered office for non-individuals.
- In person verification is also required to be made by the broker or by the person authorised by him of each new client added on the books.
- The client must also have a valid bank account from which transactions can be made for pay-in/out of funds. The details are to be given with the KYC. A cancelled cheque leaf with a copy of the latest bank A/C statement / pass book should also be submitted at the time of opening the trading A/C. this Bank A/C will be mapped to the Client’s Trading A/C and thereafter, generally, payment will be accepted only from this A/C . A client can map more than one Bank A/C also, but should provide the proof of the same. The client must have also opened a demat account with a DP for pay-in/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 it has to. SEBI has stipulated certain formats and stipulations with respect to POA to be followed by the broker.
- The retail clients normally do not wish to exchange cheques to and fro for every contract. They prefer to settle the account with the broker at periodic interval. To facilitate this SEBI has approved brokers to collect running authority letter from the client. In spite of this letter the broker should settle the accounts at least once a quarter or earlier as per the client preference.

3.2.1.3 Unique Client Code

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 be mapped with the PAN number of the client. The broker has to inform the exchange the UCC and the PAN details of the clients through an upload before entering into any trade for the client. If the broker fails to register the unique client code with the exchange, he is liable to be penalized.

3.2.2 Order Management

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

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

3.2.2.1 Types of order

Price, time and quantity are three major components of an order. There are generally three types of orders that can be used when placing trades. These are market orders, stop orders and limit orders. They are variations on each to which traders should be aware of. These variations are present for security and precision and there are occasions where more than one order is required. These variations are because of different conditions / preferences of price, time and quantity.

Market Order - Basic Trade

A market order is where a trader purchases or sells their security at the best market price available. In the market order there is no need to specify the price at which a trader wants to purchase or sell. There are two variations on the market order. The Market on Open Order means that the trade must be done during the opening range of trading prices. So the highest price for selling and lowest price for buying.

The Market on Close order is done within minutes of the market closing. This is done at whatever price is available at the time. This is generally the volume weighted average price of the security in the last half-an-hour of the trade before the market close and trade takes place in a separate session called “post closing session”.

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

Limit orders involve setting the entry or exit price and then aiming to buy at or below the market price or sell at or above it. Unlike market order, the trader here needs to specify at least one price. They of course can be changed any time before execution. Reaching these limits/targets is not always possible and sometimes the orders do not go through. Limit orders are very common for online traders.

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

Stop Orders

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

The stock price can also move downwards much against expectations of the trader. It may so happen that the trader may have limited risk appetite and does not want to incur loss of more than Rs. 5/- per share. In such a scenario, trader can give stop loss order with trigger price of Rs.94/- and limit price of Rs. 95/-. When the stock price starts moving downwards, as soon as it hits price of Rs.94/- , the sell order of Rs.95/- will automatically get executed. Any further downward movement in price will not affect the trader as he has already limited his loss on the position.

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

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

3.2.2.2 Placing of orders through the Internet / Phone

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

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

- For the purpose of availing of this service, the Client is required to call on the specific numbers intimated or notified from time to time by the stock broker for the

said purpose by means of an email and/or by putting up such numbers on the website or otherwise.

- In case the Client opts for this service, he may be required to provide accurate answers to the questions asked by the Dealing Desk Executive, including the Client's user id and TPIN, for ascertaining the genuineness of the caller. Once this is done, the order can be placed and will be processed in the normal course.

3.2.2.3 Process of order routing through the Exchanges

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

The order gets executed at the exchange depending upon the type of order. If the order is a market order it gets executed immediately. If it is a limit order it is stored in the order book and matched against appropriate 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 informed to the broker's office which in turn informs the client through a message on the trading terminal (only if the client is trading on internet platform).

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

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

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

These quotes given in the table above are visible to clients. Now if a buy market order comes with an order quantity of 50 it gets executed for a price of Rs. 121.50 and the order book entries on the sell side moves up by one notch i.e. the Rs. 121.80 order comes to top. On the other hand if a limit order with a sell price of Rs. 121.20 for a

quantity of 500 comes 50 shares get executed and the order for remaining 450 stays at the top on the sell side.

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

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

3.2.3 Trade execution

Execution of trade occurs when a buyer and seller reach an agreement as to the terms and price of a trade, and the order to buy or sell a security is completed.

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 in a manner to willfully produce an abnormal effect on prices and / or volumes, goes against the very fundamental objective of the securities markets. Here the risk management system plays a crucial role. An efficient risk management system is integral to an efficient settlement system.

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

1) 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.

2) Impose Position Limits and Rules;

A key element of financial risk management is deciding which risks to bear and to what degree. A firm needs to impose limits to cover exposures to counter-parties, credit, and overall position concentrations relative to systematic risks.

3) 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.

3.3.1.1 Types of Risk

Operational risk is the risk of monetary loss resulting from inadequate or failed internal processes, people and systems or external events. For the stock broker, operations risk is essentially counter-party risks such as non-payment, non-delivery of scrip, denial of matched order by client/s, trading errors, and sudden closure of banks where funds are deposited. The main risk arising from securities activities is the market risk associated with proprietary holdings and collateral obtained or provided for specific transactions.

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

Regulatory risk occurs when the rules governing the securities industry are changed, giving rise to potential loss. For example, the '*customer first*' policy makes it difficult to trade house accounts and therefore a broker may not be able to liquidate a position immediately, leading to potential or actual loss. Regulatory requirement of brokers who need to maintain a higher net capital may be hard to meet.

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

3.4 Back Office Operations

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

3.4.1. Trade Enrichment

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

Trade enrichment is defined as process of including additional information in one instruction in a trade which is already being executed. Instructions can be enriched either before or after matching. Instructions could include adding specific and relevant data of counterparty, settlement instruction, etc

3.4.1.1 Updation of the security master file

This involves preliminary and confirmed information on securities issues in the form of a database of electronic text files of securities information, including *Reference Information* such as security type, instrument type, market symbol or ticker, security code, security description, issuer code, maturity date, etc. This also includes *custodian information* such as location and type of custody. The counterparty name is also included in the updation of the records.

3.4.2 Trade Allocation

In instances where a client has given the broker consent in connection with the handling and execution of the customer's orders, the broker will allocate executions for the customer's order evenly and allocated on the basis of time priority and parity for participating orders.

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).

A trade allocation system includes a computer system having a network interface over which messages can be exchanged with an order management system. The computer system is also coupled to a first database that stores data associating portfolios with different risk classes.

A second database stores instructions to configure the system to receive from order management systems messages describing trades of financial instruments. Each message can include a financial instrument identifier, a size of the trade, and a risk class identifier. The instructions also configure the processor to query the first database for determining a portfolio that is associated with a risk class identified by a risk class identifier in a message as well as to determine a target ratio for each of the portfolios. The processor then allocates the trade of the financial instrument among each of the portfolios based on the tar-

get ratios. Allocating a trade of financial instruments among a group of portfolios include receiving a message descriptive of a trade of a financial instrument. The message can include a financial instrument identifier and a size of the trade. A collection of portfolios are then identified based on a match between a risk class of the portfolio and the risk class of the traded financial instrument. The trade is then allocated among each of the portfolios based on a target ratio associated with each portfolio.

3.4.3 Trade Confirmation/Modification

Some times in moving market, orders need to be changed in their prices and quantity as per the requirement. All the orders can be modified till the time they are not fully executed. Due to some problems in moving market or when one does not want to buy or sell shares, then orders need to be cancelled. In this case only those orders can be cancelled which have not been fully or partially executed and only during market hours.

3.4.4 Clearing and Settlement Process

Clearing and Settlement is a post trading activity that constitutes the core part of equity trade life cycles. After any security deal is confirmed (when securities are obliged to change hands), the broker who is involved in the transaction issues a contract note to the client which has all the information about the transactions in detail, at the end of the trade day. In response to the contract note issued by broker, the client now has to settle his obligation by either paying money (if his transaction is a buy transaction) or delivering the securities (if it is a sell transaction).

Clearing house 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 by the Stock Exchange. The Clearing House gives an obligation report to Brokers and Custodians who are required to settle their money/securities obligations with the specified deadlines, failing which they are required to pay penalties. This obligation report serves as statement of mutual contentment.

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

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

In India, the Pay-in of securities and funds happens on T+ 2 by 11 AM, and Pay-out of securities and funds happen on T+2 by 3 PM.

The pay-in and pay-out days for funds and securities are prescribed as per the Settlement Cycle. A typical Settlement Cycle of Normal Settlement is given below:

	Activity	Day
Trading	Rolling Settlement Trading	T
Clearing	Custodial Confirmation	T +1 working days
	Delivery Generation	T +1 working days
Settlement	Securities and Funds pay in	T+2 working days
	Securities and Funds pay out	T+2 working days
Post Settlement	Valuation Debit	T+2 working days
	Auction	T+3 working days
	Bad Delivery Reporting	T+4 working days
	Auction settlement	T+5 working days
	Close out	T+5 working days
	Rectified bad delivery pay-in and pay-out	T+6 working days
	Re-bad delivery reporting and pickup	T+8 working days
	Close out of re-bad delivery	T+9 working days

3.4.5 Accounting

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

3.4.5.1 Different types of accounts

The broker has to maintain the required books of accounts as per Rule 15 of SC(R) Rules 1957 and Regulation 17 of SEBI (Stock Broker and Sub Brokers) Regulations, 1992. Stock brokers are required to maintain separate books for each exchange in which they operate. Further, for any exchange, a separate set of ledger accounts of clients is to be maintained for each particular segment of the exchange in which the stock broker operates. For a minimum of 7 years, the stock broker has to maintain a mapping of the client IDs used at the time of order entry in the system with the client's unique client ID along with all the particulars given in the KYC form.

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

- The **register of transactions (sauda book)** is to include each transaction effected. This would show the name of the security, its value, rates gross and net of brokerage and names of the clients.
- The **client's ledger**, as the name suggests, has the details of all clients, and their transactions through the broker.
- The **general ledger** accounts for all general transactions including expenses, overheads salaries, petty cash, etc.
- The **journal** is the accounting book of the general ledger. Any adjustment entries for e.g., interest receivable, etc., is accounted here.
- The **cash and bank book** contain records of all cash and cheque transactions and are normally balanced daily.
- The **securities register** is required to be maintained client-wise and scrip-wise. The details provided would include date of receipt/delivery of the security, quantity received/delivered, party from whom delivered/to whom delivered, the purpose of receipt/delivery and the balance quantity.
- A **contract note** is a confirmation of trade done on a particular day for and on behalf of a client. A contract note issued in the format and manner prescribed by the exchanges establishes a legally enforceable relationship between the stock broker and the client in respect of settlement of trades executed on the exchange as stated in the contract note. The copies of the original contract notes issued to the client are to be maintained by the broker.
- The **margin deposit book** contains details of margins paid and collected and payable and collectable.

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

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

3.4.6 Information Technology (IT)

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

- Business Functions include Customer database and document archiving including customer signature, Ordering Management System, Customer Accounting, Portfolio Management, Risk Management, Auditing System, On Line Trading System, General Accounting System, etc.
- Technical Functions include, Supports and standby database function, Disaster Recovery, Customer Database, Customer data, etc.
- Trades functions include, Automatic entry of daily executions, Automatic identification of new customers, Automatic link of executions to orders, etc.
- The IT will also include an Order Management System with issue of sell orders, buy orders, order execution, log of orders, orders confirmation, etc.

3.4.6.1 Business Continuity Plan / Disaster Recovery Management

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

3.4.7 Regulatory Compliances

The stock broker has to follow certain regulatory compliances under the law, rules and bye laws of SEBI and the exchanges. These are mandatory and non-compliance attracts penal action. These are covered in detail in section 4.2 under Regulatory Compliances and Reporting. However, the main compliances include:

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

- Maintenance of different types of Books as prescribed under SC(R)R 1957 (e.g Suda book etc.)
- Failing to send account statements to clients
- Submission of various periodic reports to the stock exchanges.

Review Questions

Questions to assess your learning:

1. Direct Market Access facility is introduced for _____.

- (a) Retail Investors.
- (b) Institutional Clients only.
- (c) Specific International Broking Firms.

Ans: (b)

2. Which of the statement is false?

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

Ans: (c)

3. A contract note is _____.

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

Ans: (b)

Chapter 4: Risk Management

4.1 Risk Management

A sound risk management system is integral to an efficient clearing and settlement system. The system must ensure that brokers / trading member's obligations are commensurate with their networth.

Risk containment measures include capital adequacy requirements, margin requirements, position limits based on capital, online monitoring of client positions etc. The main concepts of a Risk Management System are listed below:

- There should be a clear balance available in the client's ledger account in the broker's books.
- The clients are required to provide margins upfront before putting in trade requests with the brokers.
- The aggregate exposure of the client's obligations should commensurate with the capital and networth of the broker.
- Ideally, the client must square-up all the extra positions that have been created on an intra-day basis before 3.00 p.m.
- The clients must settle the debits, if any, arising out of MTM settlements.
- In futures and options segment, the positions are allowed based on the margin available to satisfy initial margin requirements of the Exchange. The clients are expected to pay the MTM margin as and when required failing which the client or the broker may square off the trade.

4.1.1 Capital Adequacy Requirements

Credit risks are inevitable in financial markets, and managing them is a crucial part of market functioning. In the equities and derivatives market, brokers' capital adequacy is one of the two critical components of credit risk management, the other being daily margins. The Capital Adequacy Requirements consists of two components i.e. the Base Minimum Capital and the Additional or Optional Capital related to volume of the Business.

4.1.1.1 Base minimum capital/ Additional Base Capital

Base Minimum capital is the deposit a stock broker has to make with the stock exchange to get trading rights on the exchange. Even then, the broker may take positions (the sum of his and his clients') only up to a pre-specified multiple of this deposit amount.

As per the SEBI (Stock Brokers and Sub-Brokers) Regulations, an absolute minimum of Rs. 5 lakh as a deposit with the Exchange shall be maintained by member brokers of the Bombay and Calcutta Stock Exchange, and Rs. 3.5 lakhs by the Delhi and Ahmedabad Stock Exchanges. This requirement is irrespective of the volume of business of an

individual broker. The security deposit kept by the members in the exchanges shall form part of the base minimum capital.

The additional or optional capital required of a member shall at any point be such that together with the base minimum capital it is not less than 8% of the gross outstanding business in the Exchange. The gross outstanding business would mean aggregate of upto date sales and purchases by a member broker in all securities put together at any point of time during the current settlement.

Exchanges are free to stipulate a higher base capital. The capital adequacy requirements stipulated by the NSE are substantially in excess of the minimum statutory requirements as also in comparison to those stipulated by other stock exchanges. Corporate seeking membership in the capital market segment and the F&O segment of NSE are required to keep an Interest Free Security Deposit (IFSD) of Rs. 125 lakh and Collateral Security Deposit (CSD) of Rs. 25 lakh with the Exchange/Clearing Corporation of the exchange. The deposits kept with the Exchange as a part of the membership requirement may be used towards the margin requirement of the member. Additional capital may be provided by the member for taking additional exposure. However, for individual membership an IFSD of Rs. 25 lakh and CSD of Rs. 25 lakh needs to be maintained with the Exchange / Clearing Corporation.

4.1.2 Internal client account control

The stock broker shall segregate client funds from its own funds. Stock broker shall keep the client's money in a separate bank account designated as client account and their own money in a separate bank account.

There are only certain circumstances in which the stock broker shall transfer funds from own account to the clients' accounts and vice versa. The stock broker shall also not transfer funds from one client's account to another. The stock broker shall not use clients' funds for the purpose of self trading or other clients trading.

All payments made to/received from the client shall be through account payee cheques or demand drafts or by way of direct credit to the account through EFT. Cash transactions are not permitted except in exceptional circumstances with the limit prescribed by Income tax department.

Payout of Funds and securities to the clients shall be made within one working day from the day of pay-out by the Exchanges. Sometimes clients may authorize stock broker not to transfer payout of funds and securities to their bank/depository accounts and retain the same towards margins or otherwise.

The stock broker is also required to maintain records in respect of dividends received on shares held on behalf of the clients. This is to distinguish between the dividends received

on own account and clients account. The transfer of such dividends to clients account should be carried out within appropriate time.

Balances lying in client's bank account if it contains, a portion representing brokerage, stock broker may transfer such brokerage to own bank account. Stock brokers are not supposed to incur any expenses from client bank account directly out of such amount.

The stock brokers are required to maintain separate beneficiary accounts for clients' securities and own securities. This is to prevent improper use of clients' securities by stock brokers. The account is to be opened in the name "constituents' beneficiary account". This could be one consolidated account for all clients or separate accounts for each client as they may deem fit.

The stock broker, may deliver securities into such accounts only towards pay-in, margin or security deposit or as replacement for those which have been withdrawn by mistake from the account. Similarly, they cannot be withdrawn unless the client so authorizes for delivery on his / her behalf or towards dues to the stock broker, or to remove securities deposited by mistake into that account.

The clients securities shall not be mixed with those of trading members own securities. The stock broker shall not use the clients' securities for purposes other than the specified.

Receipt and delivery of securities shall be from/ to respective clients demat account only.

4.1.3 Margin Requirements – On what Basis it is Calculated?

One of the critical components of risk management for the futures and options segment is the margining system. The Exchange levies daily margin, Mark-to-Market (MTM) margin, Extreme loss margin in the equities segment and initial margin and MTM margin in case of futures and options segment.

The daily margin is calculated based on Value at Risk (VAR) discussed in section 4.1.3.3. The broker needs to maintain upfront capital with the exchange to cover his daily margin at the time of order placement. To ensure this, the broker collects upfront margin by way of funds/ shares from the client and deposits the same with the exchange.

Initial Margin is calculated on a portfolio basis and not on individual scrip basis. The margin calculation is done using SPAN (Standard Portfolio Analysis of Risk) a product developed by Chicago Mercantile Exchange. The margin is levied at trade level on real-time basis. The rates are computed at 5 intervals one at the beginning of the day 3 during market hours and one at the end of the day.

The objective of SPAN is to identify overall risk in a portfolio of futures and options contracts for each client. The system treats futures and options contracts uniformly, while at the same time recognizing the unique exposures associated with options portfolios like extremely deep out-of-the-money short positions and inter-month risk.

Initial margin requirements are based on 99% value at risk over a one-day time horizon. However, in the case of futures contracts (on index or individual securities), where it may not be possible to collect mark to market settlement value, before the commencement of trading on the next day, the initial margin may be computed over a two-day time horizon, applying the appropriate statistical formula.

Exposure Margin is based on a single percentage on the value of the scrip determined at the beginning of every month for the following month by the exchange. This is charged over and above the initial margin and is popularly referred as second line of defence.

In case of option purchase the margin levied will be equivalent to the premium amount. This margin will be levied till the time premium settlement is complete.

Box 4.1: Standard Portfolio Analysis of Risk (SPAN)

Developed by the Chicago Mercantile Exchange in 1988, the Standard Portfolio Analysis of Risk (SPAN) performance bond margining system for calculating margin requirements has become the futures industry standard. SPAN evaluates the risk of an entire account's futures/options portfolio and assesses a margin requirement based on such risk. It accomplishes this by establishing reasonable movements in futures prices over a one day period. The resulting effect of these "risk arrays" is to capture respective gains or losses of futures and options positions within that underlying. Each Exchange maintains the responsibility of determining these risk arrays as well as the option calculations that are needed to determine the effect of various futures price movements on option values.

Advantages and Rationale of SPAN

SPAN recognizes the special characteristics of options, and seeks to accurately assess the impact on option values from not only futures price movements but also changes in market volatility and the passage of time. The end result is that the minimum margin on the portfolio will more accurately reflect the inherent risk involved with those positions as a whole.

4.1.3.1 On Gross Client Basis

The margin is required to be paid on the gross open position of the stock broker. The gross open position signifies the gross of all net positions across all the clients of a member, including the proprietary position of the member. Thus, it is important for the stock broker at any time to know the position on both gross and net basis for all clients.

Two types of margins are applicable for option writing - initial margin and mark to market margins. Both are based on the standardised portfolio analysis of risk (SPAN) model.

The initial margin and the mark-to-market requirements are based on a worst-case scenario calculated by valuing the portfolio under several scenarios of changes in market conditions over a trading day.

The market conditions taken into consideration involve combinations of possible changes in the spot price of the underlying and changes in the volatility of the underlying. Sixteen possible scenarios are considered and thereafter the margin requirements are specified.

The margin requirements change considerably for the various stock options.

4.1.3.2 Mark-to-Market Margin

Mark to market 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 shall be considered as notional loss for the purpose of calculating the mark to market margin payable.

The mark to market margin (MTM) is collected from the member before the start of the trading of the next day. The MTM margin is collected/adjusted from/against the cash/cash equivalent component of the liquid net worth deposited with the Exchange. The MTM margin is collected on the gross open position of the member. The gross open position for this purpose means the gross of all net positions across all the clients of a member including broker's proprietary position. For this purpose, the position of a client is netted across its various securities and the positions of all the clients of a member are grossed.

There is no netting off of the positions and set-off against MTM profits across two rolling settlements i.e. T day and T+1 day. However, for computation of MTM profits/losses for the day, netting or set-off against MTM profits is permitted.

4.1.3.3 Value at Risk (VaR) Margining

All securities are classified into three groups for the purpose of VaR margin.

- For the securities listed in Group I, scrip wise daily volatility calculated using the exponentially weighted moving average methodology is applied to daily returns. The scrip wise daily VaR is 3.5 times the volatility so calculated subject to a minimum of 7.5%.
- For the securities listed in Group II, the VaR margin is higher of scrip VaR (3.5 sigma) or three times the index VaR, and it is scaled up by root 3.
- For the securities listed in Group III the VaR margin is equal to five times the index VaR and scaled up by root 3.

The index VaR, for the purpose, is the higher of the daily Index VaR based on S&P CNX NIFTY or BSE SENSEX, subject to a minimum of 5%.

The VaR margin rate computed as mentioned above is charged on the net outstanding position (buy value-sell value) of the respective clients on the respective securities across all open settlements. There is no netting off of positions across different settlements. The net position at a client level for a member is arrived at and thereafter, it is grossed across all the clients including proprietary position to arrive at the gross open position.

The VaR margin is collected on an upfront basis by adjusting against the total liquid assets of the member at the time of trade.

The VaR margin so collected is released on completion of pay-in of the settlement or on individual completion of full obligations of funds and securities by the respective member/custodians after crystallization of the final obligations on T+1 day.

4.1.3.4 Extreme Loss Margin

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

The Extreme Loss Margin is collected/ adjusted against the total liquid assets of the member on a real time basis.

The Extreme Loss Margin is collected on the gross open position of the stock broker. The gross open position for this purpose means the gross of all net positions across all the clients of a member including its proprietary position.

There is no netting off of positions across different settlements. The Extreme Loss Margin collected is released on completion of pay-in of the settlement or on individual completion of full obligations of funds and securities by the respective broker/custodians after crystallization of the final obligations on T+1 day.

The risk management practices undertaken by members for currency derivatives trading, is similar to those for derivatives trading in equities. We have restricted our discussion of margin calculation to only equities segment in this book.

4.2 Compliances and Regulatory Reporting

Directives are issued by SEBI and the stock exchanges for stock brokers to follow. These include directives on margin requirements, smooth functioning of pay in/payout trading restrictions, base minimum capital, etc. Other requirements include submission of audit reports along with the annual reports to the exchanges and payments of turnover fees to SEBI.

It is the duty of the stock brokers to inform the exchanges of any defaulting clients or defaulting sub-brokers. The stock broker has also to inform the public/clients that his sub-broker's registration has been cancelled and that they are not to deal with them.

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

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

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

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

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

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

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

- (a) Register of transactions (Sauda book).
- (b) Clients' ledger.
- (c) General ledger.
- (d) Journals.
- (e) Cash book.
- (f) Bank pass-book.

(g) Documents register showing full particulars of shares and securities received and delivered.

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

(a) Members' contract books showing details of all contracts entered into by him with other members of the same exchange or counter-foils or duplicates of memos of confirmation issued to such other members.

(b) Counter-foils or duplicates of contract notes issued to clients.

(c) Written consent of clients in respect of contracts entered into as principals.

4.2.3 Submission of various periodic reports

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

- System Audit Report - By 31 July yearly
- Annual Returns - Within 6 months from the end of accounting year
- Client wise Funding Report - Within seven days from the end of the month
- Internal Audit Report Half yearly basis - Within 3 months from half year ended March and September
- Net worth certificate Half yearly basis - Within 3 months from half year ending
- Networth certificate in Margin Trading for CM Segment - Within one month from the end of half year
- Proof of Insurance cover - By July 31 yearly
- Client details for Margin Trading facility - Before 9:00pm on the trade day

4.2.4 Sending account statements to clients

Each stock broker is required to send a statement of account for both funds and securities at least on a quarterly basis, within a month from the end of the period, to each client.

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

Review Questions

Questions to assess your learning:

1. Risk containment measures includes which of the following:

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

Ans: (a)

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

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

Ans: (b)

3. State which of the following is true.

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

Ans: (a)

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Chapter 5: Clearing Process

5.1 Introduction

The clearing process follows the trading process.

1. At the end of the day's trade, all details about the trades are sent by the stock exchanges to the clearing house/corporation.
2. The clearing corporation/house then groups the trades under the various clearing members and informs them about the transactions of their clients.
3. The clearing members then confirm back regarding the trades by 11.00 a.m. the next day.
4. The clearing house/corporation then performs multilateral netting and determines the obligations of all clearing members. These details are then sent to the clearing members by 1.30 p.m.

5.2 Role of the Clearing Agency / Corporation

Clearing Agencies ensure trading members meet their fund/security obligations. It acts as a legal counter party to all trades and guarantees settlement for all members. The original trade between the two parties is cancelled and clearing corporation acts as counter party to both the parties, thus manages risk and guarantees settlement to both the parties. This process is called novation.

It determines fund/security obligations and arranges for pay-in of the same. It collects and maintains margins, processes for shortages in funds and securities. It takes help of clearing members, clearing banks, custodians and depositories to settle the trades.

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

Thus, the clearing agency is the main entity managing clearing and settlement on a stock exchange. It interacts with the stock exchange, clearing banks, clearing members and depositories through electronic connection.

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

The Bank of India Share Holding Limited (BOISL) takes care of the clearing and settlement on BSE. It is a subsidiary of BSE and Bank of India and is called the clearing house. Multi

Commodity Exchange- Stock Exchange (MCX-SX) Clearing Corporation Ltd. is the clearing corporation for all the trades executed on the MCX-SX.

5.3 Clearing Banks and their function

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

Multiple clearing banks facilitate introduction of new products and clearing members will have a choice to open an account with a bank which offers more facilities.

Normally the demat accounts of clients require the details of a bank account linked to it for facilitation of funds transfer. Ideally, all transactions of pay-in/pay-out of funds are carried out by these clearing banks. The obligation details are passed on to the clearing banks, who then carry out the pay-in/pay-out of funds based on the net obligations. This happens on T+2 day.

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. They are-

- Professional Clearing Member (PCM)
- Trading Cum Clearing Member (TCM)
- Self Clearing Member (SCM)

Trading and Clearing membership in Currency Derivatives - A membership in this category entitles a member to execute trades on his own account as well as on account of his clients. He also clears and settles trades executed by themselves as well as by other trading members who choose to use clearing services of the member in Currency Derivatives Segment.

Clearing members also need to take membership with the clearing agencies. They then get a unique member ID number from the agency. The clearing agency gives a list of the trading transactions made by the respective members, which have to be confirmed by the clearing members (about the genuineness of the transactions). Once this is done, the clearing agency then determines the net obligations of the clearing members through multilateral netting.

It is mandatory for clearing members to open demat accounts with both the depositories, i.e., CDSL and NSDL. This account is called a clearing member account. Separate accounts are to be opened for all the exchanges.

Unlike the usual demat accounts, the clearing member does not get any ownership or beneficiary rights over the shares held in these accounts. The accounts are of three types:

Pool accounts are used to receive shares from selling clients and to send shares to buying clients.

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

Receipt accounts are used to transfer securities from clearing agency's account to pool accounts.

5.5 Depositories & Depository Participants

A depository can be defined as an institution where the clients / investors can keep their financial assets such as equities, bonds, mutual fund units etc in the dematerialised form and transactions could be effected on it. In clearing and settlement process, the depositories facilitate transfer of securities from one account to another at the instruction of the account holder. In the depository system both transferor and transferee have to give instructions to its depository participants [DPs] for delivering [transferring out] and receiving of securities. However, transferee can give 'Standing Instructions' [SI] to its DP for receiving in securities. If SI is not given, transferee has to give separate instructions each time securities have to be received.

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 is called 'off-market' transaction.
- b. Transfer arising out of a transaction done on a stock exchange.
- c. Transfer arising out of transmission and account closure.

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

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

Any trade that is cleared and settled without the participation of a clearing corporation is called off-market trade, i.e., transfer from one beneficiary account to another due to a trade between them. Large deals between institution, trades among private parties, transfer of securities between a client and a sub-broker, large trades in debt instruments are normally settled through off-market route. The transferor will submit a DI with 'off-market trade' ticked off to initiate an off-market debit. The account holder is required to specify the date on which instruction should be executed by mentioning the execution date on the instruction. The debit will be effected on the execution date. DP will enter the instruction in the system of the depository participant (which links the DP with its depository) if the instruction form is complete in all respects and is found to be in order. This system will generate an 'instruction number' for each instruction entered. DP will write the instruction number on the instruction slip for future reference. The instruction will be triggered on the execution date. If there is adequate balance in the account, such quantity will be debited on the execution date. If adequate balances do not exist in the account, then instruction will wait for adequate balances till the end of the execution day. The account will be debited immediately on receipt of adequate balances in the account. If adequate balances are not received till the end of the day of the execution date, the instruction will fail. Transferee will receive securities into the account automatically if SI were given to the DP at the time of account opening. If SI is not given, transferee has to submit duly filled in 'Receipt-Instruction' [RI] form for every expected receipt. Exchange of money for the off-market transactions are handled outside the depository system.

A market trade is one that is settled through participation of a Clearing Agency. In the depository environment, the securities move through account transfer. Once the trade is executed by the broker on the stock exchange, the seller gives a delivery instruction to his DP to transfer securities to his broker's account. The broker has to then complete the pay-in before the deadline prescribed by the stock exchange. The broker transfers securities from his account to Clearing Agency of the stock exchange concerned, before the deadline given by the stock exchange. The Clearing Agency gives pay-out and securities are transferred to the buying broker's account. The broker then gives delivery instructions to his DP to transfer securities to the buyer's account. The movement of funds takes place outside the Depository system.

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

5.5 Clearing Process

At the end of the trading day, the transactions entered into by the brokers are tallied to determine the total amount of funds and/or securities that the stock broker needs either

to receive or to pay the other stock brokers. This process is called clearing. In the stock exchanges this is done by a process called multilateral netting. This process is performed by clearing members.

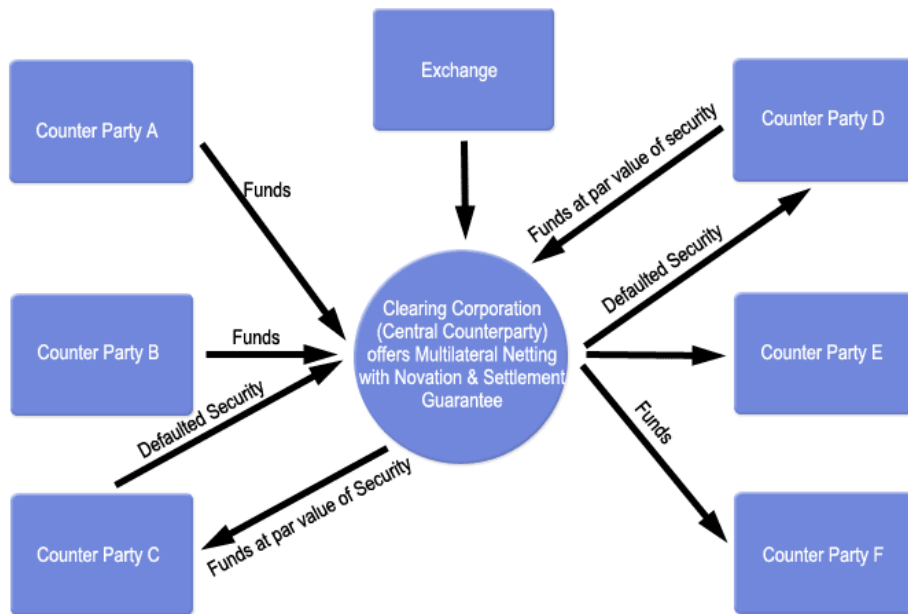
The clearing agency guarantees that all contracts which are traded will be honoured. Clearing therefore serves to create a more efficient market, since all the players involved need not include the original counterparty risk in the price calculation. Generally, the clearing and settlement process can be classified into: Matching, Central counterparty, Cash settlement and Delivery

Matching means that the parties agree on the conditions of the transaction, i.e. what has been bought or sold, price, quantity, etc. 'Central counterparty clearing' is when the clearing organization becomes the legal counterparty in a transaction. Cash settlement refers to settlement of premiums, fees, mark-to-market and other cash settlements, and delivery of the underlying instrument or cash settlement occurs after expiration or premature exercise.

As central counterparty, the clearing agency:

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

Figure 5.1: Diagrammatic Representation of the clearing process



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

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

- Depository informs custodians/Clearing members through Depository Participants about pay-in and pay-out of securities.
- Clearing Banks inform custodians/Clearing members about pay-in and pay-out of funds.
- In case of buy order by normal investors Clearing members instruct his DP to credit the client's account and debit its account. The money will be debited (Total settled amount - margins paid at the time of trade) from the client's account.
- In case of sell order by retail clients Clearing members instruct his DP to debit the client's account and credit its account. The money will be credited to the client's account.

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

- T is trade date by broker
- On T+1 morning Trade confirmation to broker (exchange obligations move from broker to custodian)
- On T+1 evening payment of margins. Usually it is 100% of funds/ securities
- On T+2/T+3 credit of shares /funds to client account

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

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

The process of clearing for derivatives products is as follows:

The clearing mechanism essentially involves working out open positions and obligations of clearing members. This position is considered for exposure and daily margin purposes. The open positions of clearing members are arrived at by aggregating the open positions of all the TMs and all custodial participants clearing through them, in contracts in which they have traded. A TMs open position is arrived at as the summation of his proprietary open position and client's open positions, in the contracts in which they have traded. 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.

All derivatives contracts irrespective of whether it is index futures, stock futures, index options, stock options or currency futures and options are cash settled. The settlement amount for a clearing member is netted across all their TMs/Clients with respect to their obligations on Mark-to-Market settlement. The settlement process would be discussed in detail in chapter 6 of this workbook.

5.5.2 Determination of Obligation of Clients

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

5.5.3 Balancing / netting of clients accounts within the brokers firm

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

5.5.4 Broker netting within the Exchange

Every day, the clearing corporation sends the clearing member a list of all trading transactions made by him and his clients for the day. The clearing member then verifies the list and makes the corrections and sends it back to the clearing corporation. 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.

Review Questions

Questions to assess your learning:

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

Ans: (b)

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

Ans: (a)

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

Ans: (b)

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Chapter 6: Settlement Process

6.1 Settlement Cycle

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

T+2 settlement cycle is followed in the Indian equities market, i.e. which means that a transaction entered into on Day 1 has to be settled on the Day 1 + 2 working days, when funds pay in or securities pay out takes place. 'T+2' here, refers to Trade day + 2 working days.

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

The settlement of derivative trades is on T+1 working day basis. Members with a funds pay-in obligation are required to have clear funds in their primary clearing account on or before 10.30 a.m. on the settlement day. The payout of funds is credited to the primary clearing account of the members thereafter.

Settlement Price for derivatives is given in the following table:

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

6.2 Settlement of Internet based trading & order placed on phone

Under the screen based environment, computerised matching of orders and quotes takes place. At the end of the trading session the member has to download his daily transaction reports etc. from the system. At the end of the settlement period, Delivery Price (usually the closing price at the last day of the Settlement period) will be fixed by the system to enable the members to receive or deliver scrips at uniform rates and netting of trades is done by the system and the following Settlement reports are generated by the system for each member. The member can download these reports on second day of the Settlement end date.

- Statement of scrip-wise net deliveries to be made by the member.
- Statement of scrip-wise net deliveries to be received by the member.
- Balance Sheet showing the net receivable or net payable by the Member.

The Members has to deliver the Securities (otherwise known as Securities pay-in) to the Exchange as per the Statement of scrip-wise net deliveries downloaded by them.

6.3 Settlement of Funds

The Clearing Bank debits the settlement accounts of the members maintained with the bank within 11 a.m. on the last date of settlement period. This appears in the Member's Balance Sheet.

The Clearing Bank credits the settlement accounts of the members maintained with the bank after 3 p.m. on the last date of Settlement period. This appears as net receivable in the Members Balance Sheet.

6.3.1 Informing obligations to Clients and custodians

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

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

- f. The client shall bring any dispute arising from the statement of account or settlement so made to the notice of the broker preferably within 7 working days from the date of receipt of funds/securities or statement, as the case may be.
- g. Such periodic settlement of running account may not be necessary:
 - i. for clients availing margin trading facility as per SEBI circular
 - ii. for funds received from the clients towards collaterals/margin in the form of bank guarantee (BG)/Fixed Deposit receipts (FDR).
- h. The stock broker shall transfer the funds / securities lying in the credit of the client within one working day of the request if the same are lying with him and within three working days from the request if the same are lying with the Clearing Member/Clearing Corporation.
- i. There shall be no inter-client adjustments for the purpose of settlement of the 'running account'.
- j. These conditions shall not apply to institutional clients settling trades through custodians. The existing practice may continue for them.

6.3.2 Margin Payment

The initial and exposure margin is payable upfront by Clearing Members. Initial margins can be paid by members in the form of Cash, Bank Guarantee, Fixed Deposit Receipts and approved securities.

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

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

Non-fulfillment of either whole or part of the margin obligations will be treated as a violation of the Rules, Bye-Laws and Regulations of the clearing agency and will attract penalty.

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

The clearing members and custodians, if required, shall pay to the Clearing Agency the margin moneys payable by them and the Clearing Agency shall release the margin moneys due to the clearing members and custodians based on the information provided by the Exchange or Clearing Agency, as may be specified by the Clearing Agency in the relevant Regulations from time to time.

6.3.3 Settlement dues

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

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

6.4 Settlement of Securities

Securities and Exchange Board of India (SEBI) had specified for settlement only in the dematerialized for most scrips. This is the norm now and almost the entire securities markets transactions happen only in demat mode.

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

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

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

6.4.1 Settlement through the Depository Clearing System

The securities pay in takes place on the T+2 day after the trade date. Members have to deliver the shares by 11.00 a.m. on the pay in date through their depository participant. The securities pay in takes place through both Depositories simultaneously.

The securities pay out takes place on the same date as the securities pay in date i.e. in the T+2 working days after the trade date. The securities pay-out is done simultaneously through both depositories and the process is usually completed by 3 p.m.

6.5. Corporate Actions Adjustment

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

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

6.5.1 Corporate Actions to be adjusted

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

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

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

6.5.2 Time of Adjustment

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

6.5.3 Adjustment

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

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

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

6.5.4 Methodology for adjustment

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

6.5.4.1 Bonus, Stock Splits and Consolidations

Strike Price:

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

Market Lot / Multiplier:

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

Position:

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

Adjustment factor:

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

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

1. Compute value of the position before adjustment
2. Compute value of the position taking into account the exact adjustment factor

3. Carry out rounding off for the Strike Price and Market Lot
4. Compute value of the position based on the revised strike price and market lot

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

6.5.4.2 Dividends

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

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

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

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

6.5.4.3 Mergers

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

After the announcement of the Record Date, no fresh contracts on Futures and Options would be introduced on the underlying, that will cease to exist subsequent to the merger.

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

GTC/GTD orders for the futures & options contracts on the underlying, outstanding at the close of business on the last cum-date would be cancelled by the Exchange.

6.5.4.4 Rights

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

6.6 Auction of Securities

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

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

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

6.6.1 Auction of securities on the BSE

An Auction Tender Notice is issued by BSE to the Members informing them about the names of the scrips short or not delivered, quantity slated for auction and the date and time of the auction session on the BOLT. The auction for the undelivered quantities is conducted on T+3 day between 11:00 a.m. and 12 noon for all the scrips under Compulsory Rolling Settlements except those in "Z" group and scrips on "trade for trade" basis which are directly closed-out. A Member who has failed to deliver the securities of a particular company on the pay-in day is not allowed to offer the same in auction. The Members, who participate in the auction session, can download the Delivery Orders in respect of the auction obligations on the same day, if their offers are accepted. The Members are required

to deliver the shares in the Clearing House on the auction Pay-in day, i.e, T+4. Pay-out of auction shares and funds is also done on the same day, i.e., T+4.

6.6.1.1 Self Auction

The Delivery and Receive Orders are issued by BSE to the Members after netting off their purchase and sell transactions in scrips where netting of purchase and sell positions is permitted. It is likely 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 of his some other buying client in the same scrip 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. To provide shares to the Members in such cases, they have been given an option to submit the details of such internal shortages on floppies on pay-in day for conducting self-auction (i.e., as if they have defaulted in delivery of shares to the Clearing House). These shortages are clubbed with the normal shortages in a settlement arrived at by the Clearing House and the auction is conducted by the Clearing House for the combined shortages.

6.6.2 Auction of Securities on the NSE

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

6.6.3 Close Out of Securities

Close out will be at the highest price prevailing in the exchange from the day of trading till the auction day or 20% above the official closing price on the auction day, whichever is higher.

For all short deliveries in Z group in BSE and trade for trade group in both exchange the trades are compulsorily closed out. During the auction process if there are no bids received from the members then also close out is resorted to.

When the auction seller fails to deliver in part or full on auction pay-in day, the deal will be closed out at the highest price prevailing on the Exchange from the day on which the trade was originally executed till the day of closing out or 20% over the official closing price on the close out day whichever is higher and will be charged to the auction seller unless otherwise specified.

Review Questions

Questions to assess your learning:

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

Ans: (b)

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

Ans: (a)

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

Ans: (b)

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Chapter 7: Investor Grievances and Arbitration

7.1 Introduction

Investors are the backbone of the securities market. Protection of the interests of these investors is of paramount importance for the intermediaries, stock exchanges and the regulators associated with the markets. Though care is taken through regulations and compliance efforts that the investor's rights are protected and they by no means are aggrieved by any intentional or unintentional wrong doing or activities of any participants in the market, there are occasions when the investors have grievances against the intermediary /broking firm through which it deals in the market or against the company for which it is a shareholder. In event of such a grievance, the investor is required to first approach the concerned intermediary /trading firm /company for settling of the grievance. The investor may however not be satisfied with the response. In such a situation, the matter can be brought to the notice of the stock exchange where the broking firm holds its membership or can also be brought to the notice of the market regulator, the SEBI. The Exchange and SEBI also takes up grievances against the various intermediaries registered with it independently and advises the registered trading member to redress the grievance.

7.2 Investor Grievance

In the following sections of this chapter, we would understand the procedures followed in the Indian market for redress of investor grievances. Generally all the trading firms have a designated cell / person dealing with the investor grievances. When a complaint is filed by the investor, care is taken to settle the matter at the branch level or the firm level depending upon the nature of the complaint.

In case the complainant is unsatisfied then the same is taken to the Exchange or the SEBI. The Exchange normally has an Investor Grievance Redress Committee (IGRC) which looks into all the complaints /matters against the trading members registered with the Exchange. The committee is generally manned by a team of professionals possessing relevant experience in the area of securities markets, company and legal affairs and specially trained to identify problems faced by the investor and to find and effect a solution. An issue generally arises, when the complainant puts a claim for the losses incurred by any act of the trading member. In that case, the committee generally tries to seek a consensus or a mid path on hearing both the parties i.e. the complainant and the trading member. Both the parties can also seek to settle the matter outside the purview of the Exchange and then report it to the Exchange. The trading member has to take a *satisfaction letter* from the investor stating that the grievance has been redressed and submit the same to the Exchange. The matter is then supposed to be closed.

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

7.3 Arbitration

Arbitration, which is a quasi judicial process, is an alternate dispute resolution mechanism prescribed under the Arbitration and Conciliation Act, 1996. The Exchanges prescribe the provisions in respect of Arbitration and the procedure therein has been prescribed in the Regulations. Arbitration aims at quicker legal resolution for the disputes. When one of the parties feels that the complaint has not been resolved satisfactorily either by the other party or through the complaint resolution process of the Exchange (IGRC), the parties may choose the route of arbitration.

The Exchanges have a panel of arbitrators that consists of member brokers of the exchange and non-members in the ratio of 40 to 60. Non-members are typically retired judges from High-Courts, Chartered Accountants, Advocates and other Professionals having knowledge related to the Capital Markets.

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

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

Arbitration for claims up to Rs. 25 lakh is decided by a sole arbitrator while a claim of above Rs. 25 lakh is dealt by a panel of 3 arbitrators. The stock exchange has to ensure that the process of appointment of arbitrator(s) is completed within 30 days from the date of receipt of application from the applicant.

After hearing both the parties and after examining all the relevant documents and the submissions given by the parties, the arbitrators close the arbitration reference. Then, the arbitrators give the award. The Award has to be a Speaking Award⁴. Ex-parte Awards are also given. The Final Award is taken on stamp paper of Rs. 100 and arbitrator's signatures

⁴ Speaking awards are those awards which are passed upon hearing both the parties i.e. the complainant and the respondent. This is unlike the Ex-parte award, wherein one party does not attend the proceedings even upon being served the notice and the arbitrators have to pass a decision based on a documents and arguments given by one party.

are obtained on Final Award. The award is forwarded to the applicant as well as Respondent.

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

The arbitration reference shall be concluded by way of issue of an arbitral award within four months from the date of appointment of arbitrator(s). However, the Managing Director/ Executive Director of the stock exchange may for sufficient cause extend the time for issue of arbitral award by not more than two months on a case to case basis after recording the reasons for the same.

Arbitration Fees

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

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

A client, who is a party to the arbitration for a claim /counter claim upto Rs. 10 lakh, is exempt from the deposit provided the arbitration reference for the same is files within six months from the end of the quarter during which the disputed transaction were executed /settled.

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

Appellate Arbitration

A party aggrieved by an arbitral award may appeal to the appellate panel of arbitrators of the stock exchange against such award. An appeal before the appellate panel of arbitrators may be filed within one month from the date of receipt of arbitral award. The appellate panel consists of three arbitrators who are different from the ones who passed the arbitral award appealed against. The stock exchange shall ensure that the process of appointment of appellate panel of arbitrators is completed within 30 days from the date of receipt of application for appellate arbitration. The appeal should be disposed of within three months from the date of appointment of appellate panel of such appeal by way of issue of an appellate arbitral award. The Managing Director/ Executive Director of the stock exchange may for sufficient cause extend the time for issue of appellate arbitral award by not more than two months on a case to case basis after recording the reasons for the same. A party aggrieved by the appellate arbitral award may file an application to the Court of competent jurisdiction in accordance with Section 34 of the Arbitration and Conciliation Act, 1996.

Review Questions

Questions to assess your learning:

1. Who is the backbone of the securities market?

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

Ans: (c)

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

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

Ans: (b)

3. The Exchanges have a panel of arbitrators that consists of member brokers of the exchange and non-members in the ratio of

- (a) 20 member brokers and 80 non members
- (b) 60 member brokers and 40 non members
- (c) 40 member brokers and 60 non members
- (d) 80 member brokers and 20 non members

Ans: (c)

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

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

Ans: (a)

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Chapter 8: Other Services provided by Brokers

8.1 Introduction

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

Typically, big stock brokers have converted themselves to 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 HNIs. They also have branches all over the country and provide services via internet or telephone. Licenses and certifications have to be obtained for each of the services offered by the stockbrokers.

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

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

- Online BSE and NSE executions through terminals
- Investment advice
- Research reports and market review
- Personalised Advice
- Live Market Information
- Depository Services
- Derivatives Trading
- Commodities Trading
- IPOs & Mutual Funds Distribution
- Internet-based Online Trading
- Specialised Research For Investors
- Margin Funding

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

8.2 IPO Applications

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

The Book Running Lead Manager⁵ will give the list of trading members who are eligible to participate in the Book Building process to the Exchange. Eligible trading members as per the prescribed format have to give the details of the user IDs they would use for the purpose of book building to the Exchange. Once this is approved by the exchanges, the stock broker is eligible to accept applications for IPOs and submit them through his terminals online.

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 have introduced a facility called **“Application Supported by Blocked Amount (ASBA)”** in the Primary market for investor. ASBA provides an alternative mode of payment in issues whereby the application money remains in the investor’s account till finalization of basis of allotment in the issue, or in other words, if an investor is applying through ASBA, his application money is debited from the bank account only if the investors application is selected for allotment after the basis of allotment is finalized, or the issue is withdrawn/failed.

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

⁵ 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.

once basis of allotment is finalized and transfer the amount for allotted shares, to the issuer.

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

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

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

8.3 Trading of Mutual Fund Units

The client can invest in different mutual fund schemes online or through phone, availing of the tele-services offered by the trading members. The trading members who are AMFI Registration Number (ARN) holders and have passed the AMFI 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. 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 Exchange and comply with the various SEBI and Exchange regulations as notified from time to time. The NSE and BSE have the following designated trading platforms for Mutual Fund viz., the Mutual Funds Service System (MFSS) and the BSE Star MF respectively.

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

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

The stock broker shall not be allowed to place an order for the client if registration details of the client are not maintained. The user can modify/ delete client registration already maintained subject to certain restrictions. A bulk upload facility is also available to set up client registration.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Risk Management

- The corporate manager⁶ can set the limit on the total value of orders that can be entered by the specific branch within the trading member's firm by specifying the branch order value limit.
- The corporate manager or branch manager⁷ can set the day limit on the total value of the orders that can be entered by the specific user within the trading member's firm by specifying the user order value limit.

⁶ The **Corporate Manager** of the stock broker is the user placed at the highest level. Such a user can perform all offer-related activities and receive the reports for all branches of the trading member. Additionally, the Corporate Manager can define the offer value limits for the branches and individual dealers of his firm. The Corporate Manager can modify his own offer or offers of all dealers and branch managers of his trading member firm.

⁷ The **Branch Manager** is the user who is placed under the Corporate Manager. Such user can perform and view Bid related activities for all dealers under that branch. The Branch Manager can modify his own offer or offers of any dealer under his branch.

- The dealer⁸ can set quantity / amount limits for individual orders entered by self by specifying the order limit.

Settlement Procedure

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

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

▪ **Subscription –Physical Mode:**

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

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

The trading member/broker after verifying the application of the investor for the mandatory details which includes PAN details and KYC compliant acknowledgment shall enter the subscription order in the trading system of the Exchange with the option of physical settlement. For physical order the folio no. is also captured at the front end of the system. Once the order is created, the system generates a unique confirmation no. for the order. The investor then receives from the trading member / brokers a confirmation slip. This slip serves as a proof of transaction till the time the investor receives the allotment details from the trading member /broker. In addition to this, the investor also receives a statement of account from the RTA directly. The brokers /trading member's needs to submit the physical documents super scribing it with the unique confirmation number to the RTA or AMC offices. In case of any discrepancy, the Exchange informs the trading members along. The clearing corporation provides the participants with funds obligation report end of the day for all valid transactions.

T+ 1 Day Activities: The Clearing Corporation of the Exchange shall debit the designated clearing bank account of the broker /trading member for the required funds obligation on T+1 morning. In case of any shortage the concerned trading member / broker will be pro-

⁸ **Dealers** are users at the lower most level of hierarchy. A Dealer can perform and view offer related activities and information only for oneself and does not have access to information on other dealers under either, the same branch or other branches. A Dealer can modify only the Offers entered by him. Additionally, Syndicate members can view, modify and cancel bids placed by other members.

vided an opportunity to identify transactions and provide details of the transactions for which payments have been received and transactions for which payment have not been received.

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

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

▪ **Redemption –Physical Mode:**

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

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

▪ **Subscription – Depository Mode:**

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

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

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

T + 1Day Activities: The Clearing Corporation of the Exchange shall debit the designated clearing bank account of the trading members / brokers for the required funds obligation on T+1 morning. In case of shortage if any, the concerned trading member /broker will be provided an opportunity to identify transactions and provide details of the transactions for which payments have been received and transactions for which payment have not been received. The funds collected from the bank account of the trading member /broker shall be compared with the details provided by the trading member /broker on the payment received status as per above. If the funds collected from the bank account of the trading member /broker covers the details of the payments received as provided by the trading member /broker, the same shall be further processed. Wherever the funds collected from the bank account falls short of the amount indicated in the details provided by the trading member /broker, the details shall be considered defective and shall not be further processed. In such cases, the funds collected, if any, shall be returned to the designated bank account of the trading member /broker.

The Exchange will notify RTA for all such defective transactions and rejections due to non payment of funds. The RTA will reverse such transactions for respective trading member /broker and transactions for other trading member /broker who have fulfilled their funds

obligations will be processed by the RTA. The RTA will intimate the allotment details for the accepted transactions.

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

▪ **Redemption –Depository Mode:**

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

8.4 Portfolio Management Service

Many stock brokers also offer Portfolio Management Services (PMS) to their clients. For this, a PMS license has to be obtained by them. This is normally offered to High Networth Individuals (HNIs). Here 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 new stocks replacing existing stocks as and when required to optimize performance.

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

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

Portfolio manager can be discretionary or non-discretionary. The discretionary portfolio manager individually and independently manages the funds of each client in accordance

with the needs of the client in a manner which does not partake character of a Mutual Fund, whereas the non-discretionary portfolio manager manages the funds in accordance with the directions of the client.

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

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

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

The principal officer of the portfolio manager is to have:

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

OR

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

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

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

The SEBI (Portfolio Managers) Regulations, 1993, have not prescribed any scale of fee to be charged by the portfolio manager to its clients. However, the regulations provide that the portfolio manager shall charge a fee as per the agreement with the client for rendering portfolio management services. The fee so charged may be a fixed amount or a return based fee or a combination of both. The portfolio manager shall take specific prior permis-

sion from the client for charging such fees for each activity for which service is rendered by the portfolio manager directly or indirectly (where such service is outsourced),

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

The portfolio manager provides to the client the Disclosure Document. The Disclosure Document, inter alia, contains 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 outsourced), portfolio risks, complete disclosures in respect of transactions with related parties as per the accounting standards specified by the Institute of Chartered Accountants of India in this regard, the performance of the portfolio manager and the audited financial statements of the portfolio manager for the immediately preceding three years.

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

8.5 Research Reports

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

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

Research reports normally educate investors about 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. And now, these advice and recommendations can be obtained as SMS on to the mobile phone. So it is more online now.

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

8.6 Depository Services

The brokers also provide depository services to investors amongst other services. To provide these services, the broker or the trading member has to get registered as a depository participant of a depository as per the SEBI Act 1992 and the Depositories Act of 1996. The relationship between the DPs and the depositories is governed by an agreement made between the two under the Depositories Act. The form of the agreement is specified in the Bye-Laws of the depository. Under the Depositories Act, 1996, a DP is described as an agent of the depository. The SEBI (Depository & Participants) Regulations, 1996 and the Bye-Laws of depositories prescribe the eligibility criteria to become a DP.

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

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

8.7 Margin Trading

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

Corporate brokers with net worth of at least Rs.3 crore are eligible for providing Margin trading facility to their clients subject to their entering into an agreement to that effect. Before providing margin trading facility to a client, the member and the client have been mandated to sign an agreement for this purpose in the format specified by SEBI. It has

also been specified that the client shall not avail the facility from more than one broker at any time.

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

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

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

Initial margin has been prescribed as 50% and the maintenance margin has been prescribed as 40%.

8.7.1 Functions and importance of the margin department

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

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

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

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

Initial margin has been prescribed as 50% and the maintenance margin has been prescribed as 40%.

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

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

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

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

Review Questions

Questions to assess your learning:

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

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

Ans: (b)

2. ASBA is the acronym for_____.

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

Ans: (a)

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

- (a) scheme name
- (b) depository settlement
- (c) symbol and series
- (d) all of the above

Ans: (d)

4. What is the non-refundable application fee to be paid to SEBI for registration or renewal of as a portfolio manager?

- (a) Rupees fifty thousand
- (b) Rupees seventy five thousand
- (c) Rupees one lakh
- (d) Rupees one lakh twenty five thousand

Ans: (a)

ANNEXURES

ANNEXURE I – CONTRACT NOTE

BUY CONTRACT / TAX INVOICE

Brokers Logo and Name

Brokers Name and Address Details

Your Name and Address Details

Security: _____ Company: _____ Companies Name

Contract Date: Settlement Date: Contract Note No.: Account No.: Advisor:	<table border="1"> <thead> <tr> <th>Quantity</th> <th>Price</th> <th>Consideration</th> </tr> </thead> <tbody> <tr> <td>Quantity of Shares Ordered</td> <td>Price shares obtained at</td> <td>Total Consideration due (Quantity x Price)</td> </tr> <tr> <td colspan="2"> Brokerage Stamp duty GST on Brokerage Total GST Payable </td> <td>Associated Brokerage & GST fees</td> </tr> <tr> <td colspan="2">Amount due and payable</td> <td>Total Due –</td> </tr> </tbody> </table>	Quantity	Price	Consideration	Quantity of Shares Ordered	Price shares obtained at	Total Consideration due (Quantity x Price)	Brokerage Stamp duty GST on Brokerage Total GST Payable		Associated Brokerage & GST fees	Amount due and payable		Total Due –
Quantity	Price	Consideration											
Quantity of Shares Ordered	Price shares obtained at	Total Consideration due (Quantity x Price)											
Brokerage Stamp duty GST on Brokerage Total GST Payable		Associated Brokerage & GST fees											
Amount due and payable		Total Due –											

Contract details including order date (contract date), Settlement Date, Contract Number, Your Account Number and your Advisor Details

Order Status (i.e. Completed)

If payment for this contract is not received by the settlement date penalty charges will be applied - see reverse.

This contract note is issued subject to the terms and conditions set out overleaf.
 You will be deemed to have accepted and ratified the contents of this contract note unless an objection is raised within 48 hours of receipt.
 Please retain portion for your records.

T + 3 indicates payment must have occurred 3 days after transaction was processed

Payment must be received by 2.30pm T+3 in our

Payment details if they have not already occurred

PLEASE DISREGARD IF YOU HAVE A CASH ACCOUNT OR HAVE ALREADY PAID

Current Registration details Your Name and Address Details	Please indicate your method of payment: <input type="radio"/> BPAY * <input type="radio"/> Cheque attached - Please make cheque payable to: (cash or credit cards not accepted) Biller Code: _____ Ref: _____ Broker methods of payment
---------------------------------------------------------------	--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------

Account No.: _____ Contract No.: _____ Advisor: _____
 Contract Date: _____ Settlement Date: _____ Amount: _____
 Quantity: _____ *Share Number _____
 Security: _____

Summary details reprinted for broker if payment has not occurred

Source TD Waterhouse

ANNEXURE II - ACCOUNT OPENING FORM

FORM-I

[NAME OF THE BROKER]

Member, _____ Stock Exchange
(Address of Head Office and concerned Branch Office)

Broker Registration No. _____

ACCOUNT OPENING FORM

NOTE 1: EACH AND EVERY COLUMN MUST BE FILLED IN
NOTE 2: EACH PAGE OF THIS FORM WILL BE DULY SIGNED BY THE ACCOUNT HOLDER(S) AND THE BROKER

NATURE OF ACCOUNT:			
SINGLE: <input type="checkbox"/>	JOINT: <input type="checkbox"/>	CLIENT ID / ACCOUNT NO.	
COMPANY: <input type="checkbox"/>	FIRM: <input type="checkbox"/>	CDC ACCOUNT NO.	

<u>ACCOUNT HOLDER</u>	<u>JOINT ACCOUNT HOLDER</u>
ACCOUNT TITLE/NAME: _____ ADDRESS: _____	ACCOUNT TITLE/NAME: _____ ADDRESS: _____
TEL: _____ E-MAIL: _____ FAX NO: _____ PERMANENT/REGISTERED ADDRESS: _____	TEL: _____ E-MAIL: _____ FAX NO: _____ PERMANENT ADDRESS: _____
<u>For individuals only:</u>	
DATE OF BIRTH: _____ NATIONALITY: _____ STATUS: _____ RESIDENT _____ NON-RESIDENT GENDER: _____ MALE _____ FEMALE FATHER'S/HUSBAND'S NAME: _____ NATIONAL IDENTITY CARD NO. (IN CASE OF NON RESIDENT PASSPORT NO.) _____	DATE OF BIRTH: _____ NATIONALITY: _____ STATUS: _____ RESIDENT _____ NON-RESIDENT GENDER: _____ MALE _____ FEMALE FATHER'S/HUSBAND'S NAME: _____ NATIONAL IDENTITY CARD NO. (IN CASE OF NON RESIDENT PASSPORT NO.) _____
OCCUPATION: _____	OCCUPATION: _____
<u>For Companies or Firms only:</u>	
Company Registration No. _____	
STATUS: _____ RESIDENT _____ NON-RESIDENT	

Declaration of Solvency

The Account Holder hereby declares that:

- a) It has not applied to be adjudicated as an insolvent and that it has not suspended payment and that we have not compounded with our creditors;
- b) It is not un-discharged insolvent; and
- c) It has not been declared defaulter in repayment of loan of a bank/financial institutions.

Name of Authorized Persons to operate the account

The account shall be operated by the following:

	<u>Names</u>	<u>Specimen Signature</u>	<u>Singly/Jointly</u>
(a)	_____	_____	_____
(b)	_____	_____	_____
(c)	_____	_____	_____

The authority of the person(s) authorized to operate the account will be clearly spelled out in the letter of authorization from the Account Holder.

MARGIN DEPOSIT

The Account Holder(s) hereby undertakes to deposit and maintain ____ % margin against his/her/their outstanding trades/exposure for the purpose of trading in his/her/their account. The broker shall notify the Account Holder(s) about any change in the above margin requirements for the already executed trades at least 3 days prior to the implementation of the revised margin requirements.

CLIENT BANK DETAILS (OPTIONAL):

ACCOUNT(S) WITH OTHER BROKER(S) (OPTIONAL)

NAME OF THE BANK: _____
 SAVINGS/CURRENT A/C NO.: _____
 BRANCH ADDRESS: _____

NAME OF THE BROKER(S)	MEMBER EXCHANGE	CLIENT ID/ ACCOUNT

NOMINATION:

(In the event of death of the Account Holder, the nominee shall be entitled to receive securities / cash available in the account of the account holder after set-off against losses/liabilities in the account.)

Name of Nominee: _____ Surname: _____
 NIC Number: _____
 Date of Birth: _____ (DD/MM/YYYY)
 Postal Address: _____
 Tel: _____ E-mail: _____

SPECIAL TERMS AND CONDITIONS

The terms and conditions set herein below shall be equally binding on the Broker and the Account Holder(s).

- All transactions between the parties shall be subject to the Articles, Rules and Regulations of the Exchange, revised policies, Board Directions and new regulations to be framed in pursuance of Section 34 of the Securities & Exchange Ordinance, 1969. Moreover, all applicable provisions of the Securities & Exchange Ordinance, 1969 read with the Securities & Exchange Commission of Pakistan Act, 1997, Brokers and Agents Registration Rules, 2001, Securities and Exchange Rules 1971 and all directions/directives passed from time to time to regulate the trades between the parties and to regulate Brokers conduct and the Central Depository Companies of Pakistan Act, 1997, Rules framed there under and the National Clearing and Settlement System Regulations and any other law for the time being in force. The Broker shall ensure provisions of copies of all the above Laws, Rules and Regulations at his office for access to the Account Holder(s) during working hours.
- (a) In case any dispute in connection with the trade or transaction between the Broker and the Account Holder is not settled amicably, either party may refer the same to arbitration in accordance with the provisions of General Regulations of the Exchange, which shall be binding on both the parties. The Account Holder hereby agrees that he would have no objection if his name and other relevant particulars are placed on Exchange's database accessible by members of the Exchange if he fails or refuses to abide by or carryout any arbitration award passed against him in his dispute with the Broker.

2. The amount deposited as security margin by the Account Holder(s) with the Broker shall only be used for the purposes of dealing in securities, such as trading and/or settlement of deliveries of securities on behalf of the Account Holder(s). The Broker shall not use such amounts for his own use.
- 2(a). The credit amount of the Account Holder(s) shall be kept by the broker in a separate bank account titled "Account Holder / Client Account" and shall not be used by the broker for his own business.
3. The Broker shall be authorized to act on the verbal instructions of the Account Holder(s). The Broker shall provide a written confirmation of the executed transactions as required under rule 4(4) of the Securities & Exchange Rules, 1971, and all such transactions recorded by the Broker in his books shall be conclusive and binding upon the Account Holder(s), which shall not be questioned by him/her/them, subject to clause 5 below.

Or

The Account Holder(s) shall give written instructions for the sale/purchase of securities to the Broker. The Account Holder(s) shall not give any verbal/oral instructions. The Broker shall provide a written confirmation of the executed transactions as required under rule 4(4) of the Securities & Exchange Rules, 1971, and all such transactions recorded by the Broker in his books shall be conclusive and binding upon the Account Holder(s), which shall not be questioned by him/her/them, subject to clause 5 below.

4. The Broker shall provide the confirmation of the executed transactions to the _____ (Name of Account Holder) at the above stated address by means of acceptable mode of communication or by hand subject to acknowledgment receipt as noted in clause 16.
5. In case there are any error(s) in the daily confirmation statement, the Account Holder(s) shall report the same to the Broker within one-business day of the receipt of confirmation. In case the Account Holder(s) do not respond within one business day of the receipt of the said daily confirmation statement, the confirmation statement shall be deemed conclusively accepted by the Account Holder(s).
6. In the event that the Account Holder(s) fail(s) to deposit additional cash or securities as margin within one business day of the margin call (in writing), the Broker shall have absolute discretion to and, without further notice to Account Holder(s), liquidate the Account Holder(s) outstanding positions, including the securities purchased and carried in such account, so that the margin is maintained at the required level.
7. The Broker shall be responsible to ensure delivery of CDC eligible securities in the CDC account of the Account Holder(s) subject to full payment by the Account Holder(s). In case of companies which are not on the CDS, the Broker shall ensure delivery of physical shares along with verified transfer deeds against payments, to the Account Holder(s). Further, the Broker shall be responsible for the payment of any credit cash balance available in the account of the Account Holder preferably in form of A/c Payee cross cheque only within 1 business day of the request of the Account Holder(s) (subject to the maintenance of the margin requirements).
8. The Broker shall encourage the Account Holder(s) to make payments to the Broker by "A/c Payee Only" cross cheque (in case of amounts in excess of Rs. 50,000/-) and "A/c Payee only" cheque or cash (for amounts below Rs. 50,000). The Broker shall be responsible to provide the receipt to the Account Holder(s) in the name of the Account Holder(s) duly signed by authorized agents/employee of the Broker and the Account Holder(s) shall be responsible to obtain the receipt thereof. In case of cash dealings, proper receipt will be taken and given to the Account Holder(s), specifically mentioning if payment is for margin or the purchase of securities. The broker shall immediately deposit in its bank account all cash received in whole i.e. no payments shall be made from the cash received from clients.
9. The members shall make all the payments of Rs. 25,000/- and above, through crossed cheques / bank drafts / pay orders or any other crossed banking instruments showing payment of amount from their business bank account. Copies of these payment instruments including cheques, pay orders, demand drafts and online instructions shall be kept in record for a minimum period of five years.

10. The Account Holder(s) shall have a right to obtain a copy of his/her or their ledger statement under official seal and signature of the Broker or his authorized representative on a periodic basis. In case of any discrepancy in the ledger statement, the Account Holder(s) shall inform the Broker within 1 day of receipt of the ledger statement to remove such discrepancy.
11. The Account Holder(s) shall operate the account and execute transactions himself/herself/themselves unless the Account Holder(s) authorize Mr./Ms./ _____ I. D. No. _____ to transact in the account. All transactions executed by the authorized person shall be binding upon the Account Holder(s).
12. For Joint Account Holder(s) only:
 We, the Account Holders shall operate the account jointly or severally and the instructions issued either jointly or severally shall be binding on us as well as upon the broker in respect of the joint titled account.

Or

 Our titled account shall be operated only by _____ who shall be deemed as the authorized person for operating the joint account or issuing any instructions relating thereto.
13. The Broker shall be responsible to append a list of his authorized agents/traders and designated employees, who can deal with the Account Holder(s), with this account opening form and a copy of both the opening form and the list will be provided to the Account Holder(s). Any change therein shall be intimated in writing to the Account Holder(s) with immediate effect.
14. The Broker shall debit the account of the Account Holder(s) for the commission charges or any other charges in connection with the brokerage services rendered, which shall be clearly detailed in the ledger statement/daily confirmations.
15. The Broker shall not disclose the information of the transactions of the Account Holders to any third party and shall maintain the confidentiality of this information. However, in case the Exchange or the Commission, as the case may be, requires any such information, the Broker shall be obliged to disclose the same for which the Account Holder(s) shall not raise any objection whatsoever.
16. In case a Broker converts his individual membership rights to corporate membership and vice versa the agreement and conditions laid down herein above shall remain effective unless otherwise agreed by the parties.
17. Acceptable mode of communication between the Account Holder(s) and the Broker shall be through letter (courier/registered post/fax/E-mail) or by hand subject to receipt/acknowledgment. The onus of proving that the e-mail has been received by the recipient shall be on the sender sending the e-mail. Confirmation of orders to clients made through fax or e-mail will have a time record.
18. All orders received telephonically and placed on KATS shall be supported by recording on dedicated telephonic lines, preferably connected with a computerized taping system so as the orders could possibly be sorted on UIN basis and made user friendly.
19. In case of change of address or contact numbers of either party, the concerned party shall immediately notify the other party of the changes in writing.
20. I/We, the Account Holder(s) acknowledge receipt of this account opening form (signed here by me/us in duplicate) along with the copies of all the annexures and I/we, the Account Holder(s) also undertake that I/we have understood all the above terms and conditions of this agreement which are acceptable to me/us.
21. I/We, the Account Holder(s) understand that the shares trading business carries risk and subject to the due diligence on part of the broker I/we may incur losses for which I/we, the Account Holder(s) shall not hold the Broker responsible.
22. I/We, the Account Holder(s) further confirm that all information given in this application is true and complete and hereby authorize the Broker to verify any information mentioned above.

Signature of Broker

Signature of Account Holder

Signature of Joint Account Holder

WITNESSES: 1. _____ (I. D. Card No. _____)
 2. _____ (I. D. Card No. _____)

ANNEXURE III A – KYC FORM FOR INDIVIDUALS

Know Your Client (KYC) Application Form
(For Individuals Only)

Application No. : _____

Please fill this form in ENGLISH and in BLOCK LETTERS (All information as applicable in Sections A, B and C below is mandatory). This information is sought under the Prevention of Money Laundering Act, 2002, the rules notified thereunder and SEBI's guidelines on Anti Money Laundering. For existing Mutual Fund Investors, the address(es) furnished herein will be replaced in the records of the Mutual Fund / Authorised Agent. (Refer Notes / Guidelines overleaf)

A. Identity Details (Please see guidelines A1 to A5 overleaf)

1. Name of Applicant (As appearing in supporting identification document) Title Mr. Ms. Others (Please specify) _____ Gender Male Female

Name _____

Father's Name _____

2. Date of Birth / /

3. Nationality Indian Others (Please specify) _____

4. Status Please tick (✓) Resident Individual Non-Resident

5. Permanent Account Number (PAN) (MANDATORY) _____

Please tick (✓) Copy of PAN Card attached

Please affix most recent colour photograph
30mm x 40 mm
Sign across the photograph

B. Address Details (Please see guidelines B1 to B4 overleaf)

1. Address for Correspondence _____

City / Town / Village _____ Postal Code _____

State _____ Country _____

2. Contact Details

Tel. (Off.) (ISD) (STD) _____ Tel. (Res.) (ISD) (STD) _____

Mobile (ISD) (STD) _____ Fax (ISD) (STD) _____

E-Mail Id. _____

3. Proof of address to be provided by Applicant. Please submit ANY ONE of the following valid documents & tick (✓) against the document attached.

Latest Telephone Bill Latest Electricity Bill Passport Driving License Latest Bank Passbook Latest Bank Account Statement

Latest Demat Account statement Voter Identity Card Ration Card Registered Lease / Sale Agreement of residence Any other proof of address document (as listed overleaf)

4. Permanent Address of Resident Applicant if different from B1 above OR Overseas Address (Mandatory) for Non-Resident Applicant

City / Town / Village _____ Postal Code _____

State _____ Country _____

5. Proof of address to be provided by Applicant. Please submit ANY ONE of the following valid documents & tick (✓) against the document attached.

Latest Telephone Bill Latest Electricity Bill Passport Driving License Latest Bank Passbook Latest Bank Account Statement

Latest Demat Account statement Voter Identity Card Ration Card Registered Lease / Sale Agreement of residence For NRIs - Any other document attested by local authority.

C. Other Details (Please see guidelines C1 and C2 overleaf)

1. Gross Annual Income Details Please tick (✓)

Upto Rs. 5,00,000 Rs. 5,00,001 to Rs. 25,00,000 Rs. 25,00,001 to Rs. 1,00,00,000 Rs. 1,00,00,001 to Rs. 5,00,00,000 Rs. 5,00,00,001 and above.

2. a. Occupation Details Please tick (✓) any one

Private Sector Service Public Sector / Government Service Business Professional Agriculturist Retired Housewife

Student Forex Dealer Others (Please specify) _____

b. If the following is additionally applicable to you Please tick (✓) one or more as applicable

Civil Servant Bureaucrat Current or Former MP, MLA or MLC Politician Current or Former Head of State

DECLARATION

I hereby confirm that I have read and understood the instructions mentioned overleaf and apply to COSL Ventures Limited (CVL) or other agent of the mutual fund registered under the SEBI (Mutual Funds) Regulations, 1996 for compliance of Know Your Client (KYC) procedure for transacting in units issued by Mutual Funds and I agree to abide by the terms, conditions, rules, regulations and other statutory requirements applicable to the respective Mutual Funds. I hereby declare that the particulars given herein are true, correct and complete to the best of my knowledge and belief, the documents submitted along with this application are genuine and I am not making this application for the purpose of contravention of any Act, Rule, Regulations or any statute or legislation or any Notifications, Directions issued by any governmental or statutory authority from time to time. I hereby undertake to promptly inform CVL, the mutual fund agent of any changes to the information provided hereinabove and agree to accept that CVL, the respective Mutual Funds, their authorised agents and representatives (the Authorised Parties) are not liable or responsible for any losses, costs, damages arising out of any actions undertaken or activities performed by them on the basis of the information provided by me as also due to my not informing / delay in informing such changes. I hereby authorise CVL, the mutual fund agent to disclose, disseminate in any form, mode or manner, all / any of the information provided by me to the respective Mutual Funds in which I may transact / have transacted and / or to their authorised agents and representatives including all changes, updates to such information as and when provided by me. I hereby agree to provide any additional information / documentation that may be required by the Authorised Parties, in connection with this application. I hereby confirm that this is a unique KYC application and I have not applied for KYC in the past.

SIGNATURE OF APPLICANT

Place : _____

Date : _____

For Office Use Only

Stamp of PCS and Receiver's Signature

Name and mobile number of Receiver

(Originals Verified) Self-Certified Document copies received

(Attested) True copies of documents received

KYC Ref. _____

Please note that the KYC Application Form and overleaf instructions should be printed on the same page (back to back), if printed separately then both the pages should be attached and signed by the applicant.

INDIVIDUAL KYC FORM

IMPORTANT NOTES - PLEASE READ BEFORE FILLING UP THE FORM

- This Application Form is meant to enable a person to comply with the client identification programme laid down by the Revision of Money Laundering Act, 2002 (RMLA) hereinafter referred to as Know Your Client (KYC) requirements. It is for use by INDIVIDUALS only. A separate form is provided for non-individual entities such as Hindu Undivided Family (HUF), Corporates, Trusts, Societies, etc.
- This form is not an Investment Application Form, and is only meant for providing information and documents required for KYC compliance. Applicant must be KYC compliant while investing with any SEBI registered Mutual Fund which has submitted to the services of CDSL, Venkates Limited (CVL) for compliance of the KYC procedure. A list of Mutual Funds is available on the website of AMR at www.amrindia.com.
- Subscription to Mutual Fund Units may be made only after obtaining the KYC Acknowledgement at their respective designated Points of Acceptance / Investor Service Centres.
- Each Unitholders / Investors must attach their KYC Acknowledgement along with the Investment Application Form(s) / Transaction Slip(s) while investing for the first time in every folio. Applications Form(s) / Transaction Slip(s) not accompanied by KYC Acknowledgement are liable to be rejected by the Mutual Funds.
- Joint Holders: Joint holders need to be individually KYC compliant before they can invest with any Mutual Fund, e.g. in case of three joint holders, all holders need to be KYC compliant and copies of each holder's KYC Acknowledgement must be attached to the investment application form with any Mutual Fund.
- Minor: In case of investments in respect of a Minor, the Guardian should be KYC compliant and attach their KYC Acknowledgement while investing in the name of the minor. The Minor, upon attaining majority, should immediately apply for KYC compliance in his/her own capacity and intimate the concerned Mutual Fund(s), in order to be able to transact further in his/her own capacity.
- Power of Attorney (PoA) Holder: Investors desirous of investing through a PoA must note that the KYC compliance requirements are mandatory for both the PoA issuer (i.e. Investor) and the Attorney (i.e. the holder of PoA), both of whom should be KYC compliant in their independent capacity and attach their respective KYC Acknowledgements while investing.
- If an individual becomes a Mutual Fund investor due to an operation of law, e.g., transmission of units upon death of an investor, the claimant / person(s) entering the Register of Unitholders of the Mutual Fund(s) will be required to be KYC compliant before such transfer can take place.
- The KYC process requires investors to provide their Proof of Identity (PAN card copy only) and Proof of Address (any valid documents listed in section B of the KYC Application Form) to comply with KYC requirements. Mutual Funds reserve the right to seek any additional information / documentation in terms of the RMLA at any point of time.
- Mutual Funds/ CVL will not be liable for any errors or omissions on the part of the applicant / Unit holder in the KYC Application Form. Documents received in support of KYC requirements will be verified at the designated 'Points of Service' (PoS), on a best effort basis. However acceptance and processing of the KYC Application Form is subject to independent verification by CVL. In the event of any KYC Application Form being rejected for lack of information / deficiency / insufficiency of mandatory documentation, etc., CVL will inform the applicant of such rejection.
- The Mutual Fund, its Asset Management Company (AMC), Trustee Company and their Directors, employees and agents shall not be liable in any manner for any claims arising whatsoever on account of freezing the folios / rejection of any application / non-allocation of units or mandatory redemption of units / refund due to non-compliance with the provisions of the RMLA, SEBI guidelines or where the AMC / Mutual Fund believes that transaction(s) by an applicant / investors is / are suspicious in nature within the purview of the RMLA and SEBI guidelines and requires reporting the same to Financial Intelligence Unit - India (FI-IND).
- Once the investor is KYC compliant, he will be required to intimate his/her KYC details to all the Mutual Funds with whom he/she has investments. The KYC Compliance will be deemed to have been completed for the investor in all folios held by him/her (identified by his/her PAN) in the records of the Mutual Fund.

GUIDELINES FOR FILLING UP THE KYC APPLICATION FORM

- General**
- The Application Form should be completed in ENGLISH and in BLOCK LETTERS.
 - Re-use tick in the appropriate box wherever applicable.
 - Re-use fill the form in legible handwriting so as to avoid errors in your application processing. Re-use do not overwrite. Corrections should be made by canceling and re-writing, and such corrections should be counter-signed by the applicant.
 - Applications incomplete in any respect and/or not accompanied by required documents are liable to be rejected.
 - Applications complete in all respects and carrying necessary documentary attachments should be submitted at the designated PoS. A complete list of PoS is available on the website of AMR at www.amrindia.com, www.cdslindia.com and Mutual Fund websites.
 - You are required to submit a Proof-of-Identity document (PAN card) is the only document which can be submitted) and a Proof-of-Address document for each address filed by you in this form. Documents submitted to support Identity and Address should be:
 - Proof of Identity
 - Original PAN Card + Self-attested photocopies (Originals will be returned over-the-counter after verification)
 - Proof of Address
 - Original Documents + Self-attested photocopies (Originals will be returned over-the-counter after verification) OR
 - True Copies attested by a Notary Public / Gazetted Officer / Manager of a Scheduled Commercial Bank or Multinational Foreign Banks (Name, Designation and Seal should be affixed on the copy). Un-attested photocopies of an original document are not acceptable.
 - If the above documents including attestation / certifications are in regional language or foreign language then the same has to be translated into English for submission.
- A. Identity Details**
- Name : Re-use state your name as Title (Mr / Mrs / Ms / Dr / Commander / etc.), First, Middle and Last Name in the space provided. This should match with the name as mentioned in the PAN card. Failing which the application is liable to be rejected. If the PAN card has a name by which the applicant has been known differently in the past, that the one provided in this application form, then requisite proof should be provided e.g. marriage certificate, or gazetted copy of name change.
 - Date of Birth: Re-use ensure that this matches with the Date of Birth as indicated in the PAN card.
 - Nationality: Foreign Nationals are not allowed to apply, unless they are Non-Resident Indians (NRIs) or Persons of Indian Origin (PIO).
 - Status : Re-use tick your current residential status.
 - PAN : PAN is mandatory to be KYC compliant. Re-use read instruction given in (6) above carefully. Re-use affix most recent colour photograph and sign across the photograph.
- B. Address Details**
- Address for Communication : Re-use provide here the address where you wish to receive all communications sent by the Mutual Funds with whom you invest. The address you give here will supersede existing information in the records of the Mutual Fund / Registrars and Transfer Agent to the Mutual Fund. This address should match with the address in the 'Proof-of-Address' submitted as supporting document; otherwise the KYC Application Form is liable to be rejected.
 - Contact Details: Re-use provide your Telephone / Email contact details. The contact details given by you here will not supersede existing information in the records of the Mutual Fund / Registrars and Transfer Agent to the Mutual Fund. You will have to independently communicate the same to them in case of any change(s).
- 3. Proof of Address Documents :** Re-use note that each of the two addresses mentioned by you will need to be supported by a 'Proof-of-Address' bearing your or your spouse's / parent's (documents to establish relationship also to be submitted) name as supporting documents. Re-use tick the box as applicable, for the document provided by you. You may attach any one of the following documents (Any document having an expiry date should be valid on the date of submission):
- Latest* Telephone Bill + Latest* Electricity Bill + Passport + Driving License + Latest* Bank Passbook + Latest* Bank Account Statement + Voter Identity Card + Ration Card + Latest* Demand Account Statement + Registered Lease / Site Agreement of residence + Proof of Address issued by Bank Managers of Scheduled Commercial Banks / Multinational Foreign Banks / Gazetted Officer/ Notary Public / Elected Representatives to the Legislative Assembly / Parliament / Document issued by any Government or Statutory Authority
- * These documents should not be more than three months old as on the date of submission of this form.
- 4. Permanent Address/ Overseas Address:** If you are a Resident Indian, and your Permanent address is different from the one mentioned in the Address for Correspondence, please state it here. If you are a Non-Resident Indian or a Person of Indian Origin, it is mandatory for you to state your Overseas Address here.
- C. Other details**
- Gross Annual Income details: Re-use tick the applicable box indicating your Gross Annual Income (including both taxable and tax-free income).
 - Occupation details: Re-use indicate your current occupation by ticking the one most applicable to you. You are required to fill up the next section, if it additionally applies to you.
- After you have completed filling up the KYC Application Form, please submit the same along with the entire set of supporting documents to any designated PoS. Please also submit it a photocopy of the Form to acknowledge purpose, which you can retain for your records.
- Other important notes, after the KYC Acknowledgement is issued to you:**
- Re-use preserve the document Form CVL, which confirms your KYC compliance. You will need to attach photocopies of this document when you invest for the first time in every folio, in any Mutual Fund.
 - If you observe any error in the details captured by CVL, you are requested to approach your nearest designated PoS.
 - If you are already holding investments in any Mutual Funds, please provide a copy of your KYC acknowledgement, giving details of your folio / account numbers to such Funds or their Registrars. Re-use note that your signature on the KYC Application Form should match with that on the records of the Mutual Funds.
 - In respect of new investors, signature on the Application Form for investing / transacting in Mutual Fund should match with that on this KYC Application Form.
 - After allotment of KYC compliance, if there are any changes in an Applicant's details such as Name, Address, Status, Income bracket, Occupation or Signature, the change should be registered with CVL through a designated PoS expeditiously, by using the KYC Details Change form. It should be noted that only after such registration will the change be reflected in the Mutual Fund's records. Particularly with respect to change of address, investors should register such change giving 10 days time for the subsequent communications from Mutual Funds to reach them at their new address. Original / Attested copies of documents supporting the change will be required to be submitted together with the KYC Details Change Form. For any other investment related information or changes thereto, the applicant should approach the Mutual Funds or their Registrars.

CHECKLIST
(Before submitting this form, please go through the following checklist)

- Re-use ensure that the form is completed in all respects and signed by you.
- Re-use affix your recent photograph and sign across the photograph.
- Re-use attach a your PAN card as proof of Identity Document. This should be a photocopy plus original for verification.
- Re-use attach a Proof of Address Document (one for each distinct address). These should be either original + photocopies or attested / notarized photocopies.
- If you are an NRI, you must mention your overseas address in B4).
- Re-use submit a photocopy of the duly completed KYC Application Form.

For assistance or enquiries please approach the Point of Service where you had submitted your KYC Application Form.

IMPORTANT NOTES – PLEASE READ BEFORE FILLING UP THE FORM

1. This KYC Application Form is for use by **NON-INDIVIDUALS** only. A separate form is provided for **INDIVIDUALS**.
2. This form is not an Investment Application Form, and is only meant for providing information and documents required for KYC compliance. Applicant must be KYC compliant while investing with any SEBI registered Mutual Fund which has subscribed to the services of CDSL Ventures Limited (CVL) for compliance of the KYC procedure. A list of Mutual Funds is available on the website of AMR at www.amfiindia.com.
3. Subscription to Mutual Fund Units may be made only after obtaining the KYC Acknowledgement at their respective designated Points of Acceptance / Investor Service Centres.
4. Investors must attach their KYC Acknowledgement along with the Investment Application Form(s) / Transaction Slip(s) while investing for the first time in every folio. Applications Forms / Transaction Slips not accompanied by KYC Acknowledgement are liable to be rejected by the Mutual Funds.
5. **Power of Attorney (PoA) Holder:** Investors desirous of investing through a PoA must note that the KYC requirements are mandatory for both the PoA issuer (i.e. Investor) and the Attorney (i.e. the holder of PoA), both of whom should be KYC compliant.
6. Mutual Funds require investors to provide their identity and address information, supported by documentary evidence for the "Know Your Client" requirements laid down by the Prevention of Money Laundering Act, 2002 (PMLA). They reserve the right to seek any additional information / documentation in terms of the PMLA at any point of time.
7. Mutual Funds/ CVL will not be liable for any errors or omissions on the part of the applicant / Unit holders in the KYC Application Form. Documents received in support of KYC requirements will be verified at the designated "Points of Service" (PoS) on a best effort basis. However acceptance and processing of the KYC Application Form is subject to independent verification by CVL. In the event of any KYC Application Form being rejected for lack of information / deficiency / insufficiency of mandatory documentation, etc. CVL will inform the applicant of such rejection.
8. The Mutual Fund, its Asset Management Company (AMC), Trustee Company and their Directors, employees and agents shall not be liable in any manner for any claims arising whatsoever on account of freezing the folios/rejection of any application / non-allotment of units or mandatory redemption of units / refund due to non-compliance with the provisions of the PMLA, SEBI guidelines or where the AMC / Mutual Fund believes that transaction(s) by an applicant / investors is / are suspicious in nature within the purview of the PMLA and SEBI guidelines and requires reporting the same to Financial Intelligence Unit - India (FIU-IND).
9. Once the investor is KYC compliant, it will be required to intimate its KYC details to all the Mutual Funds with whom it has investments. The KYC Compliance will be deemed to have been completed for the investor in all folios held by it (identified by its PAN) in the records of the Mutual Fund.

GUIDELINES FOR FILLING UP THE KYC APPLICATION FORM

General

1. The Application Form should be completed in **ENGLISH** and in **BLOCK LETTERS**.
2. Please tick in the appropriate box wherever applicable.
3. Please fill the form in legible handwriting so as to avoid errors in your application processing. Please do not overwrite. Corrections should be made by canceling and re-writing, and such corrections should be countersigned by the applicant.
4. Applications incomplete in all respects and / or not accompanied by required documents are liable to be rejected.
5. Applications complete in all respects and carrying necessary documentary attachments should be submitted at the designated PoS. A complete list of PoS is available on the website of AMR at www.amfiindia.com, www.cdslindia.com and Mutual Fund websites.

A. Identity Details

1. Name : This should match exactly with the name as mentioned in the PAN Card and other supporting documents; otherwise the application is liable to be rejected. If the PAN Card and other supporting document has a name by which the applicant has been known differently in the past, than the one provided in this Application Form, then requisite proof should be provided, e.g. Name Change Certificate.
2. Please mention the date of incorporation or registration of your organisation. If your company is listed on the National Stock Exchange of India Limited, please mention the scrip symbol.
3. Please indicate the Status as applicable.
4. It is **MANDATORY** to mention your PAN in the space provided and attach a self attested photocopy of the PAN Card. Please also submit your original PAN Card which will be returned across the counter after verification.

B. Address Details

1. Address for Communication : Please provide here the address where you wish to receive all communications sent by the Mutual Funds with whom you invest. The address you give here will supercede existing information in the records of the Mutual Fund / Registrars and Transfer Agent to the Mutual Fund. This address should match with the address in the 'Proof-of-Address' submitted as supporting document; otherwise the KYC Application Form is liable to be rejected.
2. Contact Details: Please provide the Contact Person's Name / Telephone / E-mail contact details for the Mutual Fund to communicate with you. The contact details given by you here will not supercede existing information in the records of the Mutual Fund / Registrars and Transfer Agent to the Mutual Fund. You will have to independently communicate the same to them in case of any change(s).
3. Permanent Address / Registered Address / Overseas Address: FIs / other entities must quote their Permanent Overseas Address supported by required documents duly certified.

C. Other Details

1. Gross Annual Income details: Please tick the applicable box indicating your Gross Annual Income (including both taxable and tax-free incomes).
2. All documents indicated here are **MANDATORY**. Please ensure that you submit the documents as under:
 - Original Documents + Self-attested photocopies (Originals will be returned over-the-counter after verification) OR
 - True Copies attested by Company Secretary / Director / Notary Public / Gazetted Officer / Manager of a Scheduled Commercial Bank (Name, Designation and Seal should be affixed on the copy). Unattested photocopies of an original document are not acceptable.
 - If the above documents including attestation / certifications are in regional language or foreign language then the same must be translated into English for submission.

After you have completed filling up the Form, please submit the same along with the entire set of supporting documents to any designated PoS. Please also submit a photocopy of the Form for acknowledgement purposes, which you can retain for your records. Other important notes, after the KYC Acknowledgement is issued to you:

1. Please preserve the document from CVL which confirms your KYC compliance. Please attach photocopies of this document when you invest for the first time in every folio, in any Mutual Fund.
2. If you observe any error in the details as captured by CVL, you are requested to approach the nearest designated PoS.
3. If you are already holding investments in any Mutual Fund, please provide a copy of your KYC acknowledgement, giving details of your folio / account numbers to such Funds or their Registrars. Please note that your signature on the KYC Application Form should match with that on the records of the Mutual Fund.
4. In respect of new investors, signature on the Application Form for investing / transacting in Mutual Fund should match with that on this KYC Application Form.
5. After allotment of KYC compliance, if there are any changes in an Applicant's details such as Name, Address, Status, Income bracket, Occupation or Signature, the change should be registered with CVL through a designated PoS expeditiously, by using the KYC Details Change form. It should be noted that only after such registration will the change be reflected in the Mutual Fund's records. Particularly with respect to change of address, investors should register such change giving 10 days time for the subsequent communications from Mutual Funds to reach them at their new address. Original / Attested copies of documents supporting the change will be required to be submitted together with the KYC Details Change Form. For any other investment related information or changes thereto, the applicant should approach the Mutual Funds or their Registrars.

CHECKLIST

(Before submitting this Form, please go through the following checklist)

1. Please ensure that the form is completed in all respects and signed by the authorised signatories.
2. Foreign Institutional Investors must mention their overseas address in B(2).
3. Please attach all required documents. These should be either original + photocopies or attested / notarised photocopies.
4. Please submit a photocopy of the duly completed KYC Application Form.

For assistance or enquiries please approach the Point of Service where you had submitted your KYC Application Form.

ABBREVIATIONS

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

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

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