Study Notes for

NISM Series VII : SECURITIES OPERATIONS & RISK MANAGEMENT MODULE (SORM)

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Prepared By

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NISM SERIES VII : SECURITIES OPERATIONS & RISK MANAGEMENT

Exam Details

Total Questions	100 X 1 Marks
Type	Multiple Choice
Pass Score	50%
Duration	2 Hours
Negative marks	-0.25

Chapterwise Weightages

Unit 1: Introduction to Securities Markets	5%
Unit 2: Market Participants in the Securities Markets	10%
Unit 3: Introduction to Securities Broking Operations	20%
Unit 4: Risk Management	15%
Unit 5: Clearing Process	15%
Unit 6: Settlement Process	15%

Unit 7: Investor Grievances and Arbitration	**10%**
Unit 8: Other Services Provided by Brokers	**10%**

Chapter 1: Introduction to the Securities Market

Securities Market

The securities market has two interdependent and inseparable segments, viz., the new issues (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.
The secondary market provides liquidity to these instruments, through trading and settlement on the stock Exchanges

The secondary market operates through two mediums - **Over-The-Counter (OTC) market & the Exchange Traded Market / Screen Based Trading System** (SBTS).

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

Initial Public Offer (IPO) or Follow on Public Offer (FPO) → It is a public issue, anybody and everybody can subscribe for it.
Private Placement → the issue is made to select group of people.
Rights Issue → fresh shares are issued to existing shareholders at a particular price.
Bonus issue/stock split → Issues without any cost to the existing shareholder (Free Shares).

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 <= 1 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.

Equity Markets and its Products

Equity Shares represents the form of fractional ownership in a business venture.

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.

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

Indian Depository Receipt (IDR)

- Foreign companies are allowed to raise capital in Indian currency through an instrument called Indian Depository Receipt (IDR).
- IDRs are issued by foreign companies to Indian investors.
- IDRs are depository receipts which have the equity shares of the issuing company as the underlying security.
- The underlying shares are held by a foreign custodian and the DRs are held in the Indian depository.
- IDRs are listed in the Indian stock exchanges.
- The investor can either hold the IDR, trade in them in the stock exchange or request for redemption into the underlying shares.
- Redemption is permitted after 1 year from the date of listing.
- Two way fungibility of IDRs is permitted i.e. depository receipt can be converted into underlying shares and the underlying shares can be converted into depository receipt

Derivative Market and its Products

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

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

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

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. Currency futures are traded on the USD-INR, GBP-INR, EUR-INR and JPY-INR at the NSE, MSE & BSE.

Commodity Derivatives → raw or primary products (gold, silver, metal, energy and agricultural goods) are exchanged.

Interest Rate Futures- In India, interest rate future or bond futures are based on 13-year, 10-year and 6-year maturity GOI Security and 91-day GOI Treasury Bill.

Foreign Stock Indices Derivatives – SEBI has permitted the stock exchanges to introduce derivative contracts on the foreign stock indices such as **S&P 500, Dow Jones Industrial Average (DJIA) and FTSE 100**

Debt Market → In India, the debt market is broadly divided into two parts: **government securities** (G-Sec) market and **the corporate bond market**.

Corporate Bond Market or corporate debt market is a market where debt securities of corporate such as corporate bonds, T-bills, commercial papers and certificate of deposits are issued and traded.

Chapter 2: Market Participants in the Securities Market

The four important participants of securities markets are the investors, the issuers, the intermediaries and regulators.

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 2 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)

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**).

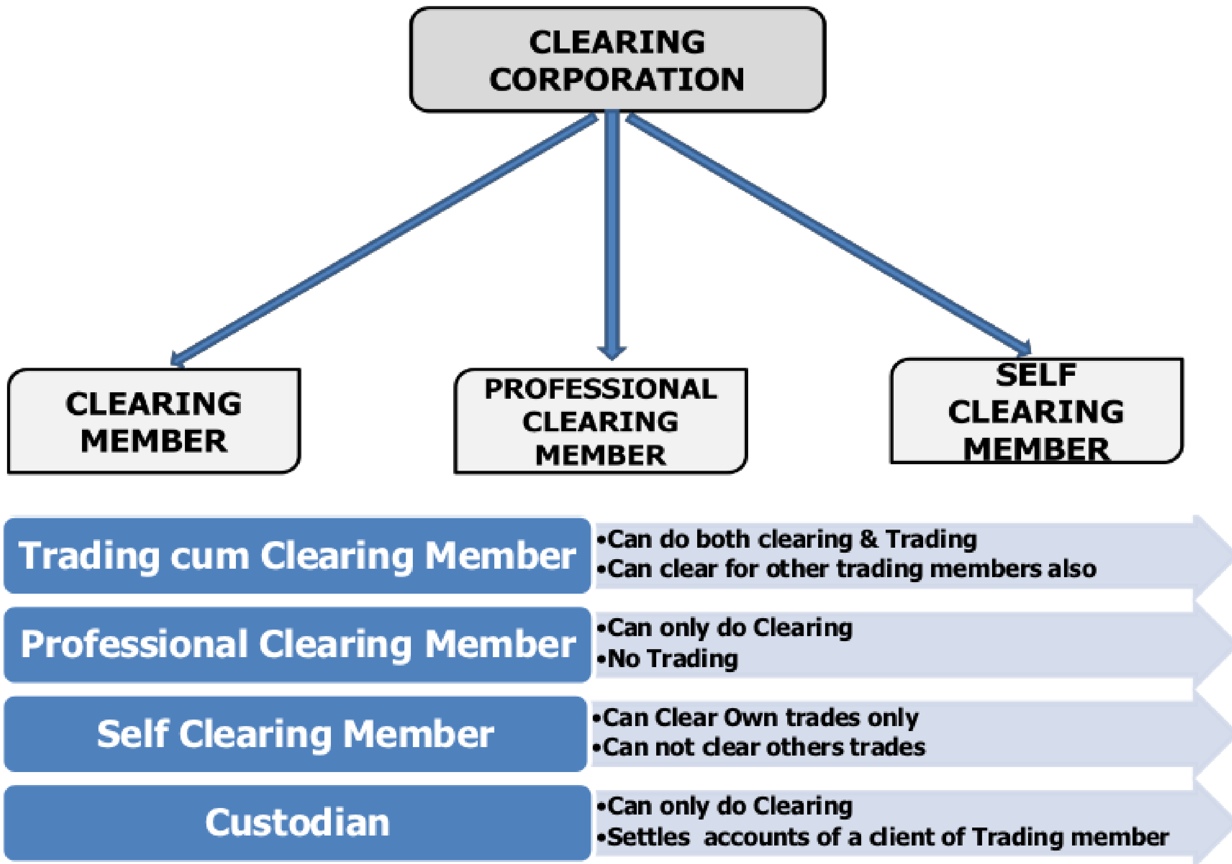
GDRs are essentially equity instruments issued abroad by authorized overseas corporate bodies against the shares/bonds of Indian companies held with nominated domestic custodian banks.

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.

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.



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 corporation acts as a central counterparty to all the trades.
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 Banks

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.

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).

Regulators

- 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 & Development Authority (PFRDA) regulate the pension fund.
- Ministry of Finance (MOF)
- Ministry of Corporate Affairs (MCA)

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.

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.

Depositories Act, 1996

The Depositories Act passed by Parliament received the President's assent on August 10, 1996. 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.

Companies Act, 2013

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

Prevention of Money Laundering Act, 2002

Money laundering has been defined as "any process or activity connected with proceeds of crime including its concealment, possession, acquisition or use and projecting or claiming it as untainted property".

The PMLA 2002 - came into effect from 1st July, 2005.

Amended w.e.f. 01.06.2009.

Latest Amendment w.e.f. 15-02-2013.

The offences listed in the Schedule to the Prevention of Money Laundering Act, 2002 are scheduled offences in terms of Section 2(1)(y) of the Act. The scheduled offences are divided into two parts - **Part A & Part C.**

In **part A**, offences to the Schedule have been listed in 28 paragraphs and it comprises of offences under Indian Penal Code, offences under Narcotic Drugs and Psychotropic Substances, offences under Explosive Substances Act, offences under Unlawful Activities (Prevention) Act, offences under Arms Act, offences under Wild Life (Protection) Act, offences under the Immoral Traffic (Prevention) Act, offences under the Prevention of Corruption Act, offences under the Explosives Act, offences under Antiquities & Arts Treasures Act etc.

Part 'C' deals with trans-border crimes, and is a vital step in tackling Money Laundering across International Boundaries.

The Directorate of Enforcement in the Department of Revenue, Ministry of Finance is responsible for investigating the cases of offence of money laundering under Prevention of Money Laundering Act, 2002.
Financial Intelligence Unit - India (FIU-IND) under the Department of Revenue, Ministry of Finance is the central national agency responsible for receiving, processing, analyzing and disseminating information relating to suspect financial transactions to enforcement agencies and foreign FIUs.

Imprisonment for Money Launderers – 3 to 7 years

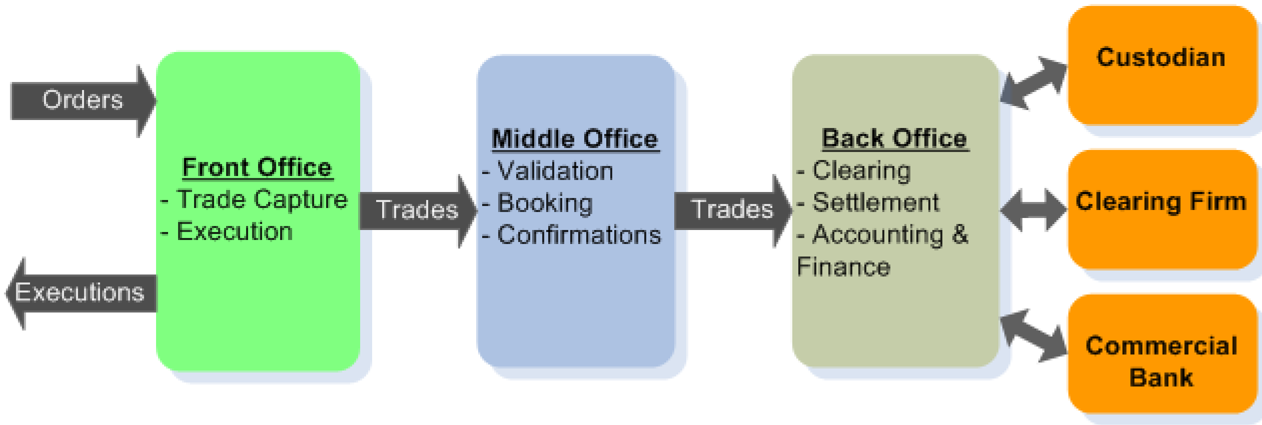
SEBI (Prohibition of Insider Trading) Regulations, 2015
Insider Trading is considered as an offence and is hence prohibited as per the SEBI (Prohibition of Insider Trading) Regulations, 2015 .
Regulation 2(g) of the SEBI Insider regulations, defines an '**insider'** any person who is:
i) a connected person; or
ii) in possession of or having access to unpublished price sensitive information;

Regulation 2(n) defines unpublished price sensitive information as any information related to the following: –
(i) financial results;
(ii) dividends;
(iii) change in capital structure;
(iv) mergers, de-mergers, acquisitions, delistings, disposals and expansion of business and such other transactions;
(v) changes in key managerial personnel; and
(vi) material events in accordance with the listing agreement.

<u>Chapter 3: Introduction to Securities Broking Operations</u>

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.
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



Securities Trade Processing Flow

In the year 2008, SEBI permitted the facility of Direct Market Access for institutional clients . DMA is a facility which allows brokers to offer its institutional clients direct access to the exchange trading system through the broker's infrastructure. This does not involve any manual intervention of the broker.

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 work-flow of a financial transaction, including what is commonly known as the Front, Middle, and Back office, and General Ledger. STP can be defined as electronically capturing and processing transactions in one pass, from the point of first 'deal' to final settlement.

Contract Notes

- A contract note is a confirmation of trade done on a 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 stock broker and client in respect of settlement of trades executed on the exchange
- 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.

- 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, PAN and client's code written on them. It should also contain the exact order number, order entry time, trade number, trade time, quantity of securities transacted, rates/price, etc.
- The contract notes should be signed by stock broker or by an authorised signatory of the stock broker.
- Contract should also mention all statutory charges like Securities Transaction Tax (STT), Service Tax (ST), Education Cess, SEBI and Exchange charges, etc. Contract notes should be affixed with the brokers note stamps, as a percentage of the total value of the contract, as per the respective state government stamp acts / rules.

Affirmation and Confirmation (For Institutional Clients)

FIIs 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. On behalf of their clients, they settle the trades that have been executed through other brokers. A broker assigns a particular trade to a custodian for settlement. Upon Confirmation by the custodian whether he would settle the trade, the broker communicates the same to the clearing corporations who then assigns the obligation to the custodian. The overall risk that the custodian is bearing by accepting the trade is constantly measured against the collateral that the institution (who trades) submits to the custodian for providing this service.

In 2004, SEBI had mandated that all the institutional trades executed on the Stock Exchanges should be processed through the Straight through Processing (STP) system. STP is a mechanism that automates the end-to-end processing of transactions of the financial instruments.

<u>Front Office Operations</u>

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.

Account Opening Kit

1) **Client Account Opening Form** which is in two parts.

a) Know Your Client (KYC) - form capturing the basic information about the client and instruction/check list to fill up the form and

b) Additional Document capturing additional information about the client related to trading account.

2) Document stating the **Rights & Obligations of stock broker** (Member-Client Agreement), sub-broker and client for trading on Exchanges (including additional rights & obligations in case of internet/wireless technology based trading).

3) **Uniform Risk Disclosure Documents (RDD**) for all segments/Exchanges.

4) **Guidance Note** detailing Do's and Don'ts for trading on Exchanges.

5) Document describing the **Policies and Procedures of the stock broker**

6) **A tariff sheet** specifying various charges, including brokerage, payable by the client to avoid any disputes at a later date.

SEBI has prescribed a new simplified **Account Opening Form ('AOF') or 'SARAL AOF'** for new individual investors participating in the cash segment of the Exchange but not availing facilities such as internet trading, margin trading, derivative trading and use of power of attorney.

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.

UID – Unique Identification Number (Aadhaar) can be a proof of Identity.

The **e-KYC** service launched by UIDAI is accepted as a valid process for KYC verification, provided the client has authorized the intermediary to access his data through UIDAI system.

Authority Letter for settle account - The retail clients normally do not wish to exchange cheques to and fro for every contract. They prefer to settle the account with the broker at periodic interval. To facilitate this SEBI has approved brokers to collect **running authority**

letter from the client. In spite of this letter the broker should settle the accounts at least once a quarter or earlier

KRA – Know Your Client Registration Agency

The new KRA system was developed for centralization of KYC records in the securities markets. It is applicable from January 1, 2012. The members may upload the KYC data on the KRA system and send the relevant KYC documents within 10 working days.

Central Know Your Client (CKYC)

CKYC refers to Central KYC (Know Your Customer), an initiative of the Government of India which aims to have a system which allows investors to complete their KYC only once before interacting with various entities across the financial sector. CKYC is managed by **CERSAI** (**Central Registry of Securitization Asset Reconstruction and Security Interest of India**), which is authorized by Government of India to function as the Central KYC Registry (CKYCR). Thus, **CKYCR** will act as centralized repository of KYC records of investors in the financial sector with uniform KYC norms and inter-usability of the KYC records across the sector. CKYC requires additional information (for e.g. - **investor's maiden name, mother's name, FATCA** information etc.) to be collected and submitted to CERSAI for completion of the CKYC formalities of an investor. Currently, CKYC is applicable only to Individuals (both Resident Individuals and Non-Resident Individuals (NRIs)).

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.

Brokerage

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

Brokerage rule for equity segment:

- Maximum brokerage - 2.5% of the trade value.
- If the value of share is Rs.10/- or less, a maximum brokerage of 25 paise per share can be collected.

There is no minimum brokerage requirement specified.

Brokerage rule for F&O segment:

- Brokerage for F&O is similar to the equity segment except for options contract
- Options contracts - maximum brokerage can be 2.5% of the option premium or Rs.100/- per contract whichever is higher.

Trading member can be a full service broker, discount broker or an online broker.

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)

Types of order

Price, time and quantity are three major components of an order

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.

Market order without Protection – Best available price in the market at that time
Market order with Protection – Best Available price within a specified range
Limit Order - the trader here needs to specify the price.
IOC - Immediate or Cancel

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.

Types of Risk

Operational risk → 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.

Market risk → Loss 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 → Losses occurring 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 in Proprietary accounts and therefore a broker may not be able to liquidate a position immediately, leading to potential or actual loss The back office exists for three reasons: confirmation, payments, settlements and accounting.

Back Office Operations

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

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.

Trade Allocation

In the case of institutional trades, the front office may enter a single order for a particular client and subsequently distribute it across various sub schemes of the client at the back office end. For example, hedge fund makes a trade, and manages several portfolios. Often, they will choose to allocate their trade to various portfolios for a number of reasons

Clearing and Settlement Process

Clearing and Settlement is a post trading activity that constitutes the core part of equity trade life cycles.Clearing house/corporation is an entity through which settlement of securities takes place. The details of all transactions performed by the brokers are made available to the Clearing House/Corporation by the Stock Exchange.

The Clearing House/Corporation gives an obligation report to the brokers and custodians who are required to settle their money/securities obligations within the stipulated time period, failing which they are required to pay penalties. This obligation report serves as statement of mutual contentment.

In India, the pay-in of securities and funds happens on T+ 2 day by 10.30a.m., and pay-out of securities and funds happen on T+2 by 1.30p.m.The pay-in and pay-out days for funds and securities are prescribed as per the settlement Cycle

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.

The **register of transactions** (**sauda book**) → Details of each transaction with the name of the security, its value, rates gross and net of brokerage and names of the clients.

• The **client's ledger** → has the details of all clients and their transactions

• 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 day for and on behalf of a client.

• **The margin deposit book** → details of margins paid/collected/payable/ collectable.

Securities Transaction Tax

S.No.	Taxable securities transaction	Rates w.e.f June 1, 2016	Payable by
1	Purchase of an equity share	0.1 Percent	Purchaser
2	Sale of an equity share	0.1 Percent	Seller
3	Sale of a unit of an equity oriented fund	0.001 Percent	Seller
4	Sale of an equity share where there is no delivery	0.025 percent	Seller
5	Sale of an option in securities	0.05 per cent	Seller
6	Sale of an option in securities, where option is exercised	0.125 per cent	Purchaser
7	Sale of a futures in securities	0.01 percent	Seller

Bulk Deal

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

Block Deals

A trade, with a minimum value of Rs. 10 crore executed through a single transaction on this separate window of the stock Exchange constitutes a "block deal" as distinguished from "bulk" deal.

Morning Block Deal Window – 8.45am to 9am
Afternoon Block Deal Window – 2.05pm to 2.20pm

The orders may be placed in this window at a price not exceeding **+1%** of the applicable reference price in the respective block deal window

Chapter 4: Risk Management

Risk Management framework consists of the following components:

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

Margin

Margining is a process by which a clearing corporation computes the potential loss that can occur to the open positions (both buy and sell) held by the members

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

VaR Margin

The VaR Margin is a margin intended to cover the largest loss that can be encountered on 99% of the days (99% Value at Risk). For liquid stocks, the margin covers one-day losses while for illiquid stocks, it covers 3-day losses so as to allow the clearing corporation to liquidate the position over 3 days

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

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

Index sigma means the daily volatility of the market index (CNX Nifty or S&P BSE Sensex) computed as at the end of the previous trading day. The computation uses the exponentially weighted moving average method applied to daily returns.

Index VaR means the higher of 5 percent or 3 index sigmas.

Liquidity Categorization	One-Day VaR	Scaling factor for illiquidity	VaR Margin
Group I (Liquid Securities)	Scrip VaR	1	Scrip VaR
Group II (Less Liquid Sec.)	Higher of Scrip VaR & 3 times Index VaR	1.73	Higher of 1.73 times Scrip VaR and 5.20 times Index VaR
Group III (Illiquid Securities)	5 times Index VaR	1.73	8.66 times Index VaR

Mark to Market Margin

Mark to market loss is calculated by marking each transaction in security to the closing price of the security at the end of trading.

In case the net outstanding position in any security is nil, the difference between the buy and sell values is considered as notional loss for the purpose of calculating the mark to market margin payable.

Extreme Loss Margin

- The Extreme Loss Margin for a security is higher of 5% or 1.5 times standard deviation of daily logarithmic returns of the security price in the last 6 months
- 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

Liquidity Categorization	Trading Frequency	Impact Cost
Group I (Liquid Securities)	**At least 80 percent of the days**	**<= 1%**
Group II (Less Liquid Sec.)	**At least 80 percent of the days**	**> 1%**
Group III (Illiquid Securities)	**Less Than 80 percent of the days**	**n/a**

Base minimum 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 prespecified multiple of this deposit amount.

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

For stock brokers/ trading members who do not have nationwide trading terminal, BMC requirement is 40% of the amount stipulated above. No exposure will be granted on the BMC deposit.

Dynamic Price Bands

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

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

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

Types of Margins

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

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

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

Initial margin requirements shall be based on 99% Value at Risk (VaR) over a one day time Horizon.

Exposure margins

Index Futures contracts: **3 percent** of the notional value of the futures positions

Short Index Options contracts: **3 percent** of the notional value of the short open positions in options on index

Futures contracts on individual Securities: Higher of 5 percent or 1.5 standard deviation of the notional value of gross open position in futures on individual securities

Short Option contracts on individual Securities: higher of 5 percent or 1.5 standard deviation of the notional value of short open positions in options on individual securities

Premium Margin

Premium Margin shall mean and include premium amount due to be paid to the Clearing Corporation towards premium settlement, at the client level. The premium margin is paid by the buyers of the Options contracts and is equal to the value of the options premium multiplied by the quantity of Options purchased.

Assignment Margin

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

Graded Surveillance Measure (GSM) and Additional Surveillance Measure (ASM)

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

The main objective of these measures is:

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

Settlement of accounts (funds and securities) & Statement of accounts

It is mandatory for stock brokers to do periodical actual settlement of funds & securities of clients, at least once in a calendar quarter or month, depending on the preference of the client, given by him in KYC Form.

Core Settlement Guarantee Fund

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

Chapter 5: Clearing Process

The clearing process follows the trading process.

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

Role of the Clearing Agency / Corporation/House

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

Novation (*Defined in SEBI Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2012*) - The Act of a clearing corporation interposing itself between both parties of every trade, being the legal counterparty to both

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.

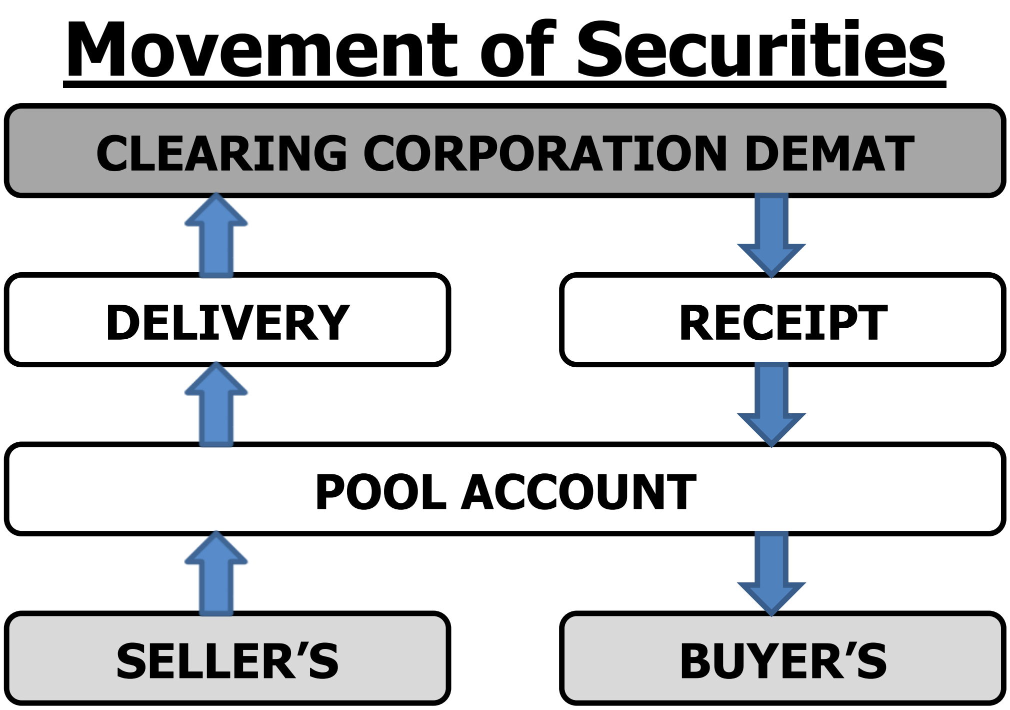
The **Indian Clearing Corporation Limited** takes care of the clearing and settlement on BSE. It is a Wholly Owned subsidiary of BSE.

Metropolitan Clearing Corporation of India Ltd. (MCCIL), jointly promoted by Metropolitan Stock Exchange of India Ltd. (MSE), Multi-Commodity Exchange of India Limited (MCX) and Financial Technologies India Limited (FTIL), is the clearing corporation for all the trades executed on the Metropolitan Stock Exchange of India Limited.

The clearing agency then determines the net obligations of the clearing members through **Multilateral Netting**.

Different types of clearing member accounts

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



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 may be done for any of the following purposes:
a. Transfer due to a transaction done between 2 persons 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] .**
Any trade that is cleared and settled without the participation of a clearing corporation is called **off-market trade**.
A **market trade** is one that is settled through participation of a Clearing Agency

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

Summary of Clearing and Settlement process in India for equities:

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

- Pay-out of funds: CC advises Clearing Banks to credit account of custodians/ CM and debit its account and clearing bank does the same.
- CM's for buy order and sell order are different and Clearing Corporation acts as a link.

Chapter 6: Settlement Process

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.
T+2 settlement cycle is followed in the Indian equities market.
If a transaction entered into on Day 1, then it 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.

The settlement of derivative trades is on T + 0 or T + 1 working day basis. Final settlement of Currency derivatives is T + 2 days.

Product	**Settlement**	**Price**
Futures Contracts on Index or Individual Security	Daily Settlement	Closing price of the futures contracts on the trading day (closing price for a futures contract shall be calculated on the basis of the last half an hour weighted average price of such contract).
Un-expired illiquid futures contracts	Daily Settlement	Theoretical Price computed as per formula $F=S *e^{rt}$
Futures Contracts on Index or Individual Securities	Final Settlement	Closing price of the relevant underlying index / security in the Capital Market segment of NSE, on the last trading day of the futures contracts.
Futures Contracts on Global Indices (S&P 500 & DJIA)	Final Settlement	The Special Opening Quotation (SOQ) of the Global Indices S&P 500 and DJIA on the last trading day of the futures contracts.
Options Contracts on Global Indices (S&P 500 & DJIA)	Final Exercise Settlement	The Special Opening Quotation (SOQ) of the Global Indices S&P 500 and DJIA on the last trading day of the futures contracts.
Options Contracts on Index and Individual Securities	Final Exercise Settlement	Closing price of such underlying security (or index) on the last trading day of the options contract.
Currency Derivatives	Daily Settlement	Closing price of the futures contracts
Final Settlement Price		The reference rate fixed by RBI.

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

Adjustment

Adjustments - Modifications to positions / contract specifications listed below

a) Strike Price

b) Position

c) Market Lot / Multiplier

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

Dividends

Dividends which are **below 5% 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**, **>= 5% of the market value** of the underlying security or all cases of dividends , where the listed entity has sought exemption from the timeline prescribed under the provisions of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, 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.

Auction of Securities

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

Chapter 7: Investor Grievances and Arbitration

SEBI Complaints Redressal System (SCORES)

- SEBI handles the investor grievances through a system called SEBI Complaints Redressal System (SCORES) .Its a 24x7, web based centralised system to capture investor complaints against listed companies and registered intermediaries.
- It allows the investors to lodge their complaints and track the status online. When a complaint is lodged on SCORES, an email acknowledgement is generated for reference and tracking.
- The system also allows market intermediaries and listed companies to receive complaints lodged against them electronically.
- SEBI encourages the investors to lodge complaints through electronic mode in SCORES. However,if an investor submits a manual complaint, the same is digitized by SEBI and uploaded on SCORES. Thereafter, follow-up actions of the complaint are done in electronic form only i.e. through SCORES.
- Investors may contact the Investor Associations (IAs) recognized by SEBI for any assistance in filing complaints on SCORES.
- Stock Exchanges and Depositories designate a person to resolve the complaints reported through SCORES within 30 days from the date of receipt on SCORES. If additional information is required, then it is mandated to be sought within 7 days of receipt of complaint. If additional information is sought, then 30 days will be counted from the date of receipt of information.
- The stock exchanges are required to maintain a record of complaints which are not addressed within 30 days from the date of receipt of the complaint along with reason for such delay.

Investor Protection Fund

Stock Exchanges have set up and managed Investor Protection Fund (IPF) to compensate clients who suffer financial loss due to their member being declared defaulter

Constitution and Management

- The fund should be administered by way of a Trust created for the purpose.
- The Trust should have at least one public representative, one representative from the registered investor associations recognised by SEBI and the Executive Directors/Managing Directors/Administrators of the Stock Exchange.
- The Stock Exchange shall provide the secretariat for the IPF/CPF Trust.
- The Stock Exchange shall ensure that the funds in the IPF/CPF are well segregated and that the IPF/CPF is immune from any liabilities of the Stock Exchange.

Contribution

a) 1 percent of the listing fees received, on a quarterly basis.

b) 100 percent of the interest earned on the 1 percent security deposit kept by the issuer companies towards public issue.

c) Difference between auction price and close out price.

d) Proceeds from the sale of securities written off by Foreign Institutional Investors (FIIs) held by them for their sub accounts, where the custodian is unable to determine claimant for various reasons as per SEBI circular No. FITTC/FII/02/2002 dated May 15, 2002.

e) The amounts specified in pursuance of Regulation 28(12) (e) (ii), Regulation 28(13) and Regulation 29 (2) of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997.

f) Contribution towards the IPF based on the transaction charges collected by Stock Exchanges, as per Stock Exchange practice.

Arbitration

Arbitration, which is a quasi judicial process, is an alternate dispute resolution mechanism prescribed under the Arbitration and Conciliation Act, 1996

The Exchanges have a panel of arbitrators that consists of retired judges from High-Courts, Chartered Accountants, Advocates and other Professionals having knowledge related to the Capital Markets. Arbitration facility is provided at all centers which are specified by SEBI from time to time. SEBI has now identified 16 such centers where investor services as well arbitration facility are to be provided by stock exchanges.

The list of arbitrators across all stock exchanges are pooled together and called "Common pool".

This list grouped centre wise, is made available to the investors on the stock exchanges' websites. The applicants can choose any arbitrator for the required centre from the "Common Pool". If they fail to do so, the arbitrator will be chosen by an 'automatic process' which is a randomised computer generated selection process.

Arbitration for claims <= Rs. 25 lakh → decided by a sole arbitrator
Claim > Rs. 25 lakh → 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.

Speaking awards → Awards passed upon hearing both the parties i.e. the complainant and the respondent.
Ex-parte award → 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.

The Final Award is taken on stamp paper of Rs. 100

The arbitration reference shall be concluded by way of issue of an arbitral award within 4 months from the date of appointment of arbitrator(s). (Additional Extension of time – 2 months)
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 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.

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 1 month from the date of receipt of arbitral award. The appellate panel consists of 3 arbitrators who are different from the ones who passed the arbitral award appealed against.

A party filing an appeal before the appellate panel is required to pay a max fee of Rs. 30,000, in addition to statutory dues (stamp duty, service tax, etc) along with the appeal. If a client's appeal is upto Rs.10 lakhs, the fee cannot exceed Rs.10000/-

Chapter 8: Other Services provided by Brokers

• Online BSE and NSE executions through terminals • Investment advice
• Research reports and market review • Mobile Trading • Depository Services • Direct Market Access • Derivatives Trading • Commodities Trading • Smart Order Routing • IPOs & Mutual Funds Distribution • Internet-based Online Trading • Specialised Research For Investors • Margin Funding • Algorithmic Trading

SEBI have introduced a facility called "**Application Supported by Blocked Amount (ASBA)"** in the Primary market for investor.
The application money remains in the investor's account till finalization of basis of allotment in the issue. 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 with-drawn/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.

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 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

No subscription/ redemption order should be entered with amount equal to or greater than Rs**. 1 crore.**

PMS

Many stock brokers also offer Portfolio Management Services (PMS) to their High Networth clients.

Portfolio manager can be discretionary or non-discretionary.

The **discretionary** portfolio manager **individually** and **independently manages** the funds of each client

The **non-discretionary** portfolio manager manages the funds in **accordance with the directions of the client.**

SEBI fee structure & Eligibility criteria

- Non-refundable Application fee (Renewal / Registration)- Rs. 1 lakh.
- Initial Registration fee – Rs10 Lakhs
- Minimum of 2 persons with atleast 5 years experience as portfolio manager or stock broker or investment manager or in the areas related to fund management.
- The principal officer of the portfolio manager is to have: (i) a professional qualification in finance, law, accountancy or business management OR (ii) an experience of at least 10 years in the securities market
- Minimum networth of portfolio manager - 2 crore rupees.
- Every portfolio manager who has total assets more than 500 cr rupees shall appoint a custodian. This condition will not be applicable to portfolio managers offering purely advisory services.
- Min Investment that a portfolio manager can accept from clients – Rs 25 Lakhs

Margin Trading

Only corporate brokers with networth of at least Rs.3 crore are eligible for providing margin trading facility to their clients.

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%.

IMPORTANT NOTE :

1. Attend ALL Questions
2. For the questions you don't know the right answer – Try to eliminate the wrong answers and take a guess on the remaining answers.
3. DO NOT MEMORISE the question & answers. It's not the right to way to prepare for any NISM exam. Good understanding of Concepts is essential.

All the Best ☺