

# Arbitration on Unauthorized Trading by the Trading Member of Indian Stock Exchange: An Empirical Study\*

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## Abstract

The paper investigates the unauthorized trading indulged in client's accounts by the trading members of the stock exchanges. Trading systems, misuses and abuses of the securities market by trading members have been identified and analyzed. It finds how some trading members violate trading rules, misinterpret regulatory compliances and indulge unauthorized trading. The findings and conclusions provide inputs for the development of appropriate regulatory framework for the securities market. However, the results may be generalized in the emerging markets environment. Hence, researchers are advised to study trading practices, stock market operations, appreciate the dynamics of stock market and apply the same in their future research in India and abroad.

## Keywords

Arbitration, Unauthorized Trading, Applicant, Respondent, Stock Exchange

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## 1. Introduction

This is a dispute matter between a client and a trading member of the Stock Exchange which was referred to Investors Grievances Redressal Cell (IGRC) of the Stock Exchange for resolution of the disputes through negotiation under dispute resolution mechanism by the Stock Exchange, the first level of the dispute resolution framework of the stock exchange. IGRC could not resolve the matter amicably between the parties and they were directed to refer the matter to the Arbitration and Conciliation Commission.

\*This paper is based on an arbitration matter resolved through Alternative Dispute Resolution (ADR) mechanism at the leading stock exchange of India. The names of the applicant, respondent, names of stock, stock exchange, and monetary values were disguised to preserve confidentiality.

tration under the Rules, Bye-laws and Regulations of the Stock Exchanges, which were framed under the Arbitration and Conciliation Act of India 1996 [1]. The paper is a reference for the Arbitration to the sole arbitrator under the Rules, Bye-laws and Regulations of the Stock Exchange of India. The hearing for the matter was held on April 20, 2018 at the regional office of the Exchange. The Applicant was represented by Mr. GS Rao and Respondent was represented by Mr. A K Jain, Compliance Officer of the Respondent appeared for the hearing. Applicant as well as Respondent argued and presented their case matters.

## 2. Case and Claim of the Applicant

In her statement of claim, Applicant stated that one Mr. DS Reddy approached her during June and July, 2017 claiming himself as sub broker and authorized person of SKB Brokers Ltd. Mr. DS Reddy brought an account opening application form along with all other documents of SKB Brokers Ltd. and requested her to open account with SKB Brokers Ltd. DS Reddy requested her to sign the blank documents and asked her not to fill the application form. She had claimed that she signed the blank forms as advised by DS Reddy and opened an account for obtaining the loan against pledge of shares. At the time of opening the account, she issued three cheques drawn on KVB Bank Ltd., Hyderabad. One cheque bearing no. 111,116 was issued for INR 10,000/- (rupees ten thousand only) towards account opening charges and the other two cheques bearing Nos 111,117 and 111,118 were signed and issued as blank cheques towards security for availing of loan against pledge of 3,000,000 shares of QBR Constructions Ltd. DS Reddy promised her to arrange loan against the pledge of shares from SKB Brokers Ltd. and requested her to transfer shares to her Demat Account opened with the Respondent. Accordingly, Applicant transferred 3,000,000 QBR Constructions Ltd. shares to SKB Brokers Ltd. on August 07, 2017 as advised by DS Reddy. Applicant submitted that DS Reddy filled her application after obtaining her signatures and filled his name as an authorized person without her knowledge and information for doing business with the respondent on behalf of applicant. Applicant claimed that she opened her account with the respondent only for availing of loan against pledge of shares and not for trading purpose. Mr. DS Reddy had operated her account without her knowledge and authorization and traded in her account *i.e.*, bought and sold shares of QBR Constructions Ltd. as an authorized person with the respondent. As a result of these unauthorized and illegal trades, a loss of INR 3.0 million was incurred in her account. Applicant understood that something went wrong and the Respondent was conducting transactions without her knowledge and instructions. Applicant sent a mail to the then Zonal Manager, Mr. SK Reddy of the Respondent from her registered mail ID with the respondent on September 21, 2017 and Applicant requested them (Respondent) not to buy any more shares in her account. Applicant claimed that through her mail, the authorization of Mr. DS Reddy came to end and DS Reddy was prevented from placing orders on behalf of her, who fraudu-

lently obtained authorization. In spite of applicant's clear instructions to the respondent to stop trading in her account, respondent continued unauthorized and illegal trading in her account. Applicant argued that she didn't place any orders with respondent, and it was the respondent, who traded in her account without her placing orders and instructions to buy or sell shares. Respondent contributed to the loss of INR 5.66 million. Applicant sent another mail on October 17, 2017 while instructing the compliance officer of respondent not to buy any more shares in her account and clear her debit balance by selling shares lying in her account. After having seen the respondent's irresponsible approach, acts and behavior, she suspected fraudulent act and requested KVB Bank, Hyderabad to stop payment against two cheques nos 111,117 and 1,111,118. In view of foregoing submissions and statements, applicant requested to get back her shares of 3,000,000 of QBR Constructions Ltd. which were lying with the respondent, declare the debit balance of INR 5.6 million as void and take action against SKB Brokers Ltd. for unauthorized trades [1].

### **3. Statement of Defense and Reply of Respondent**

Respondent states that applicant opened trading account with respondent after complying with statutory formalities as prescribed by the National Stock Exchange (NSE), Bombay Stock Exchange Ltd. (BSE) and Securities and Exchange Board of India (SEBI). Respondent claimed that applicant executed trades by and through her duly executed authorized person in the scrip of QBR Constructions Ltd. allegedly misusing trading terminal of respondent. Respondent submitted that the pattern of trades were carried out contemplated itself that that they had breached and violated the regulations of SEBI. It was alleged that these were matched trades from one counter to another counter and left huge debit balance of INR 6.38 million as on April 05, 2018. Respondent argued and contended that applicant had played with the legal system and misused trading platform of respondent through her appointed authorized person and filed multiple complaints against respondent. Respondent claimed that applicant had intentionally hidden the material facts from the respondent while opening trading account with respondent that she was an insider of QBR Constructions Ltd. within the meaning of SEBI Insider Trading, Rules and Regulations [2]. Respondent stated that applicant is the daughter-in-law of Mr. GS Rao, who is the Managing Director of QBR Constructions Ltd. They shared the same residential address. This material fact was not disclosed by the applicant at the time of opening her account. Under provisions of SEBI (Prohibition of Insider Trading) Regulations, 2015, Applicant was an insider with respect to QBR Constructions Ltd. Respondent also alleged that applicant had done her matching transactions with related accounts at some other trading terminals resulting wrongful gains by leaving the debit balance at the respondent's counter and gaining credit balance at other trading member.

It is further stated that applicant issued a cheque in favour of respondent for

the said amount but when presented with the Bank, the same was not honored and returned back from the banker with the remarks "Payment Stopped by Drawer". The respondent forced to file a complaint against applicant in accordance with the provisions of Section 138 of Negotiable Instruments Act, 1881. Respondent also contended that in view of the nature of dispute and issues involved, the appropriate forum for adjudication of this dispute would be the Court of Law and not the quasi-judicial body. Respondent also argued that this dispute matter has to be adjudicated in the Court of Law under the provisions of Civil Procedure Code (CPC) and not in the Arbitration. In view of the above submissions, it is stated that the Hon'ble Arbitrator didn't have jurisdiction to adjudicate the present dispute and is necessarily be required to be adjudicated in the Court of Law. Respondent also prayed to pass an order under Section 16 of Arbitration and Conciliation Act, 1996 [3] and to decide the jurisdiction in the interest of justice.

#### **4. Findings, Results and Conclusions**

It is found that Mr. DS Reddy managed to get applicant's signatures in the blank application forms and subsequently duly filled her application. While filling her application, Mr. DS Reddy wrote his name as an authorized person of Applicant to do business with the respondent. DS Reddy also collected three cheques, one for INR 10,000 (rupees ten thousand only) towards account opening charges and other two as blank cheques. It was noticed that signatures were taken from applicant at Hyderabad but it was mentioned that the documents were executed purportedly at Delhi. The respondent could not provide either evidence or proof that applicant had visited Delhi to execute and sign documents. Applicant opened trading account and Demat account with respondent and transferred her 3,000,000 shares of QBR Constructions Ltd. as advised by DS Reddy. Applicant noticed that some transactions were executed in her account without her placing orders or instructions to buy or sell shares. Applicant sent a mail on September 21, 2017 instructing the Respondent not to buy any more shares. There was neither proper reply nor any response to this mail from respondent. Respondent was totally silent and reluctant to reply this email. Applicant gave clear instruction to the respondent that no trades should be done in her account. Mr. DS Reddy obtained authorization fraudulently, once Applicant (principal) instructed the respondent, the authorization ceased to exist *i.e.*, authorization was revoked by the principal. The respondent was without replying/responding to this basic issue and complaint and on the contrary alleged adversely by suppressing the material facts and misrepresentations. Contrary to the applicant's instructions, respondent indulged in unauthorized trades and incurred huge losses in the applicant's account. Once she requested to stop trading in her account, there was no question of Applicant indulged in insider trading and illegal trading. It is found that the applicant did not issue the cheque for said amount of INR 5.6 million. Respondent failed to substantiate why two blank cheques were

collected from applicant. It was noted that there was no need to trade on the applicant's account without meeting the pay outs obligations for trades of previous trading days. As per extant rules and regulations of the Stock Exchange, client (Applicant) had to make payment within two days from the trading day. It was not clear what motivated the respondent to do trading on credit basis for a longer time. Applicant neither requested for trading nor requested to extend credit limits in her account. Respondent without responding to basic dispute and complaint, raised and argued irrelevant and unrelated issues and alleged that applicant had indulged in insider trading. It is totally baseless, false and fabricated; applicant had instructed the respondent through her e-mail on September 21, 2017, not to buy any more shares in her account. Respondent indulged in unauthorized trades contrary to the applicant's instructions and alleged that the applicant had carried out insider trading. If at all, there is any insider trading in applicant's account, it is the respondent, who will be held responsible for such Insider Trading. Respondent is also responsible for any other violations under SEBI's Insider Trading Rules and Regulations. There was a debit balance in the applicant of INR 3.0 million, as on September 21, 2017, the date on which, the applicant instructed not to buy any more shares in her account. The trades conducted in applicant's account after that date was treated as unauthorized. Therefore, the losses incurred on account of unauthorized trades were to be borne by the Respondent and not by the Applicant. It was found that Applicant's 3,000,000 shares of QBR Constructions Ltd. were lying with the Respondent as on date complaint.

Respondent argued and contended that the appropriate forum for adjudication of present dispute matter was the Court of Law and not in the jurisdiction of arbitration. It was important and pertinent to note that the respondent ignored and forgot that respondent is a registered trading member with NSE and BSE and respondent is subject to the regulations by BSE, NSE and SEBI. Respondent has to follow the rules, regulations and bye laws of the Exchange. Trading and transactions carried out in the NSE and BSE were under purview of Rules, Bye-laws and Regulations of NSE and BSE respectively. The unauthorized trades were not allowed under extant rules, regulations of NSE, BSE and SEBI. The nature of complaint was relating to unauthorized trades and these were indulged and undertaken by the trading member of BSE and NSE. Hence, it is very much within the scope and purview of Stock Exchange Arbitration mechanism. Therefore, it is within the jurisdiction of present arbitrator, who has right and authority to adjudicate the matter under Arbitration and Conciliation Act, 1996. Accordingly, arbitrator confirms and concludes that it is very much within its purview, jurisdiction and scope, fit and proper case to deal, adjudicate, and pass appropriate awards under the Arbitration and Conciliation Act of India 1996. Trading systems, misuses and abuses of the securities market by trading members have been identified and analyzed. It finds how some trading members violate trading rules, misinterpret regulatory compliances and indulge unautho-

rized trading. Therefore, the loss has to borne by the Respondent on the principles of equity, fairness and natural justice.

## 5. Recommendations

In view of the foregoing submissions, hearings, documents, and pleadings of the both parties, and on the basis of findings and conclusions and on the principles of equity, fairness and natural justice, the following award was passed by the arbitrator. The debit balance of INR 5.6 million as claimed by the Respondent has to be borne by the Respondent and not by the Applicant. The debit amount of INR 5.6 million has to be written off by the Respondent. Award was passed that SKB Brokers Ltd. (Respondent) was directed to return 3,000,000 shares of QBR Constructions Ltd. on or before by June 30, 2018 otherwise the Respondent shall pay to the Applicant the value of these shares, *i.e.* INR. 16.5 million as per closing price of per share as on April, 20, 2018. The stock exchanges and SEBI have to look into these misinterpretation of rules, regulations, and abuses and misuses of securities market by the trading members and take appropriate measures to prevent such practices. Stock exchanges have to consider the domain knowledge of capital market and stock market operations while considering the appointments of members for IGRC and arbitrators. Not only legal knowledge but also domain knowledge of stock market operations is an important ingredient for resolving the issues and disputes between clients and trading members effectively, efficiently, fairly and correctly in the interest of justice. Managements of trading members have to train their officers of market operations, business development and compliance departments to comply with the rules and regulations of the stock exchanges and adhering to the best practices so that they can avoid these kinds of issues, misuses, and prevent the clients from incurring heavy losses [4]. Investors have to develop practice of following and adhering to know your customer (KYC) rules and regulations properly so that they can avoid this kind of unauthorized authorization and prevent from disputes with trading members. However, the results may be generalized in the emerging markets environment. Hence, researchers are advised to study trading practices, stock market operations, and apply the same in their future research in India and abroad.

## Conflicts of Interest

The author declares no conflicts of interest regarding the publication of this paper.

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