

ADR on Unauthorized Liquidation of Futures Positions at the Stock Exchange in India: An Empirical Study

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Abstract

The paper investigates margin rules, and regulations of Futures segment of Stock Exchanges in India and practices followed by stock brokers of the Stock Exchanges. Trading practices, misuses and abuses of securities market by trading members have been identified and analyzed. It finds how trading members violate of trading rules, misinterpret regulatory compliances and indulge unauthorized trading. The findings and conclusions provide inputs for the development of appropriate regulatory framework for the futures segment of securities market. However, the results may be generalized only in the emerging markets environment. Hence, researchers are suggested to study margin guidelines of futures market, appreciate the dynamics of futures market and apply the same in their future research in India and abroad.

Keywords

Arbitration, Futures, Applicant, Respondent, Stock Exchange

1. Introduction

This is a dispute matter between a client of futures market 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 dispute through mediation and negotiation under alternative dispute resolution (ADR), the first tier 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 under the Rules, Bye-laws and Regulations of the Stock Exchange of India Ltd, which were framed under the Arbitration and Conciliation Act of India 1996 [1]. Personal hearing for the matter was held at the Regional Arbitra-

tion Centre of Stock Exchange, Hyderabad, India. Both parties appeared for personal hearing and argued their respective cases.

2. Claim of the Client (Applicant)

The Applicant is a registered client' with the Respondent. Applicant and Respondent have excellent trading relations with each other for last couple of years. Applicant has been holding the 4800 PHARMA Ltd positions in futures segment as on August, 20, 2016. He has been continuously holding position PHARMA Ltd since January, 2015 onwards because of his confidence and faith on future growth prospects of PHARMA Ltd. In spite of his limited financial resources, he wanted to carry forward the PHARMA Ltd series in F&O for a further period of two to three years so as to realize the growth prospects of the Company. Respondent executed an unauthorized sale transaction of 4800 PHARMA at an average price of INR 6115. The trade was executed on August 21, 2016 without any prior information to the client and as result he lost the position in the market and incurred heavy losses. The margin statement showed a shortfall of INR 2,802,686 on trading trading session of August 20, 2016. The said margin shortfall was supposed to be paid by him on August 21, 2016, the next trading day (T+1). Had they asked him before execution of the sale, he would have arranged the funds immediately, *i.e.*, within the stipulated time prescribed by the Exchange. Hence, the trade executed by the respondent was an arbitrary and unauthorized trade and caused huge losses.

Applicant submits that he had not received any confirmation for the trade executed by Respondent till in the evening of August 21, 2016 whereas they were supposed to take mandatory order confirmation from the client. He received an SMS regarding trade confirmation on August 21, 2016. Respondent failed to inform him regarding margin short fall or its intention to sell his Futures positions. It neither directed him for remitting additional funds nor took his permission to sell Futures position. He requested the Respondent to reverse the unauthorized and illegal trade executed by it but it had turned a deaf ear to his request. Applicant claims that it is the fault and gross negligence on the part of the officers of Respondent (trading member) who mindlessly executed the trade at the cost of small investor like him without following the due process and procedure prescribed by the NSE and BSE. Hence, the trading member (respondent) should take responsibility for its violation and unauthorized trade in his account so recklessly and caused a loss of INR 23.0 million. Applicant claims that the loss should be reimbursed to him. Applicant reiterates that the Respondent (trading member) sold 4800 PHARMA Ltd.'s Futures position without his consent. The unauthorized trade resulted a loss of INR 23.0 million [$4800 \times (\text{INR } 6115 - 10,900)$], the difference between the liquidation price of August 21, 2016 *i.e.*, INR 6115 and the closing price of INR 10,900 as of March 31, 2017, being the date of filling of Arbitration Application. Applicant requested the Stock Exchange to direct the Respondent to pay INR 23.0 million towards the mark to

mark price of March 31, 2016 or restore 4800 PHARMA Ltd.'s stock to his account.

3. Proceedings at the IGRC

Applicant strongly condemned and deeply regretted proceedings of the Investors Grievances Redressal Cell (IGRC) and attitude and approach of the member, IGRC in resolution of his dispute. Member, IGRC carelessly and recklessly declined and rejected all written submissions. He hurriedly conducted the proceedings, and concluded the proceedings accordingly. The submissions and supporting documents were not taken for consideration. The lapses and violations committed by SKS Stock Brokers Ltd were not looked into and the order was passed in an arbitrary manner. The member, IGRC neither demanded nor insisted on the trading member to produce written evidences and requisite proofs in support of its claim. It is clearly evident that the entire IGRC proceedings were not conducted properly, orderly and fairly.

4. Counter and Defense by the Respondent (Trading Member)

SKS Brokers Ltd, (Respondent) states that it is a trading member of the National Stock Exchange of India Limited (NSE) and Bombay Stock Exchange Limited (BSE). The Respondent is active on all segments of NSE and BSE. The Respondent provides retail and whole sale broking services, equity research, portfolio management services, in cash and the derivative segments of the stock exchanges. Applicant had executed a Member Client Agreement [2] with the Respondent and client was allotted a unique Client Code for trading. He commenced trading in his account off line and also had access to online trading facility. Respondent submits that Applicant had raised a dispute on September, 5 2016 that on August 21, 2016, he was having position of 4800 PHARMA Ltd. Respondent squared off 4800 shares of PHARMA Ltd, without his permission on August 21, 2016. Respondent had replied to the Applicant vide its reply dated 11th September 2016. Respondent confirmed that 4800 shares of PHARMA Ltd were liquidated due to margin shortfall. Respondent submits that same was very well informed to the Applicant. Respondent denies all the allegations and contentions raised by the Applicant in his claim of the case. Respondent further submits that the arbitration application filed by the Applicant is false, frivolous and baseless and the same is filed with malafide intention only. The Respondent further states that the present Arbitration Application is totally misconceived, groundless and unsustainable in law and is therefore liable to be dismissed.

The Respondent states that Applicant was holding position of 4800 quantity of PHARMA Ltd which was purchased by him and due to sudden fall in the prices of the scrip, there arose the margin requirements for the client. The same was informed to the Applicant through SMS. In spite of this, Applicant failed to ar-

range the payment and meet the margin requirement. Respondent also requests to refer to and rely on Clause No. 1.19 of Terms and Conditions accepted by the Applicant while executing KYC documents [3]. “The Client acknowledges and undertakes to immediately deposit with the stock broker such cash, securities or other acceptable security, which the stock broker may require as margin. The client acknowledges that the stock broker shall be entitled to require the client to deposit with the stock broker a higher margin than the levels prescribed by the Exchange. The stockbroker shall also be entitled to require the Client to keep permanently with the stock broker a margin of a value specified by the stock broker so long as the client desires to avail of the Stock broker’s e-broking system.” This was also very well conveyed to Applicant at the time of account opening. Respondent further states that as the Applicant failed to meet the margin requirement for the positions and Respondent squared-off the PHARMA Ltd 4800 quantity in order to ensure sufficiency of margin on August 21, 2016. The Respondent submits that the shares were sold due to shortfall of the margin on August 21, 2016 and same was also very well intimated to Applicant through SMS and electronic contract notes. Respondent submits that Applicant was very well aware of functions of markets as he is the regular trader which is very well evident from his ledger statement.

Respondent further submits that loss calculated by the Applicant is notional as he has taken the difference of liquidated price as of August 21, 2016 and closing price of March 31, 2017, which is false, baseless and notional in nature. Respondent contends that Applicant is claiming the compensation only because the price of the scrip went higher than the liquidated price. Respondent submits that SMS was duly sent to the Applicant, and Applicant is also an online client and was able to view his positions and hence he was aware of the position. However, Applicant failed to meet the margin requirements and the resultant to which the position of the Applicant was liquidated. Hence, Respondent was not liable for losses, if any, incurred by the Applicant. The Respondent states that the claim of the Applicant is based upon absurd calculations. Therefore, Respondent was not liable to pay any compensation of the loss as allegedly claimed by the Applicant. Respondent submits that the claim of the Applicant is liable to be dismissed with costs.

5. Analysis, Results and Conclusions

It is found that the client (Applicant) has been trading for more than two years with the Respondent. Respondent and Applicant had excellent trading relations. It is confirmed by the Respondent during the personal hearing that the Risk Management Department of the Respondent liquidated the positions of the Applicant on August 21, 2016 within a minute of market opening. It is concluded that the liquidation of 4800 shares of PHARMA Ltd at 9.16 AM on August 21, 2016 was in a hurried and reckless manner without proper understanding of the issue, and without prior intimation to the Applicant. As per extant rules and

regulations of the Stock Exchange, client has to clear the debit balances on T + 1 basis. It is found from the written submissions of the Respondent and Applicant; there was no communication, no information or no intimation to the Applicant about the margin status, margin shortfall, and intention of the Respondent to liquidate the positions of the Applicant. It is concluded that officers working in the Risk Management Department are either not aware of the rule and regulations of futures trading or they might have ignored the rules and regulations before liquidation of the positions.

As per the extant rules and regulations of the stock exchanges, trading member (Respondent) has to send communication about margin short fall and contract notes on daily basis and client has to make payments as per pay in obligations of the settlement on T + 1 basis [3]. Client has to make payment on T + 1 day, means, in present case, Applicant has time to make margin payment (short fall of margin) till August 21, 2016 provided Respondent informs the same to the Applicant. Respondent didn't send the contract notes, and margin obligations to the Applicant either on August 20, 2016 or on August 21, 2016. Respondent also failed to submit the evidence or provide any proof of email, which was sent on August 20, 2016 to the Applicant. Respondent claimed that it had sent SMS to the Applicant regarding margin requirement and intention of liquidation of the holdings. It is concluded that the Respondent neither sent an email nor communicated on telephone regarding margin short fall and payment obligations of August 20, 2016. Risk Management Department of the Respondent without verifying the settlement obligations, margin payment obligations and settlement cycle *i.e.*, due dates for payment of such obligations, liquidated the positions within a minute of market opening on August 21, 2016 since the Risk Management Department has access to the client's positions and trading member's trading system. This is nothing but an unauthorized trade and a void contract. Respondent indulged in unauthorized trades in the account of the Applicant. It is the duty of the Respondent to inform properly and promptly in time to the client about payment obligation and it has to wait one day to receive payment *i.e.*, till end of August 21, 2016. If Respondent thinks it is in risky position to wait for T+1 for client's payment, it should not have allowed positions in futures segment without adequate and sufficient initial margins, exposure margins, extreme loss margins, and mark to market settlement margins higher than the prescribed levels by the stock exchanges so that it can protect itself from the risky positions and avoid this kind of unauthorized liquidations and unnecessary losses to clients. Respondent failed to send margin statements, settlement obligations and contract note relating to the settlement obligations of August 20, 2016 to the Applicant either after market closing of August 20, 2016 or before the market opening on August 21, 2016 *i.e.*, before squaring off the transaction. Due to the unauthorized trade indulged by the Respondent, Applicant suffered a loss of INR 23.0 million, the difference between the liquidation price of *i.e.*, INR 6115 on August 21, 2016 and closing price on March 31, 2017, *i.e.* INR 10,900 (the date of filing of Arbitration Application).

The issue before the Arbitrator in this case is whether the Respondent was within its rights to liquidate the open position of the client on account of shortage of margins. Respondent could not provide any proof or submit any evidence of communication or email which was sent to the Applicant on August 20, 2016. As per extant rules and regulations of the BSE and NSE, Applicant had time till August 21, 2016 to meet the margin obligations belonging to the trading day of August 20, 2016, [4] hence, there is no question of default in pay in obligations by the Applicant. It is concluded that there was no issue of default in margin payment by the Applicant; therefore, the Respondent doesn't have the right to square off or to liquidate the position of the Applicant. Applicant suffered a loss of INR 23 million, on account of unauthorized trading indulged by the Respondent. Therefore, this loss has to borne by the Respondent, and the same has to be reimbursed to the Applicant on the principles of equity, fairness and natural justice.

6. Recommendations

In view of the foregoing submissions, hearings, documents, and pleadings of the both parties, and on the basis of arbitrator's observations, findings and conclusions, the loss incurred by the Applicant on account of unauthorized and unwarranted liquidation has to be borne by the Respondent. Accordingly, the Arbitrator passed the award that the Respondent, SKS Stock Brokers Ltd is directed to pay INR 23.0 million with an interest at the rate of 12 per cent per annum for the delayed period *i.e.*, from the date of the award till payment to the Applicant. The stock exchanges such as Bombay Stock Exchange (BSE), National Stock Exchange (NSE), Metropolitan Stock Exchange (MSE) and SEBI have to look into these kind of misinterpretation of margin rules and regulations, abuses and misuses of securities market by the trading members. Managements of trading members have to train the risk management department and compliance departments of the to comply with the existing rules and regulations of the stock exchanges so that they may avoid these kind of issues and prevent the clients from the such huge losses. Stock exchanges have to evaluate the domain knowledge of securities market and stock market operations while considering appointments of members for IGRC and arbitrators for the panel of 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 on the principles of natural justice and in the interest of justice. Investors have to develop practice of following and adhering to the margin rules and regulations without any deviation so that they can continue and maintain their open positions in the market and avoid unwarranted liquidation by the trading members.

Applicant

This paper is based on an arbitration matter resolved through Alternative Dis-

pute Resolution (ADR) mechanism at the leading stock exchange of India. The names of the applicant, respondent, stock exchange, and monetary figures were disguised to preserve confidentiality.

Conflicts of Interest

The authors declare no conflicts of interest regarding the publication of this paper.

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- [1] The Arbitration and Conciliation Act of India 1996, India, 1-26.
- [2] SEBI (2010) Arbitration Mechanism in Stock Exchanges. CIR No. /MRD/DSA/29, 1-4.
- [3] SEBI (2012) Rights and Obligations of Stock Brokers. Sub Brokers and Clients Issued by the SEBI, Mumbai, 1-15.
- [4] SEBI (2016) Circular on Comprehensive Review of Margin Trading Facility. No. CIR/MRD/DP/54/2016, 1-8.