

Impact of scripless trading on business practices of Sub-brokers.

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Introduction

While the trading in the stock exchanges is effected only through the registered trading members (brokers) of the exchanges, there are number of sub-brokers who are servicing a large cross section of investors as the agents of the main brokers. With the increasing popularity of ‘scripless trading’ many brokers and sub-brokers are attempting to assess possible impact of this in their business practices. This note tries to address the concerns of these market intermediaries and to suggest modifications in the business practices to help them effectively manage in the changed environment.

In a loose sense, the broker can be considered to be a ‘wholesaler’ of services and the sub-broker can be considered to as a ‘retailer’ of services. Although the main services provided by these brokers are execution of the buy/sell orders and settlement of these trades on behalf of the investors, they also provide advice on stock picking and trading strategies. The sub-brokers have helped brokers to extend these services to a broader cross section of investors across a larger geographical area. As a part of settlement of trades, the sub-brokers also collect the securities and funds from the investor and delivers the same to the main broker for onward settlement with the Clearing Corporation (CC)/Clearing House (CH). In addition to this broking service, today brokers sometimes use sub-brokers as a layer separating them from the client and partly protecting them from bad delivery problems.

The sub-broker is responsible to the main broker on one side and the investor on the other side. This is achieved by broker issuing the contract note on the sub-broker and sub-broker issuing the purchase/sale note on the client. Thus in view of the long term business relation the sub-broker has with the main broker, and as this is a business for him, he ends up taking the risk of a potential bad delivery on himself. In fact many sub-brokers have expressed the view that their major concern was the risk of bad delivery. The depository system provides an answer to these problems.

Trading

For trading in physical securities, the sub-brokers collect the trade orders from their clients and place these orders with the main broker for execution in the market. The main broker enters the details of each trade against each sub-broker in a separate account kept for each sub-broker.

After execution of the trade, the main broker issues the contract note. Mostly the contract note is issued in the name of the sub broker who in turn issues separate purchase/sale note to his clients. In this case, in the books kept by the main broker, all trades are shown against the sub-broker and the main broker does not track details of each individual client. However, there are some cases where brokers issue contract notes, directly in the name of the client.

Based on the commercial understanding between the broker and the sub-broker, the sub-broker may decide on when to deliver, to the main broker, securities against sale orders and funds against purchase orders. Very often, these are handed over by the sub-broker to the broker just before the pay-in.

Even in case of trading in demat securities the same system can be followed. However in this case, as there is no fear of bad deliveries unlike in the case of physical securities, the brokers can directly issue the contract note in the name of client. This is in addition to facilitating a cost effective settlement (as can be seen from the section below) with a clean audit trail, may provide further confidence to the clients.

In this case the sub-brokers need to provide the details of the clients to the main broker for issuing the contract notes.

Concern of sub-broker.

Revealing of the client details may be against the business interest of the sub-brokers

The long-term sustenance of the sub broker is not based on the secrecy of the client. Rather, it is based on the higher investor reach made possible by the sub-broker network, which otherwise may not have been attained by the main broker alone. The sub-brokers also helped to reduce the administrative overhead in client handling. In fact as explained above, the issuance of contract note to the sub-broker was more of insurance to the broker against bad delivery and this added an unnecessary risk to the sub-broker. In this safe demat environment, the sub-broker can confine his services to “**broking in real sense**” instead of providing insurance against bad paper. More over, they can also increase their reach to a larger target audience.

Moreover in the physical market, the broker would any way may come to know the details of most of the clients of the sub-brokers as these clients may be selling securities registered in their name some time or other, which would expose the client details to the main broker.

Concern of the main broker.

The need for issuing the contract note in the name of each client adds to the back office work.

Compared to the reduction in back office activities of sorting the paper certificates, this is only a small additional activity. In fact many cases, the sub-broker themselves would share a part of the job, like they help in filling up of TD, attaching share certificates with it, arranging to despatch to the main broker. etc at the time of settlement of physical securities.

Settlement Purchase of Shares

At present in settlement of physical securities, the sub-broker would collect funds from the clients who have purchased securities. Mostly the sub-broker gets the funds credited to his bank account and issues a cheque to the extent of his net payable to the main broker after adjusting for his part of the brokerage, in time for pay-in or as per the credit period allowed by the main broker.

After the pay out, the sub-broker collects the securities from the main broker and arranges to deliver to his purchasing clients. In some cases, if the sub-broker also has selling clients for the same securities, the sub-broker will retain with him the securities of the selling client for distributing to the buying clients and the main broker may only be delivering net receipts to the sub-broker. To track the securities for any future bad deliveries, the sub-broker and/or the main broker would affix their respective seals on the back of the transfer deed.

In case of demat securities, the sub-brokers have two options:

1. **Arrange to deliver the securities directly from the pool account of main broker to the beneficial owner account of the buying clients.**

Towards this, the sub-broker may prepare a statement giving details of his receiving clients including name & client- ID of the client, name & DP-ID of client's DP and name and quantity of securities to be delivered. Main broker may attach the same (duly stamped and signed) to his delivery instruction duly filled and hand over the same to his DP. Based on this delivery instruction, the securities would be credited to the client accounts. The sub-broker would have to ensure that the receiving clients have a valid depository account. They should now instruct their clients to give a corresponding receipt

instruction with matching entry for Client-ID, quantity and execution date unless they have already given a **standing instruction to DP for automatic credit** to their account. The sub-broker may advise his clients to avail the facility of giving standing instruction, which would reduce the need for settlement by settlement receipt instructions.

The sub-broker at the time of giving the list of receiving clients may ensure that this list contains the details of only those clients with whom payment arrangements are settled. In cases where this is not so, the sub-broker can either retain the same in main brokers pool account (with their permission as this will attract custody charges to them) or take them to their own beneficial owner account maintained for their trading activities.

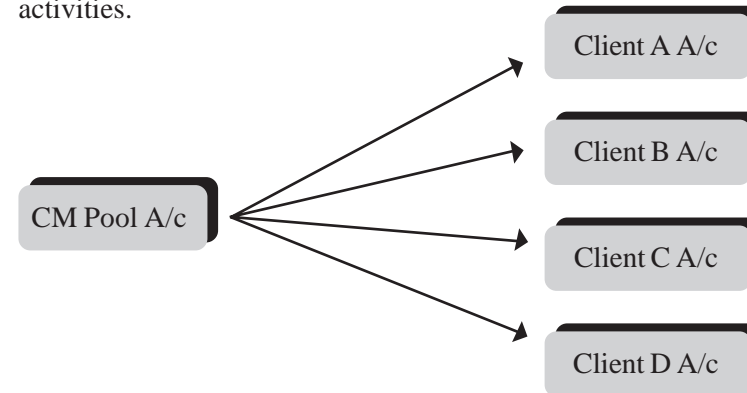


Diagram 1: Transfer of securities from main brokers pool a/c to direct credit in Clients beneficiary A/c (pay out).

Instruction to be used: Broker: Delivery instruction for pay out.
Client: Standing instruction or receipt instruction.

Here it is assumed that, the sub-brokers of the selling clients has arranged to deliver to the pool account of main broker, the securities of the selling clients in a manner explained below under section titled 'selling of securities.'

This mode of direct delivery to the client's account is independent of, whether the funds have been paid directly by the client to the main broker or paid through the sub-broker is irrelevant to the decision of direct delivery of securities to the client account so long as the sub broker has provided necessary authorisation to the broker to this effect.

2. **Arrange to deliver the securities from the pool account of the main broker to beneficial owner account of the sub-broker kept for trading purpose and then forward the same to buying client.** In this case the main broker would instruct his DP using a delivery instruction, to transfer securities from his pool account to beneficial owner account of the sub-broker, securities to the extent of purchase.

This transfer may be to the extent of his gross purchase or net purchase depending on whether the sub-broker had arranged to deliver to the pool account all the securities of his selling clients or whether he retained the securities of the selling clients in his trading account.

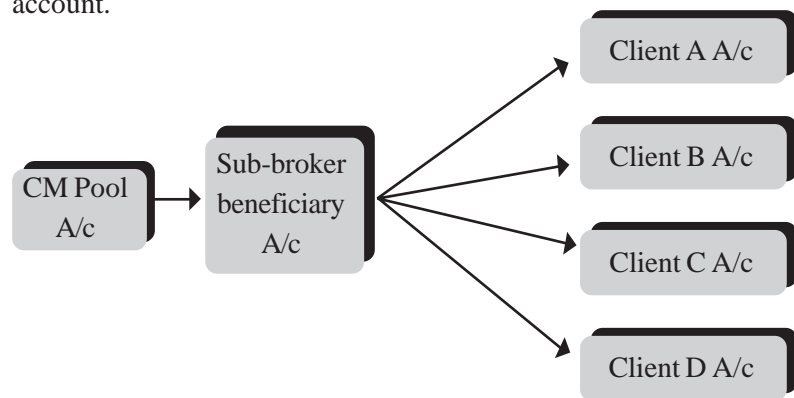


Diagram 2. Transfer securities from main brokers Pool A/c to Sub-brokers beneficiary A/c and subsequent transfer to the clients. (pay out of securities.)

Instruction to be Used: Broker: *Delivery Instruction* to transfer securities from pool a/c to Sub-brokers beneficiary a/c for pay out. **Sub broker:** *Receipt instruction* for receiving securities from brokers pool account or **standing instruction for automatic credit.** *Delivery instruction* for off market trade (scrip wise) to transfer securities to all the clients. **Clients** *Standing Instruction or Receipt instruction* for off market trade to receive securities from sub brokers beneficiary account.

As in the above case, the way funds were routed will have no bearing on the routing of the securities so long as necessary authorisation is taken on record.

Steps involved in purchase transactions under some of the scenarios discussed above are as follows.

Case 1

- Contract note :** **Directly to the client by the main broker.**
- Securities :** **Directly to Clients beneficial owner account by the main broker**
- Funds :** **Directly to Broker from the client**
(Refer Diagram 1.)

1. Sub-broker instructs main broker for purchase of securities.
2. Main broker executes the trade in trading terminal of the relevant Stock Exchange (like NEAT/BOLT etc.)
3. Main broker issues the contract note on the name of the client, which may be collected by the sub-broker and delivered to the client.
4. The sub-broker collects the payment cheque from clients and hands over to the main broker. (The payment arrangement of whether funds to be delivered before trade execution or at the time of pay-in etc. may be based on their prior commercial arrangement.)
5. The trade details are entered in the register kept by the broker for each sub-broker.
6. The sub-broker provides a statement to the main broker giving the following details for the delivery of securities to his clients on or before payout.

- ◆ Client Name
- ◆ Client ID
- ◆ Client DP's name
- ◆ DP ID of the Client
- ◆ Name of scrip & Quantity to be credited
- ◆ Execution date

7. After pay out, the main broker issues a **delivery instruction** to his DP with the above details of the target clients.
8. The Sub-broker arranges to have his matching receipt instructions of the client delivered to their respective DP for those clients who have not given standing instruction for credit to their accounts.
9. The main broker pays the sub-broker his share of brokerage.

Case 2

Contract Note : Issued to sub-broker by main broker who in turn issues a Purchase/Sale note to the client.

Securities : Through the sub-broker's beneficial owner account.

**Funds : Through Sub-brokers bank account
(Refer Diagram 2.)**

1. Sub-broker instructs main broker for purchase of securities.
2. Main broker executes the trade in trading terminal of the relevant Stock Exchange (like NEAT/BOLT etc.)
3. Main broker issues the contract note in the name of the sub-broker who in turn issues a Purchase/Sale note to the client.
4. The trade details are entered in the register kept by the broker for each sub-broker.
5. The sub-broker collects the payment cheque from clients and deposit in his bank account. (The payment arrangement of whether funds to be delivered before trade execution or at the time of pay-in etc may be based on their prior commercial arrangement.)

6. The sub-broker informs main broker to credit all the securities to his beneficiary account. Main broker gives delivery instruction to his DP and sub broker will give receipt instruction unless there is a standing instruction for credits.
7. Once the securities are credited in the sub brokers account he will give *delivery instruction* for off market trades to his DP and all his clients will give corresponding receipt instruction with common execution date unless there is standing instruction for credits. Sub broker may keep the following details of his clients for delivering securities.

- ◆ Client Name
- ◆ Client ID
- ◆ Client DP's name
- ◆ DP ID of the Client
- ◆ Name of scrip & Quantity to be credited
- ◆ Execution Date

Selling of Shares

Presently in settlement of sale of physical securities, the sub-broker would collect securities from the selling clients and forward the same to the main broker in time for pay-in or before the execution of the trade as per the previous agreement. They would deliver securities to the extent of gross sales or net sales based on their prior agreement.

After the pay out, the main broker would issue a cheque to the extent of net receivable after adjusting for his brokerage of the sub-broker who in turn would effect the payment to the client after deduction of the brokerage of the sub-broker.

In case of demat securities, the securities can be delivered to the pool account of the main broker either through the sub-broker’s account or directly as explained in the case of purchase of securities, but in the reverse direction. The main broker can monitor the receipt of securities against a sale order in to his account for each settlement with help of the transaction statement of his CM account for that settlement number and the trade (sauda) register. The transaction statement would give details of the client account number & Clients DP’ name to the extent of delivery by the client.

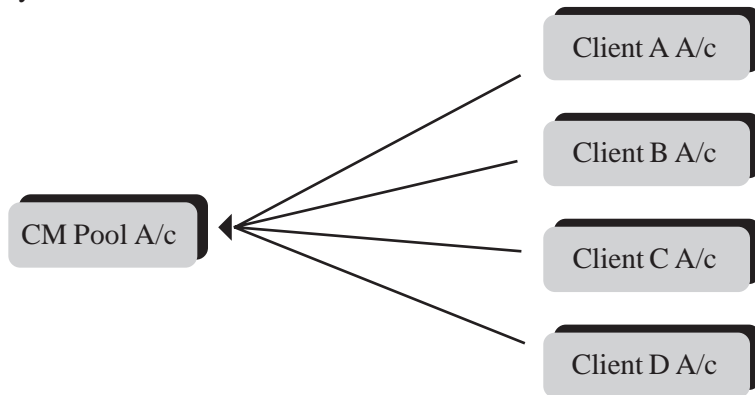


Diagram 3. Transfer securities from Clients account to main brokers Pool Account. (For pay in)

Instruction used: 1) **Client:** Delivery Instruction to their DP. 2) **Broker:** May give *standing instruction* to his DP or give corresponding receipt Instruction with common execution date.

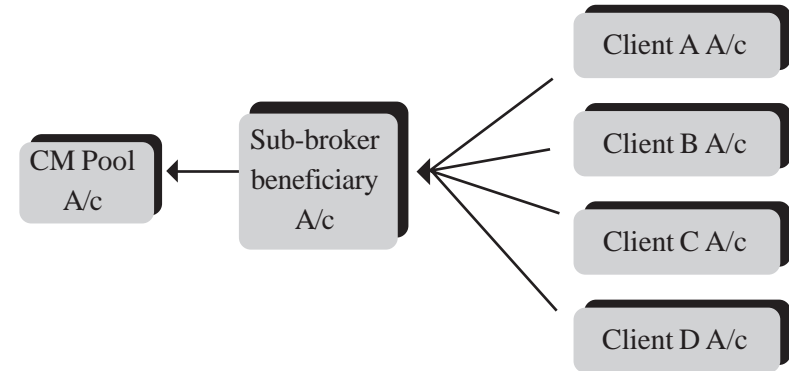


Diagram 4. Transfer securities from client’s account to sub broker beneficiary account and subsequently to CM pool A/c. (for pay in)

Instruction to be Used: Clients: Delivery Instruction for off market trades. **Sub broker:** Receipt instruction for receiving securities from his clients or *standing instruction for automatic credit* and Delivery instruction to transfer to CM pool A/c. **Broker:** *Standing Instruction* or Receipt instruction to receive from sub brokers beneficiary account.

Steps involved in sales transactions under some of the scenarios discussed above are as follows.

Case 1.

- Contract note** : **Directly to the client by the main broker.**
- Securities** : **Directly to main broker from the Clients beneficial owner account**
- Funds** : **Directly to Client from the main broker. (Refer Diagram 3.)**

1. Sub-broker instructs main broker for sale of securities.
2. Main broker executes the trade in trading terminal of the relevant Stock Exchange (like NEAT/BOLT etc.)
3. Main broker issues the contract note on the name of the client, which may be collected by the sub-broker and delivered to the client.

4. The trade details are entered in the register kept by the broker for each sub-broker.
5. The sub-broker collects all the delivery instruction from all his clients and gives it to the DPs of each client and ensures that the main brokers pool account is credited before pay in deadline. (*Sub broker needs to check the information on the instruction before submitting to DPs.*)
6. The sub-broker provides a statement to the main broker giving the following details for the receipt of securities of his clients.

- ◆ Client Name
- ◆ Client ID
- ◆ Client DP's name
- ◆ DP ID of the Client
- ◆ Name of scrip & Quantity to be credited
- ◆ Execution Date

7. After pay out, the main broker issues a cheque in the name of all the clients and may pass the same through his sub broker.

Case 2.

Contract Note : Issued to sub-broker by main broker who in turn issues a Purchase/Sale note to the client.

Securities : Through the sub-broker's beneficial owner account.

**Funds : Through Sub-brokers bank account
(Refer Diagram 4.)**

1. Sub-broker instructs main broker for sale of securities.
2. Main broker executes the trade in trading terminal of the relevant Stock Exchange (like NEAT/BOLT etc.)
3. Main broker issues the contract note in the name of the sub-broker who in turn issues a purchase/sale note to the client.
4. The trade details are entered in the register kept by the broker for each sub-broker.
5. The sub-broker informs all his clients to credit the securities sold, to

- his beneficiary account by giving *delivery instruction for off market trades*. Sub-broker will give *receipt instruction* unless there is a *standing instruction* for credits.
6. Sub broker may keep the following details of his clients for receiving securities.

- ◆ Client Name
- ◆ Client ID
- ◆ Client DP's name
- ◆ DP ID of the Client
- ◆ Name of scrip & Quantity to be credited
- ◆ Execution Date

7. Sub-broker receives all the securities in his beneficial owner account from his clients and gives each *delivery instruction*, scrip wise to credit securities to his main brokers pool account before pay in. Main broker will give receipt instruction *or standing instruction*.

It may be noted that, settlement by the main broker with the CC/CH is effected through a CM account in the depository system. But, as the sub-brokers are not members of the CC/CH directly there are no separate CM account for them. If the sub-broker intends to route the securities through his account then it is advisable that he opens a separate beneficial owner's account exclusively for trading purposes. He may keep his personal investment securities in a different beneficial owner account. This would help him keep books in a systematic fashion for filing of tax returns.

If the sub-broker is routing securities through his trading account, then the movement of securities in to this account from the client account and movement from this account to his clients account will be considered as 'off-market transactions' in the depository system and will attract different settlement charges.