



# Risky business

## What are the legal risks associated with trading in securities in India?

*Mathew Chacko explains*

**F**ailed trades – trades in securities that are not settled on the contracted settlement date – are a global phenomenon. They arise when a seller or a purchaser of a security does not deliver the security or funds, as promised. Portfolio investors have become increasingly sensitive to the risks of a failed trade following a spate of high-profile failures to settle trades on the sidelines of the financial crisis.

While India was not the epicentre of the financial turmoil, the global nature of portfolio flows demands that the Indian payment and settlement system be evaluated in order to mitigate any risk associated with failed trades.

In the process of settling a trade, both the title to the securities and the consideration are exchanged. In India, as in many other common law jurisdictions, legal title to securities and any corresponding consideration is transferred only on settlement and no right, title or interest is transferred prior

to settlement. A purchaser of securities does not obtain any beneficial right over the security purchased, even if the trade is matched.

### Short delivery

In the event of a short delivery of securities, the Bombay Stock Exchange (BSE) or the National Stock Exchange of India (NSE) debits the price of the securities from the counterparty that has failed to deliver the securities and conducts an auction to rectify the short delivery. If the auction price is higher than the amount debited from the counterparty, the shortfall is debited from the defaulting counterparty.

With regard to the short delivery of funds, both the NSE and the BSE maintain a settlement guarantee fund. However, the BSE has some discretion in using its settlement guarantee

fund to make good any loss arising out of the short delivery of funds, while the NSE is obliged to step into the shoes of the defaulting party. Further, the BSE's settlement guarantee fund is thinly capitalized and so may expose a potential purchaser to an element of risk in the event of a failed trade.

### Bankruptcy risks

The bankruptcy of a counterparty to a trade, the custodian, the broker or the clearing house increases the risk of a failed trade.

**Bankruptcy of the counterparty:** Since title to the security and funds are transferred on settlement, an investor is not subject to settlement risks on account of the bankruptcy of the counterparty. In the event of a short delivery of funds or securities, the auction process described above would take place.

Investors trading on the BSE bear the risk of an auction being unsuccessful, in which case, an investor's only recourse would be to participate in bankruptcy proceedings. If investors are trading on the NSE, its clearing house would make good any loss suffered.

## Falling short

### Manish Hathiramani shares some practical tips to avoid the hazards of short deliveries

The short delivery of shares and auction penalties are practical problems that all equity traders may face. To avoid the risk of a short delivery, what anyone who trades shares in India really needs is a sense of discipline.

One of the golden rules of trading is that one should never sell shares one does not own. This rule applies only to cash trades. In the case of derivatives, there are no risks with regard to the short delivery of shares or the auction of securities. In that market, everything is contract-based.

#### Avoiding trouble

The Securities and Exchange Board of India requires that settlement of market trades in listed securities take place in dematerialized (demat), or electronic, form. Investors must open a demat account with a depository participant that is authorized to offer depository services to investors. Banks and other financial institutions, custodians and stockbrokers that comply with the prescribed requirements can be registered as depository participants.

An investor who purchases equity shares should see those shares reflected in their demat account before giving a broker or institution the order to sell them. The stock exchange in India follows a system known as T+2, which means that securities that have been purchased from the secondary market must be received within two days after the day of trade (T).

If the T+2 deadline passes and a buyer's shares have not come into their account, the stock exchange will penalize the party that sold those shares to the buyer. This penalty is 1% of the transaction value plus the auction price at which shares are bought to deliver to the investor.

This process can be nerve-racking, especially because traders are keen on short-term gains. With this in mind, it is essential for investors to avoid selling shares even after T+2 without confirming that the shares are reflected in their account.

#### The dangers of a quick buck

This leads to another aspect of trading which has underlying risks of short delivery. Since the Indian

equity markets are particularly volatile, brokerage houses frequently recommend to their clients stocks which they expect to rise within 24 hours; in essence, to buy on one day and sell it the next day. This is popularly known as "buy today sell tomorrow" (BTST). This practice is profitable for the brokerage house since the buy/sell transaction attracts costs. The client, on the other hand, endeavours to make an extra buck overnight.

However, it is crucial to understand that by purchasing on one day and selling the next morning, investors are essentially ignoring the T+2 concept. With efficient technology it is expected that the shares will be reflected in the buyer's account by the next morning but this is like playing with fire.

A brokerage takes no responsibility once the BTST call has been made and executed. Therefore, if a seller fails to deliver the next day, the loss is entirely their own. For this reason, it is advisable to avoid BTST trading. Investors should treat trading like a business rather than a gamble. The strike rates may be tempting, but one auction cost could more than wipe out all of an investor's profits.

#### Technology and discipline

Traders should exercise diligence and responsibility in executing the delivery of shares. Having access to online demat accounts means traders are not required to physically go to a bank or institution to effect a share transfer or delivery.

Care is required when inserting details on the delivery instruction. Along with this, one must not delay in effecting the transfer. An error on these fronts could result in the delivery being rejected by the automated systems of the stock exchange.

If traders are unaware of the deadlines of the system, they should call their depository participant and obtain the details they need.

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**Bankruptcy of intermediaries:** Intermediaries such as stockbrokers and custodians are required to maintain investor funds and securities in segregated accounts. The funds and securities continue to be the property of the investor and are operated by intermediaries under an obligation of trust.

As such, other claimants would not have access to these properties in the event of the bankruptcy of the intermediary. However, the investor would not be able to freely transfer the funds or securities and would have to obtain an order of the court authorizing any such transfer.

**Bankruptcy of the clearing house:** Indian law does not specifically contemplate the bankruptcy of a clearing house. As private limited companies, National Securities Clearing Corporation Limited (the NSE's clearing house) and BOI Shareholding Limited (the BSE's clearing house) are subject to India's bankruptcy law.

National Securities Clearing Corporation Limited is a party to trades on the NSE, so an investor's claim in the event of the bankruptcy of the clearing house would receive priority over the claims of secured creditors. BOI Shareholding Limited is not a party to trades on the BSE and as such, an investor's claims in the event of BOI Shareholding's bankruptcy may be junior to those of other unsecured creditors.

However, both these clearing houses are majority owned by public-sector banks and therefore the chances of bankruptcy are minimal.

## Investor protection

In the event of a failed trade, the Indian legal system promises significant levels of investor protection. However, despite the BSE being the oldest stock exchange in Asia, the effectiveness of the settlement and payment system in the context of the bankruptcy of a party or intermediary to a trade remains substantially untested. An investor's rights to funds or securities on the bankruptcy of a counterparty, the clearing house or any other intermediary depend on the application of legal principles that have not been previously visited by Indian courts in a similar context and is uncertain to that extent.

One may be tempted to conclude that the non-application of these principles is a testament to the efficiency of the payment and settlement system and an indication that the risks are minimal – a conclusion that, after the adventures of the past few years, many would hesitate to make. ■

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