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# POLICY ON RISK MANAGEMENT SYSTEM

## BACKGROUND:

Far reaching reforms have been undertaken by Securities & Exchange Board of India (SEBI) to promote stock market and protect investor interests. Major initiatives taken are in the areas of structure and functioning of stock exchanges, automation of trading and post trade systems and the introduction of surveillance and monitoring systems. Computerized online trading of securities, and setting up of clearing houses / settlement guarantee funds have paved way to expansion of trading locations even at far flung places and bringing about the desired level of transparency and promptness in trading and settlement of dues between the traders and the counterparties.

SEBI is the primary body responsible for regulation of the securities market, deriving its power of registration and enforcement primarily from the SEBI Act. SEBI's functions include:

- Regulating the business in stock exchanges.
- Registering and regulating the working of collective investment schemes, including mutual funds,
- Prohibiting fraudulent and unfair trade practices relating of securities market
- Prohibiting insider trading in securities, with the imposition of monetary penalties, on erring market intermediaries
- Regulating substantial acquisition of shares and takeover of companies
- Calling for information from, carrying out inspection, conducting enquiries and audits of stock exchanges.

SEBI has issued comprehensive guidelines governing issue of shares and other financial instruments, and has laid down detailed norms for Stock Exchanges, Stock Brokers and other intermediaries in the secondary market.

As Share Broking firm and Depository Participant, NSL has to consider the risk management issues on two fronts viz. meeting the requirements of the Regulators / Stock Exchanges on risk containment issues and setting its own operational

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guidelines with proper parameters to combat various risk related issues like regulatory risks, market risks, client risks, employee risks etc. In the following pages we discuss the above issues in two parts, viz. (i) risks containment measures as set in by the regulators/stock exchanges and (ii) our own risk containment measures.

**PART A: TAKING CARE OF RISK MANAGEMENT ISSUES AS STIPULATED BY REGULATORS AND EXCHANGES:**

SEBI has taken several measures to improve the integrity of the secondary market. Legislative and regulatory changes have facilitated the corporatization of stock brokers. Stock brokers are now subjected to capital adequacy norms. With the advent of screen based trading discarding the age old open outcry trading system through the establishment of National Stock Exchange of India Ltd. (NSE) in 1994, the regulatory responsibilities have largely shifted to the stock exchanges. The stock exchanges are the primary regulators for detection of market manipulation, price rigging and other regulatory breaches regarding capital market functioning. The stock exchanges in turn are subjected to surveillance and inspection by SEBI.

SEBI exercises its regulatory role on the share broking firms primarily through Stock Exchanges who act as first level regulators. Stock Exchanges conduct inspection of the member stock brokers in the Capital Market segment as well as Derivative Market segment as per regulatory requirements every year. In turn, we are also regularly inspected by SEBI/Exchanges/Depository with whom we are registered as Member/Depository Participant. During such inspections the inspection team verifies the compliance of the provisions of applicable act, rules, regulations, bye-laws, guidelines and circulars by trading and clearing members. The Exchanges initiate necessary disciplinary action against the members in respect of the violation observed during the course of inspection.

In order to protect our image and reputation and at the same time to check any on slaught on our revenue stream, our risk management measures have to essentially remain alive on the compliance to the regulatory issues on the one hand and contain the client risks accentuated by the volatility / uncertainties thrown up by the stock markets, on the other hand.

As the most important risk management tool to have effective control on defaults by clearing members/ trading members the Stock Exchanges have introduced margin and exposure limit concept. In addition a mark-to-market and trading limit have been imposed. In order to contain excess volatility exchanges have put in place circuit breakers. Stock brokers are now required to disclose at the end of the day extent of short sales and long purchases to reduce price volatility and further enhance the integrity of the secondary market.

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## MARK TO MARKET MARGIN AND INTRA-DAY LIMIT

For retail investors, it is not necessary to take or deliver the shares if equal number of same stock are purchased and sold or vice-versa, during the same settlement period. Thus, squaring-off of the trading position during the same settlement period results in non-delivery of shares that the investor traded. This gives rise to opportunity and temptation to make a short-term and speculative investment at a relative low cost. To contain the risk of settlement chaos that may be caused by an increasing number of non-delivery transactions, SEBI has introduced a daily mark-to-market margin and trading limit. The daily mark-to-market margin is a margin on broker's daily position. The intra-day trading limit is the limit to the broker's trading volume. Every broker is subjected to these requirements.

Each broker's trading volume during a day is not allowed to exceed the intraday trading limit. The limit is 33.3 times the base minimum capital deposited with the exchange on a gross basis, i.e. purchase plus sale. In the event of brokers wishing to exceed this limit, they have to deposit additional capital with the exchange and this cannot be withdrawn for 6 months.

The primary focus of risk management by SEBI has been to address the market risks, operational risks and systematic risks. To this effect SEBI has been continuously reviewing its policies and drafting risk management policies to mitigate these risks, thereby enhancing the level of investor protection and catalyzing market development. The key risk management measures initiated by SEBI include:

- Categorization of securities into groups 1, 2 and 3 for imposition of margins based on their liquidity and volatility.
- VaR based margin system.
- Specification of Mark to Markets margins.
- Specification of intraday trading limit and gross exposure limits.
- Real time monitoring of the intra-day trading limits and Gross Exposure Limits by the Stock Exchanges.
- Specification of time limits of payment of margin.
- Collection of margins on T+1 basis (since modified).

- Index based market wide circuit breakers.
- Automatic de-activation of trading terminal in case of breach of exposure limits.
- VaR based margining system has been put in place based on the categorization of stocks based on the liquidity of stocks depending on its impact cost and volatility. It addresses 99% of the risks in the market.
- Additional margins have also been specified to address the balance 1% case.

Analyses of the above issues are detailed in the subsequent paragraphs in this note.

From February 2005 SEBI modified the above mentioned risk management framework by putting stress on upfront collection of VaR margin (instead of margin collection on T+1 basis). In the revised framework the liquid assets deposited by the broker with the exchange should be sufficient to cover upfront VaR margin, Extreme Loss Margin, Mark to Market margin and the prescribed Base Minimum Capital. The Mark to Market margin would be payable before the start of the next day's trading. The Margin would be computed based on gross open position of the member. The gross open position for this purpose would mean the gross of all net positions across all the clients of a member including the proprietary position. The exchanges will monitor the position of the broker's online real time basis and there would be automatic deactivation of terminal on any shortfall of margin.

**Notes on various Margins / Base Minimum Funds:**

**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 three-day losses so as to allow the clearing corporation to liquidate the position over three days. For liquid stocks, the VaR margins are based only on the volatility of the stock while for other stocks, the volatility of the market index is also used in the computation.

The VaR margin is collected by the exchange on an upfront basis by adjusting against the total liquid assets of the member at the time of trade. Collection on T+1 day is not acceptable.

**Extreme Loss Margin** – It covers the expected loss in situations that go beyond those envisaged in the 99% value at risk estimates used in the VaR Margin.
The Extreme Loss Margin is collected / adjusted against the total liquid assets of the member on a real time basis. The margin so collected is released along with the pay-in.

**Shortfall of Margins / Pay-in of funds**

a. Margin shortfall

In case of any shortfall in Margin the terminals of the broker shall be immediately deactivated.

b. Pay-in shortfall

i. In cases where the amount of shortage in a settlement for a trading member is in excess of the Base Minimum Capital (BMS) prescribed, the trading facility of the member shall be withdrawn and the securities pay-out due to the member shall be withheld.
ii. In cases where the amount of shortage exceeds 20% of the BMC but less than the BMC on six occasions within a period of three months, then also the trading

facility of the member shall be withdrawn and the securities pay-out due to the member shall be withheld.

iii. Upon recovery of the complete shortages, the member shall be permitted to trade subject to his providing a deposit equivalent to his cumulative funds shortage as the 'funds shortage collateral'. Such deposit shall be kept with the Exchange for a period of ten rolling settlements and shall be released thereafter. Such deposit shall not be available for adjustment against margin liabilities and also not earn any interest. The deposit may be by way of cash, fixed deposit receipts and bank guarantee.

iv. The exchange may levy a penal interest of not less than 0.07% per day on the pay-in shortage of the member.

**Additional Margin**

The Exchanges /Clearing Corporations have the right to impose additional risk containment measures over and above the risk containment system mandated by SEBI. Additional risk management measures (like ad hoc margins) would normally be required only to deal with circumstances that cannot be anticipated or were not anticipated while designing the risk management system. Any additional margins that the exchanges may impose shall be based on objective criteria and shall not discriminate between members on the basis of subjective criteria.

**PART B: TAKING CARE OF RISKS AS PERCEIVED BY NSL**

**Risk Management Measures of NSL in Cash Segment:**
It is, therefore, clear that all branches/AP must have systems and procedures to ensure the above concerns of SEBI. In NSL we have taken care of the above concerns however in the cash segment we do not collect any margins from the clients but it is ensured at all times that the debit balance is allowed to to be in limit and it is also our constant Endeavour to not allow debit for more than T+2+5 days.

While mitigating the regulatory risks, our liquidity management should be rigorous. The important aspects are that we should not lose sight of the need to recover all our dues from our clients as accumulation of dues over a period of time poses problem of recovery since unlike banks/financial institutions, we in the capacity of Depository Participants / Share Broker do not enjoy unfettered rights to exercise set off on the securities retained by the clients in their Demat Accounts opened with us. Apart from making full recovery of dues, prompt recovery of all dues is also equally important since delayed delivery beyond settlement day would entail loss of interest following debits made in our settlement account maintained with the Clearing House on T+2 day. If such delayed recovery is found widespread across all the branches, the quantum of interest loss will be considerable apart from the resultant strain on the overall liquidity of the company. Since we cannot take for granted the good intention of clients and their collaborative approach for recovery of dues, as stock broker we have to put in place automatic checks and balances to minimize loss on account of share broking activities.

## Areas requiring more focused attention by Risk Management Desk

Risk Management Desk should closely monitors outstanding position of top buying clients and top selling clients on a daily basis. Considering the present size of branch network, top 10 clients from each category can be considered at present and reports should be generated based on certain pre-set parameters. These reports should be scrutinized to ascertain whether a client has built up excessive purchase or sale position compared to his normal level of business. Further, it should be examined whether purchases or sales are concentrated in one or more scrip's, whether margin cover is adequate and the quality of exposure is satisfactory i.e. scrip's are not mostly illiquid. Such monitoring will also throw light whether the share broking activities undertaken by the clients are in commensurate with the financial standing disclosed at the time of opening of demat and trading accounts with us.

## EMPLOYEE RISKS

The ambit of share broking activity is no longer confined to metro and big cities. With the coming up of plethora of share broking firms operating from all corners of the country including district towns, there is a constant pressure on acquisition of employees for running the show. Job hopping has become order of the day and under such a scenario, employee loyalty can hardly be taken for granted. Thus we have to face risks on employee front mainly on account of poor quality, impulsive behavior and dishonesty manifested in employee-client nexus. Keeping the above factors in mind, we have put in the following measures to safeguard against willful wrong behavior of employees:

i) As far as possible while recruiting new employees, discreet enquiry is made with the previous employers about the antecedents of the prospective employees.

ii) No person is appointed as dealer unless he has passed NCFM dealer's module certificate course.

iii) It has been made mandatory for all employees to avail at least 15 days leave in a year.

iv) Job rotations are done at Head Office from time to time.

v) It is being considered to depute branch manager of one branch to another branch for 15 days in a year.

vi) We insist that delivery instructions are obtained from all clients and shares before delivery to the stock exchanges are routed through the beneficiary accounts. Whenever it is found that a branch is breaching these instructions frequently, clients of the said branch are contacted at random to verify the genuineness of the transactions.

vii) Meetings are held regularly at Head Office with group of employees like Branch Managers / Dealers to educate them on various aspects of their job responsibility and the danger in flouting the laid down instructions.

Circular instructions have been issued (i) in the matter of observing utmost caution in regard to custody/delivery of delivery instructions booklets to clients, (ii) issuance of proper receipts against payment

viii) by clients towards trading/margin money and by cash towards various charges, (iii) maintaining complete secrecy of system passwords allotted to dealers/branch managers, and (iv) not to hold any blank delivery instructions slips signed beforehand by the client.

ix) Any dubious/unauthorized transactions done by any employee or any attempt made to bend rules are to be reported by other employees at the branch to Head Office promptly.

Further we are about to introduce certain other important measures which will have considerable effect on our efforts to reduce employee risk as well as increasing customer satisfaction. These measures are:

i) Centralizing entire contract notes related work including dispatch of notes direct to clients at Head Office.

ii) Sending Email to clients direct reporting the transactions made by him during the day.

iii) Asking branches to send a fax of the relative cheque tendered by a client before depositing the same in bank account.

This apart we are examining the prospect of taking hedge cover from an insurance company to minimize loss arising out of complaint made against the company by our client citing employee dishonesty.

**For Nakamichi Securities Limited**

Snigdha Tibrewala

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**Director**
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