

ADR ON CLIENT'S DISPUTE WITH TRADING MEMBER AT THE LEADING STOCK EXCHANGE IN INDIA: AN EMPIRICAL STUDY¹

Dr. Bezawada Brahmaiah
Professor of Finance & Accounting
ICFAI Business School (IBS), IFHE, Hyderabad, India
E-mail: brahmaiahb@ibsindia.org

ABSTRACT

The paper evaluates trading rules and regulations of the Stock Exchange in cash segment of the stock market in India. The paper adopts case method to study the trading rules and practices of trading members of the Exchange. It investigates the stock market's misuses and abuses by the trading members. The paper provides guidance for the appropriate regulatory framework to Indian securities market and ensures investors' protection. The results may be generalized in the emerging markets. Hence, researchers are encouraged to study results further in other developed countries. The paper finds that these practices are not only violation of trading rules of the Stock Exchange but also unfair and unethical trading practices.

Keywords: Alternative Dispute Resolution, Arbitration, Stock Exchanges, Securities Market.

INTRODUCTION

This was a reference matter for the arbitration under Bye- laws, Rules and Regulations of the Stock Exchange. Client (Applicant) filed an application with the Stock Exchange that the sub broker colluded with the trading member and caused him financial losses and mental agony. Member, Investor's Grievances Redressal Panel (IGRP) dismissed his application and the claim for compensation as the payment made to the Smart Commodities Private Ltd (SCL) was not under jurisdiction and purview of Stock Exchange of India Ltd (SEIL). This arbitration has been preferred by the Applicant against the order of the IGRP. Accordingly, the arbitration proceedings were initiated and personal hearing for the matter was held on February 14, 2020 at the Regional Arbitration Centre of the Stock Exchange, Hyderabad, India. (Arbitration and Conciliation Act of India 1996).

¹The paper is based on an arbitration matter resolved at the stock exchange of India by the author. Names of client, trading member, and Exchange are disguised to preserve confidentiality. The Arbitration mechanism of the Stock Exchange is framed under the Arbitration and Conciliation Act of India 1996.

Statement of Claim by the Applicant

The Applicant submits that the Trading Member (Respondent) and Sub-broker colluded and caused him financial losses and mental agony. He narrated the sequence of events as follows. He duly filled two account opening forms, one for securities trading and other one for commodities trading and submitted both the forms along with all necessary documents to the sub broker. The sub broker opened only one account in Smart Securities Ltd (SSL) and not opened account in Smart Commodities Pvt Ltd. Applicant submits that the sub broker advised, motivated, influenced and instigated him to bring few demand drafts (DDs) for INR 4.9 million each in favor of Smart Commodities Pvt Ltd (SCL) and some more DDs in the name of Smart Securities Ltd so that he could trade in commodities as well as securities. Accordingly, Applicant bought twelve (12) DDs for INR 4.9 million each and one DD for INR 1.5 million. The details are furnished in Table-1. Seven demand drafts of INR 4.9 million each and one DD of INR 1.5 million totaling of INR 36.4 million were paid to Smart Securities Ltd and five DDs of INR 4.9 million each, totaling of INR 24.9 million were paid to Smart Commodities Pvt Ltd. Applicant paid total amount of INR 61.4 million to SSL and SCL by way of demand drafts. Applicant submitted the evidence that all 13 DDs were bought by him from his IDBI Bank and State Bank of India (SBI). Applicant came to know on August 19, 2019 that the sub broker did not give him credit to the DDs submitted by him to the sub broker. The Applicant wrote a letter to the Respondent to update his account. General Manager of the Respondent replied that such demand drafts were not credited to his account and were credited to four different clients' accounts as advised by the sub broker. It was found that all 13 DDs, totaling INR 6.14, million was paid by the Applicant was misappropriated. The sub broker (the authorized person), Mr KDP Reddy in collusion with the Trading Member fraudulently credited these DDs to others' accounts and after encashment of demand drafts, the total amount was paid to these clients. (pay outs) not to the Applicant. It clearly indicates that the sub broker in collusion with the Respondent (Trading Member) misused, abused and indulged in fraud in the trading systems of the Stock Exchange and Commodity Exchange. Applicant submits that Trading Member and sub broker together cheated him for INR 61.4 million and misappropriated the payment fraudulently and accommodated others who are their relatives and close associates. The four clients whose accounts are credited with the proceeds of the 13 DDs in question did not submit any letter/confirmation from banks that these DDs were bought by them. The said four clients did not claim the DDs. Applicant submits that the Respondent and Sub-broker colluded in this matter and caused financial losses and mental agony. The Applicant prays for recovery of INR 61.4 million which was paid by him to the Trading Member through sub broker and also damages of INR 5.0 million towards financial loss, harassment and mental agony.

Table 1. Payment details of the Applicant

S.No.	Demand Drafts Nos. & Date	Company Name	Million Amount in INR
1	023264, 25-10-2017	SSL	4.9
2	023265, 25-10-2017	SCL	4.9
3	023266, 26-10-2017	SCL	4.9
4	023267, 26-10-2017	SSL	4.9

5	257043, 08-11-2017	SSL	4.9
6	257045, 09-11-2017	SSL	4.9
7	257044, 08-11-2017	SCL	4.9
8	023673, 20-01-2017	SCL	4.9
9	023674, 20-01-2018	SSL	4.9
10	023712, 25-01-2018	SSL	4.9
11	024472, 06-07-2018	SCL	4.9
12	024473, 06-07-2018	SSL	4.9
13	024474, 06-07-2018	SSL	1.5

Statement of defense by the Respondent

The Respondent submits that the allegations made by the Applicant in the statement of case are not true, valid, tenable and binding on them. The Respondent submits that the Arbitration application itself is not maintainable, as the SEI has no jurisdiction to entertain the present arbitration application since the Applicant has not specified the placement of orders. The IGRP's Order also revealed that the ledger and contract note of the Applicant show only a pay-in of INR 1.0 million by the Applicant for trading on the SEIL. (SEBI 2010). Therefore, in view of the IGRP order, this Application is not maintainable and the SEIL has no jurisdiction to entertain this Arbitration matter. The allegation made by the Applicant that the Respondent and sub-broker colluded and caused financial losses and mental agony is all not true. Respondent submits that the Applicant himself colluded with certain clients (third party constituents) and sub-broker and executed his indirect trading operations. Respondent submits that the alleged DDs were not received from the Applicant but received from four other clients (third party constituents). The Respondent further submits that the Applicant remained silent over the matter, and didn't report the purported misappropriation of demand drafts within a reasonable period of time and coolly at his convenience after about 18 months from the date of issuance of demand drafts, chosen to allege against them and the sub broker. It vents the possibility of complicity, collusion among the Applicant and the clients / sub-broker and the third-party constituents into whose account those DDs were accounted for. The Respondent further confirms that they have received the two DDs from four other clients for which they had passed two separate receipts acknowledging the DDs. As regards the Applicant's allegation of violation of the provisions of the Securities and Exchange Board of India (SEBI) circular, in not insisting on the Banker's letter for the demand drafts accepted by it, The Respondent states that the amount of DDs were less than INR 5.0 million and hence the need was not felt, considering spirit of SEBI circular. In this connection, the Respondent urges the Arbitrator to examine the propriety of taking several DDs for less than INR 5.0 million instead of taking one demand draft, had the intended transactions were bonafide and genuine. The Respondent alleges that the fraudulent intention on the part of the Applicant in claiming the amount unlawfully after maintaining and maintained study silence over the matter for unreasonably long period. Respondent further clarifies that, after it came to know about the alleged misappropriation of DDs, it has taken steps to bring the issue to the knowledge of sub-broker as well as clients. (Third party constituents into whose account those DDs were credited and accounted for).

Respondent submitted that it had lodged a police complaint against the sub-broker, as it has suspected the role of the Applicant with the 3rd party clients. Basing on the complaint to the police, the Officer-in-Charge of Police Station, investigated the complaint and found that there were some private transactions among the Applicant, sub-broker and 3rd party clients, hence

Police had not taken up the case on record and disposed the complaint as it was civil nature. Respondent submitted that he has been sending account statement through SMS to Applicant's registered mobile number and to Applicant's registered e-mail ID at end of every quarter in April, July, October and December. But now with some evil intentions after a lapse of 18 months, he is claiming that he had handed over the demand drafts to Smart Securities Limited and Smart Commodities Private Limited. Applicant has not opened any trading account with Smart Commodities Pvt. Ltd., and alleging that he handed over DDs in favour of Smart Commodities Pvt. Ltd. It is ridiculous to state that demand drafts favoring Smart Commodities Pvt. Ltd were tendered even though the account was not maintained with them. No prudent investor will hand over the demand drafts without opening trading account and without verifying the account statements unless the Applicant is having certain private transactions. The Authorized Person Mr KPD Reddy handover the demand drafts to the Trading Member and stated that the said demand drafts were received from other clients for their business investment. Respondent herewith furnishes the complete details of the demand's drafts and respective client codes in the Table-1.

PROCEEDINGS, OBSERVATIONS AND ORDER OF THE IGRP

The matter was heard and disposed by the IGRP member on November 18, 2019. The Complainant/ Applicant informed the IGRP that he had handed over seven demand drafts of INR 4.9 million each, totaling INR 34.9 million drawn in favor of the Trading Member (Respondent) Smart Securities Ltd and five demand drafts of INR 4.9 million and one demand draft for INR 1.5 million totaling INR 24.9 million in favour of Smart Commodities Pvt Ltd. The same amount of INR 61.4 million was wrongly credited by them to four different clients' accounts. It was noticed by the IGRP member that all the demand drafts were purchased by the Applicant from his IDBI Bank and SBI Bank Accounts, and all entries were found in his bank passbooks. The Bankers also confirmed that these demand drafts were purchased by the Applicant/Complainant. When the Trading Member was directed to submit the proof that the demand drafts were purchased by those clients' whose accounts were credited by the trading Member. Trading Member couldn't provide any proof that these DDs were bought by the respective clients. Trading member confirmed that these DDs were submitted to them by its Authorized Person Mr. K.D P Reddy. Trading Member confirmed that it had not followed the conditions required to be followed while accepting prefunded instruments as per SEBI guidelines as it had missed their attention. It is important to note that the IGRP member's observation that all demand drafts were for INR 4.9 million and these were bought by one client and credited the same for different clients' accounts to suspected financial fraud. Applicant was informed that the payments made to Smart Commodities Pvt Ltd would not come under the purview of the SEIL. The IGRP member concluded wrongly that all the demand drafts totaling INR 61.4 million was paid to Smart Commodities Pvt Ltd and dismissed his claim as payments made to Smart Commodities Pvt Ltd were beyond the scope and purview of Stock Exchange of India.

ANALYSIS, OBSERVATIONS, FINDINGS AND CONCLUSIONS OF THE ARBITRATOR

The Applicant has traded only in SEI cash segment. As per Applicant's statement and version, he had duly filled two account opening forms one for securities and other one for commodities and submitted both the forms along with all necessary documents to the sub broker. The sub broker opened only one account in Smart Securities Ltd (SSL) and not opened account in Smart

Commodities Pvt Ltd. Applicant contended that the sub broker instigated, motivated, influenced and advised him to bring demand drafts of INR 4.9 million each, few DDs in favor of Smart Securities Ltd and some more in the name of Smart Commodities Pvt Ltd. Accordingly, Applicant paid an amount totaling INR 36.4 million were paid to Smart Securities Ltd and five demand drafts of INR 4.9 million each, totaling INR 24.9 million was paid to Smart Commodities Pvt Ltd. The Applicant also submitted evidence that all 13 demand drafts were bought by him from his IDBI Bank and SBI Bank accounts. As per statement of the Applicant, that the sub broker didn't give him credit to the demand drafts submitted by him. The sub broker, in collusion with the Trading Member misappropriated the proceeds of DDs to four other clients, one of them is the wife of the sub broker. It clearly indicated that the sub broker misused, abused and indulged in fraudulent transactions using the trading Member's trading system of the Stock Exchange and Commodity Exchange. The four clients, whose accounts were credited with the proceeds of DDs, did not submit any letter from banks that these were bought and owned by them. The four clients, whose accounts were credited with the DD proceeds didn't disclose how these DDs were received or obtained by them. As a result of cheating and fraud committed by the sub broker; Applicant suffered a financial loss of INR 61.4 million. There is no need of accepting demand drafts from any client as every client has mapped or notified his/her bank account details. Respondent submits that it has lodged a police complaint against the sub-broker, wherein it had suspected the role of the Applicant with the 3rd party clients.

The sub broker informed the Trading Member that the DDs were received from the said clients. After the encashment of the said demand drafts, the respective clients requested for the pay outs and accordingly the Trading Member transferred the funds through NEFT mode (not in the form of the DDs) to their respective clients' bank accounts. It was further stated by the Trading Member that the entire modus operand by its registered Authorized Person with an intention to cheat the client Mr B. KK Rao and Trading Member i.e., Smart Securities Ltd. The Respondent further submitted that the Authorized Person conspired with above said clients with the help of Mr B. K K Rao and cheated the trading member i.e., Smart Securities Ltd. It is observed that the Respondent accepted DDs without banker's letter which is a prerequisite for accepting a DD as per SEBI Circular. Respondent alleges that the Applicant himself colluded with certain clients (third party constituents) and sub-broker and conducted his indirect trading operations. It is concluded that the Authorized Person conspired with the four clients and withdrew to the tune of INR 61.4 million and cheated the Applicant and Trading Member by breach of trust by misappropriating the funds fraudulently. All the said demand drafts were credited to the respective clients' accounts. Trading Member's representative replied that it had escaped their attention. Had they followed the policy, probably they would have noticed that the DDs were from different clients. The fact that all the DDs were for an amount INR 4.9 million taken by one client and used for pay-ins of different clients, should have arouse doubt in the mind of the Respondent as a person of ordinary prudence. It was observed that the IGRP member concluded wrongly that all 13 demand drafts for INR 61.4 million was issued in favor of Smart Commodities Pvt Ltd and dismissed his claim as payments to Smart Commodities Pvt Ltd were

beyond the scope and purview of SEIL. The payment to the Commodities trading member was beyond the jurisdiction, purview and scope of the Stock Exchange of India Ltd and could not be dealt by the Arbitration mechanism of the SEIL. This is a clear, fit and proper case of cheating, fraud and criminal act and Applicant is advised to file a police complaint at concerned police station so that Police will investigate the matter properly and effectively and catch hold of the people involved in the crime and fraud under Law of the Land. Bank letter and passbook entries are the proper and valid proofs and evidences for claiming the ownership of DDs.

As regards the payment of seven DD s, totaling to an amount of INR 34.9 million drawn in favor of the Respondent, Smart Securities Limited (SSL) is well within the scope, jurisdiction and purview of the SEIL as the payment was received by the Trading Member of the SEI. It is evident from the above discussion that the sub broker fraudulently misused the trading system of the SEIL and accounted the Applicant's money to other clients who are close relatives and associates of him. As per pay in and pay out policies in vogue, no payment shall be accepted/received from third party accounts, even for that matter payments/ funds from non-mapped/ non notified bank accounts of the same clients will not accepted by the Trading Member. Respondent had accepted 13 DDs without bank letters and credited the same to third party accounts wrongly. Sub Broker wanted to cheat the Applicant by using the trading system of the Exchange so that he can escape from personal liability since DDs are not in his name. He successfully used trading system for his benefit by advising the Applicant to bring DDs even though the Applicant has bank account which was mapped in his account opening form. Trading Member simply accepted the DDs without applying its mind, without ascertaining the reasons of such pay in by way of DDs, for same amount of INR 4.9 million.

It can be stated unequivocally that the foul play of the sub broker has been successful on account of lack of due diligence on the part of the trading Member (Respondent). Had Respondent insisted on the bank letter from the sub broker before accepting the demand drafts on behalf of clients who were wrongfully accommodated by the sub broker; this misappropriation would not have been perpetrated and the loss to the Applicant would have been averted. Moreover, the authorized person is the sub broker of the Trading Member. It is observed that there were Trading Member's lapses and noncompliance of proper and prudent funds management policies in accepting pay in from third party accounts in this matter. It is concluded that Respondent allowed its Sub broker to misuse and abuse the trading system to cheat the Applicant. Sub broker misappropriated INR 34.9 million which was paid to Smart Securities Ltd.

In view of the fraud committed by the sub broker in diverting Applicant's money to his associates while using the Trading Member's trading system, Smart Securities Ltd was a conduit to cheat the funds of the Applicant. Sub broker misappropriated fraudulently as an agent of Smart Securities Ltd. As per Law of Agency, all the deeds, omissions and commissions committed by the agent are deemed to have been done by the Principal. Respondent as principal is liable, responsible and accountable for all acts and violations under the rules, regulations and bye laws of the SEIL. Trading member is held solely responsible for all the acts, lapses and violations by the sub broker under SEIL rules and regulations. Accordingly, Trading Member is

liable to compensate the Applicant's loss due to wrong and fraudulent actions of the sub broker (Authorized Person). The Transactions (pay in of Applicant and pay outs to third parties) relating to securities trading is very much within the jurisdiction, scope, and purview of the SEIL. This is not an appropriate forum to assess and evaluate compensation and damages for mental agony and hence not been dealt with.

AWARD

In view of the, hearings, and arguments of the both parties, and on my findings, the loss of Rs 36.4 million incurred by the Applicant on account of crediting the Applicant's money to third parties accounts wrongly and fraudulently. Accordingly, an Award was passed that the respondent (Trading Member) is directed to pay INR 36.4 million to the Applicant with an interest of 10 per cent per annum from date of this award date till payment of the amount.

REFERENCES

SEBI. (2010). Arbitration Mechanism in Stock Exchanges, CIR/MRD/DSA/29/, 1-4
The Arbitration and Conciliation Act of India, 1996, 1-26.

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