SHRI KRISHNA SHARE BROKERS PVT LTD

Members: NSE Stock Exchange and BSE Stock Exchange

Internal and External Shortage Policy

An **Internal and External Shortage Policy** for stock brokers is critical in managing situations where securities are not delivered or received on time, either within the firm or from external sources. This policy outlines the procedures for handling stock shortages during settlement, ensuring smooth operations while minimizing risks. It ensures compliance with regulatory frameworks and helps maintain trust with clients and counterparties.

1. Purpose & Scope

- **Purpose:** To establish guidelines for managing both internal and external shortages of securities during settlement, minimizing operational risks, ensuring compliance, and protecting client interests.
- **Scope:** This policy applies to all settlement transactions where a security shortage might arise, involving the firm's own accounts, client accounts, and counterparties.

2. Definitions

- **Internal Shortage:** Occurs when one client of the brokerage firm fails to deliver securities, leading to the firm's inability to deliver those securities to another client.
- **External Shortage:** Occurs when a counterparty (external to the brokerage firm) fails to deliver securities, leading to a shortage in the settlement process.

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3. Internal Shortage Policy

3.1 Causes of Internal Shortage

- **Client Default:** A client fails to deliver the securities by the settlement date.
- **Operational Errors:** Errors in processing, such as incorrect execution or mismatches in trade orders, can lead to a shortage.
- **Custody Issues:** Delays or errors from custodians responsible for holding the securities can cause internal shortages.

3.2 Procedures for Handling Internal Shortages

- **Client Communication:**
    - Immediately notify the client responsible for the internal shortage and request prompt action to rectify the situation.

   - Communicate the potential consequences (e.g., penalties, auction) if the securities are not delivered on time.

- **Internal Buy-In:**
   - If the client fails to deliver the securities, the firm may proceed with an internal buy-in (purchasing the short securities from the market) to meet the other client's obligation.
   - The cost of the buy-in, including any penalties or additional charges, may be passed on to the defaulting client.
- **Penalties for Default:**
   - Levy penalties or interest charges on the client responsible for the shortage, as per the terms of the client agreement.
   - The penalty may be in line with exchange rules or higher, depending on the severity of the shortage and its impact on the firm and other clients.

3.3 Record Keeping and Reporting

- Maintain detailed records of all internal shortages, including:
   - Client details.
   - Reason for the shortage.
   - Actions taken (e.g., buy-in, penalties imposed).
   - Financial impact of the shortage (e.g., cost of buying securities from the market).
- Submit regular reports to senior management and compliance teams to monitor internal shortages and take corrective action where necessary.

3.4 Risk Mitigation

- **Margin Requirements:** Implement margin requirements for clients to ensure they have sufficient funds or securities to cover their trades.
- **Pre-Trade Validation:** Check that clients hold sufficient securities before allowing them to sell, reducing the chances of internal shortages.
- **Training:** Ensure that staff are trained on operational procedures to reduce human errors and ensure proper handling of client securities.

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4. External Shortage Policy

4.1 Causes of External Shortage

- **Counterparty Failure:** A counterparty (e.g., another broker or institution) fails to deliver the securities due to operational errors or default.
- **Settlement System Failures:** Issues within the central depository, exchange, or clearinghouse can lead to delays or failures in security delivery.
- **Market Volatility:** Unpredictable market conditions can cause delays in securing the necessary securities from external sources.

4.2 Procedures for Handling External Shortages

- **Counterparty Follow-Up:**
    - Immediately contact the external counterparty responsible for the shortage and request delivery of the securities or a resolution to the shortage.
    - Document all communication and steps taken to resolve the shortage.
- **External Buy-In/Auction Process:**
    - If the external party fails to deliver the securities, the brokerage firm may participate in an exchange-sponsored auction or conduct an external buy-in to procure the securities from the open market.
    - The cost of buying the securities from the market or auction, including penalties or additional charges, may be passed on to the counterparty that failed to deliver.
- **Exchange Rules and Penalties:**
    - Follow the exchange's guidelines for handling external shortages. Most exchanges have predefined penalty structures for late delivery or failure to deliver securities.
    - Report external shortages to the exchange, as required, and adhere to their rules for rectifying shortages through auctions or buy-ins.

4.3 Handling Client Impact Due to External Shortages

- **Client Communication:**
    - Inform clients immediately if their trades are affected by an external shortage. Clearly communicate the expected timeline for resolution and any potential costs or delays.
- **Resolution Timeline:**
    - Resolve the shortage as quickly as possible to ensure that the impact on client positions is minimized. If the shortage is expected to persist, offer alternatives or compensations to affected clients where possible.
- **Cost Allocation:**

- Pass any costs related to external shortages (e.g., penalties, buy-in costs) to the responsible external counterparty. Avoid penalizing clients unless their actions contributed to the shortage.

4.4 Record Keeping and Reporting

- Maintain detailed records of all external shortages, including:
  - Counterparty details.
  - Reasons for the shortage.
  - Actions taken to resolve the shortage.
  - Financial impact of the shortage (e.g., penalties, costs incurred from buy-ins).
- **Regulatory Reporting:**
  - Submit external shortage reports to exchanges, regulators, and clearinghouses, as required, and ensure compliance with market rules for shortage resolution.

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5. Reconciliation and Monitoring

5.1 Daily Reconciliation

- Conduct daily reconciliation between the firm's internal records and the depository/exchange to identify and resolve shortages as soon as possible.
- Ensure that any mismatches are promptly investigated, and corrective action is taken.

5.2 Monitoring and Review

- Regularly monitor the frequency and causes of internal and external shortages.
- Conduct periodic reviews to assess the effectiveness of the firm's shortage management processes and identify areas for improvement.

5.3 Reporting to Management

- Submit regular reports on internal and external shortages to senior management and the compliance team, highlighting trends, root causes, and actions taken.

5.4 Automation of Shortage Handling

- Utilize software or automated systems for trade reconciliation and the identification of shortages. This can help detect potential shortages before settlement deadlines and streamline the resolution process.

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6. Penalties and Consequences

6.1 Internal Penalties:

- The firm should have a well-defined structure for imposing penalties on clients or departments responsible for internal shortages. This could include:
    - Fines for delayed delivery.
    - Interest charges on the value of the securities involved.
    - Suspension of trading privileges for repeat offenders.

6.2 External Penalties:

- Pass on penalties imposed by exchanges, clearing corporations, or other market participants to the responsible counterparty in cases of external shortages.
- Take legal or regulatory action against external parties in cases of persistent non-compliance or defaults.

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7. Client Communication and Transparency

7.1 Client Agreements:

- Ensure that client agreements clearly define the procedures for handling shortages, including:
    - Penalties for delayed deliveries.
    - The process for resolving shortages.
    - Communication protocols for notifying clients about shortages.

7.2 Client Notification:

- Inform clients promptly about any shortages that may impact their trades, including the expected timeline for resolution and any penalties or charges that may apply.

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8. Whistleblower and Reporting Mechanism

- Establish a confidential reporting mechanism for employees to report unethical practices or procedural violations related to internal or external shortages.
- Ensure that all reports are investigated, and corrective action is taken when necessary.

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9. Ongoing Review and Improvement

- **Policy Review:** Periodically review and update the shortage policy to reflect changes in regulatory requirements, market conditions, or operational needs.
- **Feedback Loop:** Gather feedback from clients, employees, and market participants to continuously improve shortage management procedures.