BEFORE THE ADJUDICATING OFFICER

SECURITIES AND EXCHANGE BOARD OF INDIA

[ADJUDICATION ORDER NO. Order/MC/RM/2022-23/15977]

UNDER SECTION 15-I OF SECURITIES AND EXCHANGE BOARD OF INDIA ACT, 1992 READ WITH RULE 5 OF SEBI (PROCEDURE FOR HOLDING INQUIRY AND IMPOSING PENALTIES) RULES, 1995

In respect of –

1. **BSE Limited (PAN No. : AACCB6672L)** having address at Phiroze Jeejeebhoy Towers Dalal Street Mumbai- 400001

In the matter of Karvy Stock Broking Limited

BACKGROUND

1. Securities and Exchange Board of India (hereinafter referred to as '**SEBI**') initiated adjudication proceedings under Section 15HB of the SEBI Act, against BSE Limited (hereinafter referred as "**Noticee/BSE**"), for alleged violations of the following:
   a) Provisions of the para 4(a) of the SEBI Master Circular SEBI/MIRSD/Master Cir-04/2010 dated March 17, 2010 read with para 2 of the Circular SMD/SED/CIR/93/23321 dated November 18, 1993.
   b) Provisions of with Para 2.3 to the annexure of the SEBI Circular SEBI/HO/MIRSD/ MIRSD2/CIR/P/2016/95 dated September 26, 2016 read with para 1.1 and 1.2 of the annexure to SEBI Circular SEBI/HO/MIRSD/MIRSD2/ CIR/P/2016/95 dated September 26, 2016
   c) Provisions of para 5 read with para 8.1 and para 2 of the Early Warning Mechanism Circular dated December 17, 2018.

APPOINTMENT OF ADJUDICATING OFFICER

2. Shri. Amit Pradhan was appointed as Adjudicating Officer under Section15-I of the SEBI Act read with Rule 3 of the SEBI (Procedure for Holding Inquiry and Imposing Penalties) Rules, 1995 (hereinafter be referred to as the **'Adjudication Rules'**),

vide order dated December 18, 2020 to inquire into and adjudge under section 15HB of the SEBI Act, the aforesaid alleged violations against the Noticees. Subsequently, vide order dated June 18, 2021, the undersigned was appointed as Adjudicating Officer (hereinafter referred to as "AO") and the appointment was communicated vide communique dated June 21, 2021.

SHOW CAUSE NOTICE, REPLY AND HEARING

3. Show Cause Notice No. EAD-2/AP/VS/00471/2021 dated January 07, 2021 (hereinafter be referred to as, the "**SCN**") and Supplementary Show Cause Notice No. EAD-2/AP/VS/10002/2021 dated May 06, 2021 (hereinafter be referred to as, the "**SSCN**") was served upon the Noticees under Rule 4 of the Adjudication Rules read with Section 15-I of the SEBI Act to show cause as to why an inquiry should not be held and penalty not be imposed upon the Noticee under Section 15HB of SEBI Act for the aforesaid alleged violations.

4. The allegations levelled against the Noticees in the SCN and SSCN are summarized as below:

5. SEBI along with National Stock Exchange of India Limited (hereinafter referred to as "NSE") and BSE conducted a joint inspection of Karvy Stock Broking Limited (hereinafter referred to as "KSBL") from June 2019. Subsequently, a forensic auditor was appointed by NSE and preliminary report was forwarded by NSE to SEBI on November 2019, based on which SEBI passed an ex-parte ad-interim order dated November 22, 2019 and a confirmatory order dated November 29, 2019 ('Orders') on the non-compliances observed with respect to the pledging/ misuse of client securities by KSBL.

6. In order to ascertain due diligence carried out by stock exchanges pursuant to circular SEBI/HO/MIRSD/MIRSD2/CIR/P/2016/95 dated September 26, 2016 on enhanced supervision, SEBI vide email dated January 08, 2020 (Copy of SEBI's email dated January 08, 2020 is enclosed Annexure-B) sought following details from BSE:

a) A factual self-contained note highlighting roles & responsibilities of exchange towards implementation of various circulars issued by SEBI as indicated in the said orders vis-a vis relating to Stock brokers including the mechanism for monitoring of compliance.
b) A chronology of events pertaining to correspondences/ inspections/ compliances/ actions and follow up actions pursuant to inspection or otherwise as were undertaken in the aforesaid matter of KSBL.
c) Details of actions so far taken commencing from the date on which such misappropriation/misuse on the part of KSBL came to their notice.

7. SEBI vide subsequent email sought additional details from BSE:
    a) Details of inspections of KSBL by BSE from 2016 to 2019 and necessary action taken, if any.
    b) Procedure followed by BSE to ensure reconciliation of clients' securities (including pledging of securities and utilization of funds raised) maintained by stock brokers and steps taken to coordinate with depositories for fetching DP account details.

8. Based on the BSE response, SEBI examined the matter and made certain preliminary findings. The said findings were communicated to BSE, vide SEBI's email dated October 20, 2020 and it was advised to submit its response. BSE submitted its response vide email dated October 23, 2020. The preliminary findings, the response of the BSE and SEBI's observations are summarized as under:

9. **<u>Preliminary Finding No. 1:</u>** While conducting inspection of KSBL during FY 2016-17, BSE did not verify the client securities (including pledged securities) with the DP account details available with the depositories.

10. In regard to the preliminary finding no.1, response of the BSE was that during the full-fledged inspection of KSBL for FY 2016-17 (from November 09, 2016 to November 10, 2016), only the pay in and pay out of the member was verified on a

sample basis and no adverse observations pertaining to mis-match of securities was observed. Further, no correspondence between BSE and the depositories (NSDL and CDSL) for client securities reconciliation is available.

11. From the above SEBI observed as under:
    a) The applicable provisions are Para 4(a) of SEBI Master Circular SEBI/MIRSD/Master Cir-04/2010 dated March 17, 2010 and Para 2 of the Circular SMD/SED/CIR/93/23321 dated November 18, 1993.
    b) From the submissions of the exchange, it was alleged that BSE did not carry out due diligence w.r.t verification of client securities (including pledged securities) in its inspection of KSBL for FY 2016-17. Had BSE verified the details of client securities as submitted by the stock broker with the DP account details available with the depositories, it could have helped exchange to find any wrongdoing by the trading member.
    c) Therefore, BSE was alleged to have followed casual approach and limited its scope for verification of client securities in case of KSBL in its inspection during the FY 2016-17.

12. **Thus, in view of the above, it was alleged that BSE failed to comply with para 4(a) of SEBI Master Circular SEBI/MIRSD/Master Cir-04/2010 dated March 17, 2010 read with para 2 of the Circular SMD/SED/CIR/93/23321 dated November 18, 1993.**

13. **Preliminary Finding No. 2:** BSE failed to monitor the timely reporting of demat accounts by the member.

14. In regard to preliminary finding no.2, the response of BSE was that KSBL started reporting the demat accounts mainly after the mismatch exercise initiated by SEBI in May 2019. Further, no correspondence between BSE and the depositories (NSDL and CDSL) regarding reporting of demat accounts and reconciliation of client securities in relation to KSBL during the period January 2016- April 2019 is available.

15. From the above SEBI observed that BSE did not receive the details of demat accounts of trading member (as part of Enhanced Supervision of Stock Brokers/Depository Participants SEBI circular dated September 26, 2016) from Depositories as no correspondence between BSE and the depositories regarding reporting of demat accounts and reconciliation of client securities in relation to KSBL is available for the period January 2016-April 2019. Had BSE monitored the timely reporting of the impugned demat account (demat account no. 11458979) by the member with appropriate nomenclature based tagging and verified the same from DP account details available with the depositories, it could have helped exchange to find any wrongdoing by the trading member. Therefore, BSE was alleged to have failed to monitor the timely reporting of demat account with appropriate nomenclature based tagging by the member.

16. **Thus, in view of the above it was alleged that BSE failed to comply with Para 2.3 to the annexure of the SEBI Circular SEBI/HO/MIRSD/ MIRSD2/CIR/P/2016/95 dated September 26, 2016 read with para 1.1 and 1.2 of the annexure to SEBI Circular SEBI/HO/MIRSD/MIRSD2/ CIR/P/2016/95 dated September 26, 2016.**

17. **<u>Preliminary Finding No. 3:</u>** As per SEBI Circular dated September 26, 2016 on Enhanced Supervision of Stock Brokers/Depository Participants, Depositories are required to provide details of all the demat accounts opened by a stock broker to the stock exchange for the purpose of reconciliation. Since, Karvy's impugned account no. 11458979 is held with NSDL, the alerts provided by NSDL to clearing corporation and /or exchanges, were examined by SEBI.

18. As per para 2 of the SEBI circular dated December 17, 2018 on Early Warning Mechanism, regarding prevention of diversion of client securities, there shall be a mechanism for sharing of information between Stock Exchanges, Depositories and Clearing Corporations to detect the diversion of client's securities by the stock broker at an early stage so as to take appropriate preventive measures. Further,

as per para 5 of the said circular, Stock Exchanges, Depositories and Clearing Corporations shall devise a mechanism to detect diversion of client's securities and to share information among themselves. Accordingly, a Standard Operating Procedure (SOP) in this regard has been framed by Market Infrastructure Institutions (MIIs), detailing the sequence of steps to be followed by MIIs based on the type of alert generated finalized and agreed upon by Market Infrastructure Institutions (MIIs) vide minutes of the meeting held on January 24, 2019. SEBI had approved the same on January 24, 2019 and as per para 9 of the aforementioned circular, the provisions of the circular shall come into force from February 01, 2019.

19. Pursuant to the SOP, NSDL and Central Depository Services Limited (CDSL) shared alerts like off-market transfers other than settlement, multiple proprietary demat accounts and opening new account for client purpose, sudden activation of significant number of dormant accounts etc. to exchange. In light of the above for the compliance of the SEBI Circular dated December 17, 2018 and SOP information was sought from the BSE. BSE vide its email dated February 18, 2021 made its submission to SEBI, which is summarised as follows:

a) BSE had received certain data from NSDL which was incomplete and not meaningful. In the joint meeting with Depositories & Exchanges on April 10, 2019, all issues were discussed to make data meaningful.

b) The off market transfers from account no. 11458979 largely pertained to account no 12691085 (which is a collateral account maintained by KSBL). Such transfers would not fall within "transfer of large value of shares through off-market transfers other than for settlement purposes" as specified under clause 3.2(c) of the Early Warning Mechanism Circular.

c) In view of the above, the data received from NSDL in the context of account no. 11458979 did not trigger any alert.

d) In addition, during the same period, SEBI had also initiated a separate exercise specifically with respect to reconciling the brokers holding statements with the depository balance. Based on such analysis, once Karvy was identified, the reconciliation of holding statement with the Depository balance for Karvy was assigned to NSE.

20. In view of the above BSE response, SEBI observed as follows:

   a) The demat account number 12691085 to which large off-market transfers were made is a collateral account, was considered so merely on the basis of submissions made by KSBL to BSE. From the details provided by NSDL to BSE vide email dated June 13, 2017, under Enhance Supervision framework, it was clearly evident that the said account had a sub-type of Stock Broker-Client Account and was therefore, not a collateral account.
   b) In view of this, it was observed that BSE did not verify the submissions made by KSBL with the depository record and did not act diligently on the alert for off-market transfers provided by NSDL.
   c) Also from the submission of BSE, it was observed that it had not taken any action against other alerts like multiple proprietary demat accounts and opening of new account for client purpose, sudden activation of significant number of dormant accounts, etc. shared by NSDL.

21. Therefore, **it was alleged that despite the various alerts pertaining to off-market transfers, multiple proprietary demat account, sudden activation of demat accounts, etc., provided by NSDL to BSE, BSE failed to take appropriate action against KSBL for the account no. 11458979. The said failure on the part of the Noticee was in violation of provisions of para 5 read with para 8.1 and para 2 of the Early Warning Mechanism Circular dated December 17, 2018.**

22. The aforesaid alleged violations, if established, make the Noticee liable for monetary penalty under Section 15HB of the SEBI Act.

23. In response to SCN dated January 07, 2021 Noticee requested additional time for filing of reply to SCN and sought inspection of file containing all the documents and information relied upon by SEBI in support of findings in the notice. Noticee was given inspection of the annexures to the SCN dated January 07, 2021 on February 10, 2021

24. Further, vide letter dated February 16, 2021, Noticee requested inspection of the documents and materials relied upon or referred to in Notice including the following documents and materials:

a) All correspondences between SEBI and BSE which are referred to in the Notice and/or relied upon by SEBI in relation to issuance of the Notice.
b) All allegations received from banks and NBFCs regarding the conduct of the stock exchanges and depositories as referred to in Annexure B of the Notice
c) Investigation report along with its annexures,
d) All documents and/or materials collected by SEBI during the course of investigation, including file notings, in relation to the issuance of the Notice.
e) All inspection reports in relation to Karvy Stock Broker Limited carried out by regulatory authorities (including NSE); and
f) All documents and/or materials which has been relied upon by the Adjudicating officer in relation to the issuance of the Notice

25. Noticee vide letter dated July 08, 2021 again sought inspection of aforesaid and sought time to file reply to SCN and SSCN from the date of complete inspection of documents. Vide aforesaid letter Noticee also informed that it has filed for a settlement application under the SEBI (Settlement Proceedings) Regulations, 2018. It is noted that the settlement application in the matter was subsequently rejected by SEBI. Noticee vide letter dated November 11, 2021 sought inspection of documents and an extension of time for filing of reply to the Notices.

26. Vide letter dated December 14, 2021 Noticee was provided with (i) correspondences between SEBI and BSE which were referred to in the Notice and/or relied upon, (ii) relevant extracts of SEBI Investigation report. Further in regard to the inspections of Stock Brokers jointly conducted by Stock Exchanges and SEBI, it was noted that Noticee was part of such inspections, hence the reports were available with the Noticee. Further, all material relied upon during the proceedings was already provided with to the Noticee.

27. Noticee vide letters dated December 28, 2021, January 25, 2022 sought extension for filing reply and reschedulement of personal hearing in the matter. The extension to file the reply was granted, and Personal hearing was rescheduled to February 08, 2022. Noticee filed reply to SCN, SSCN and Notice of Hearing vide letter dated February 07, 2022 in the matter.

28. An opportunity of Hearing before undersigned was provided to the Noticee through video conferencing on February 08, 2022. The Personal hearing on February 08, 2022 was attended by Authorised Representatives(AR) of the Noticee, viz. Mr. Rajshekhar Rao, Senior Advocate, Ms. Aanchal Tikmani, Advocate, Mr. Areeb Amanullah, Advocate, Mr. Vaidhyanadhan Iyer, Senior Partner (AZB & Partners), Mr. Jeet Chaudhuri, Senior Associate (AZB & Partners), Mr. Harshavardhan Sunder, Associate (AZB & Partners), Ms. Rhea Purohit, Associate (AZB & Partners) as well as Mr. Gopalkrishnan Iyer, Chief General Manager (BSE Limited), Ms. Usha Sharma, General Manager (BSE Limited), Mr. Shailesh Jain, Additional General Manager (BSE Limited). The AR of the Noticee reiterated the submissions made by the Noticee in its reply. Further, Noticee made supplemental submissions vide letter dated February 16, 2022 along with the list of key dates in the matter.

29. The submissions of the Noticee are summarized as below:

30. Noticee submits that BSE has at all times sought to comply with and has diligently complied with all its obligations arising out of the provisions of the circulars issued by SEBI. BSE has at all times exercised high standards of integrity and fairness in all of their functions and has conducted business in compliance with the regulatory framework in India and in accordance with all applicable laws and regulations.

31. BSE is in receipt of the Notice of Hearing from SEBI and the documents annexed thereto, please note that Noticee has not received responses to all its queries raised vide letters dated February 16, 2021, July 8, 2021, August 19, 2021 and November 11, 2021. Without prejudice to the aforesaid, based on the limited

documents provided to BSE during the inspection and thereafter, reply is being filed.

32. It is respectfully submitted that the allegations against BSE in the Notice and the Supplementary Notice are unfounded, and are not substantiated by any cogent material. In light of this, and the mitigating circumstances set out by BSE in Section D of this Response, no penalty ought to be imposed on BSE under Section 15HB of the SEBI Act, for the violations alleged to have been committed by BSE under the provisions of the relevant circulars.

33. Submissions with regard to Allegation 1:

34. The regulatory framework prevalent at the time BSE conducted the inspection of KSBL for the financial year 2016-17 did not mandate verification of client securities with the records of depositories:
BSE during the financial year 2016-17 covered the period from April, 2015 to March, 2016 ("BSE Inspection Period") and was conducted on November 9, 2016 and November 10, 2016 ("FY 2016-17 BSE Inspection"). Notably, at that time there was no regulatory requirement for stock exchanges to reconcile the details of client securities submitted by a trading member with the depository account details available with the depositories. In fact, there was no legal mandate requiring the depositories to share any information such as the client's demat account and securities details with stock exchanges for the purpose of conducting an inspection. Further, neither the SEBI Master Circular SEBI/MIRSD/Master Cir-04/2010 dated March 17, 2010, nor the Circular SMD/SED/CIR/93/23321 dated November 18, 1993, which BSE has allegedly violated as per SCN Allegation 1, require verification of the client's securities with the records of the depositories. Furthermore, the Notice fails to elucidate any regulatory requirements which required stock exchanges to seek such information from the depository and, to the best knowledge of BSE, none existed at the relevant time. Accordingly, while the SCN refers to the provisions of SEBI Master Circular SEBI/MIRSD/Master Cir-04/2010 dated March 17, 2010, and the Circular SMD/SED/CIR/93/23321 dated

November 18, 1993, it does not demonstrate the regulatory requirement which required BSE to verify the client securities (including, the pledged securities) with the details of clients available with the depositories during the FY 2016-2017 BSE Inspection.

35. Further, as evident from NSDL's letter to SEBI dated August 12, 2020 and Central Depository Services (India) Limited's ("CDSL") letter to SEBI dated July 30, 2020, NSDL and CDSL treated information relating to pledged shares in demat accounts as highly confidential, and were unable to share such information in the absence of directions from a regulatory authority empowered under law. This not only emphasizes BSE's submission regarding the lack of a legal requirement for stock exchanges to reconcile details of client securities with the details of the depositories, but also highlights the absence of any mechanism at the relevant period for BSE to suo motu procure necessary data for such reconciliation, from the depositories.

36. Additionally, SEBI's future actions and practice further substantiate BSE's position in this regard. Pursuant to discussion with SEBI on standardization of books of accounts / records, Register of Securities, Holding Statement, Bank Book and Client Ledger from time to time (which was subsequent to the FY 2016-17 BSE Inspection), stock exchanges were required to share the holding statement reported by trading members with SEBI, for reconciling transaction level client's securities.

37. Such reconciliation was undertaken, on a pilot basis, by the automated system of SEBI, which compared details submitted by trading members to the stock exchanges with the actual records of the depository, and highlighted mismatches. Accordingly, BSE shared the holding statement received from the trading member(s) with SEBI starting from January 25, 2019 (which was subsequent to the FY 2016-17 BSE Inspection). Subsequently, a list of top 10 common trading members (which included KSBL) was shared with SEBI on May 30, 2019.

38. Accordingly, it follows that the veracity of BSE's actions while conducting the FY 2016-17 BSE Inspection must necessarily be examined in context of the extant regulatory position and customs/practice prevailing at the time of the inspection, which did not entail verification of client securities with depository records. Further, it is the admitted position of the depositories that they were unable to share such information with stock exchanges in the absence of such a stipulation/requirement. Further, even the Enhanced Supervision Circular, which was made effective subsequent to the FY 2016-17 BSE Inspection, did not mandate stock exchanges to obtain details of client's securities from the depositories for the purpose of reconciliation.

39. <u>BSE conducted the inspection of KSBL in accordance with its annual inspection policy:</u> BSE conducts a full-fledged inspection of at least 1/3rd trading members annually as per SEBI requirements. The scope for such inspection is set out in the annual inspection policy prepared by BSE which, inter alia, incorporates various criterions on the basis of which members would be selected for inspection. Typically, prior to the initiation of the full-fledged inspection, BSE seeks information/ documents from the trading member. Based on review of such information/ documents, a physical inspection of the trading member and its branch office is undertaken by BSE. For theme based inspections, based on the specific input received by BSE (including, inputs/ advise received from SEBI), it conducts physical inspection of the trading member with a specific focus on the issue involved in the same. In addition, BSE also participates in joint inspections of trading members which are conducted by SEBI, stock exchanges and depositories jointly.

40. In keeping with such practice, KSBL was selected for the FY 2016-17 BSE Inspection in pursuance of BSE's annual inspection policy for inspection of trading members which was formulated in pursuance of the applicable regulations i.e., SEBI Circular CIR/MIRSD/13/2012 dated December 7, 2012 and subsequent letter from SEBI bearing reference no. MIRSD- 2/27394/2012 dated December 7, 2012.

The prevalent annual inspection policy at the time of the FY 2016-17 BSE Inspection (“Annual Inspection Policy”) is placed on records.

41. Further, SEBI had reviewed the parameters of the Annual Inspection Policy. SEBI’s annual inspection of the operations and functioning of BSE included an examination of the scope and areas covered by BSE during the inspections it conducted of its trading members. BSE states that the FY 2016-17 BSE Inspection was conducted in full compliance with the terms of the Annual Inspection Policy.

42. SEBI’s final observations pertaining to the time period during which the FY 2016-17 BSE Inspection was conducted do not require BSE to undertake verification of details of client securities as submitted by the trading member with the depositories. Additionally, it is pertinent to note that SEBI Circular No. CIR/SO/MIRSD/MIRSD2/CIR/P/2017/73 dated June 30, 2017 on Policy of Annual Inspection of Members by Stock Exchanges/Clearing Corporations, in paragraph 4 of Annexure 1 thereof (which was not applicable for FY 2016-17 BSE Inspection), also only contemplated information sharing among stock exchanges and clearing corporations, and did not extend to depositories. This further supplements the submission that the regulatory framework at the relevant time did not require verification of client securities with depository records.

43. Therefore, BSE conducted the FY 2016-17 BSE Inspection in full compliance with all applicable regulations, circulars and regulatory directions and there was no failure to comply with any circular as alleged in the Notice.

44. <u>BSE exercised due diligence in its inspection of KSBL during the FY 2016-2017 BSE Inspection:</u> In accordance with the instructions set out by SEBI in the aforementioned regulations referred above and discussed with SEBI in various meetings, the Annual Inspection Policy duly incorporates various criterions on the basis of which members would be selected for inspection. These parameters included inter alia (i) members having adverse observations in the internal audit report on high risk issues like wrong reporting of margins, pending complaints &

complaints for non-receipt / delay in payment, transfer of trades, pledging of client securities, dealing with unregistered intermediaries; (ii) members servicing investors, having overnight disablement on account of margin shortage for more than 2 days; and (iii) members servicing investors, getting disabled on account of funds shortage on more than 3 times in a month.

45. The Cash, Derivatives and Currency Derivatives ("CDX") Inspection Report of KSBL provides a comprehensive overview of the inspection conducted by BSE ("FY 2016-17 BSE Inspection Report") relating to the FY 2016-17 BSE Inspection. The FY 2016-17 BSE Inspection Report provides information under the following parameters: (i) maintenance of books of accounts and records; (ii) anti money laundering provisions; (iii) client registration process, including the KYC and KRA process; (iv) client funds and securities; (v) trades and transfers of trades; (vi) contract notes (vii) settlement of funds and securities; (viii) margin related requirements; (ix) client funding; (x) pledging of client securities; (xi) investor complaints and arbitrations; (xii) policies, disclosures of information on website and display of certificates; (xiii) office management, including systems and trading terminals and certification requirements; (xiv) dealing with intermediaries; (xv) past internal audit, stock exchange and SEBI inspection observations, penalty and compliance status; (xvi) comments on previous inspection conducted by BSE; and (xvii) observations of the internal auditor. For each applicable parameter, the inspection area, sampling, methodology and observations is recorded. With particular reference to the inspection concerning client funds and securities, the FY 2016-17 BSE Inspection Report sets out the inspection area as including (i) pay-in and pay-out of funds and securities; (ii) third party receipts and payments with regard to funds and securities; and (iii) dividend payable to clients. For client securities, a sample of the top 50 transactions for five dates across July 9, 2015; November 6, 2015; December 21, 2015; January 22, 2016; and March, 29 2016 for pay-in and pay-out of securities was selected. The methodology adopted for verification of client securities data was to cross check for the following through a verification of the trade log/exchange net position file with the pool transaction statements, statement of demat accounts of the trading member used for holding

client's securities and client wise securities holding file obtained from the trading member's from the back office: (i) whether client and own securities are maintained in separate demat accounts; (ii) whether there is any mis-utilizing one client's securities for another client's obligations; (iii) whether there are any third party securities, both receipts and payments; and (iv) whether any off market transactions were observed. Based on the aforementioned sample data, no adverse observations pertaining to the client's securities (including, the pay-in and pay-out of KSBL) were recorded by BSE.

46. Substantively, in compliance with the regulatory supervision required to be undertaken by stock exchanges at the time, the extent of BSE's verification of client securities included checks of inter alia the following on a sample basis: (i) in case of pay-in, transfer of securities from clients / client beneficiary account to pool account; (ii) in case of pay-out, transfer of securities received from pool account to member's demat account / client; (iii) trades pertaining to institutional clients are settled through custodian; and (iv) instances where securities of one client have been used to meet the pay-in obligation of another client or own obligations.

47. It is pertinent to note that in terms of the procedure adopted, assessment of voluminous data-sets on a sampling basis for the purpose of drawing conclusions in an inspection is a well-accepted routine practice. SEBI, National Stock Exchange of India Limited ("NSE"), NSDL, CDSL and Multi Commodity Exchange of India Limited adopted similar methodology of scrutiny of data on a sample basis in inspections conducted around the same time as the FY 2016-17 BSE Inspection. The inspection reports of the aforementioned organizations evidencing the same are placed on records.

48. Further, the following instances evidence the efforts taken by BSE to ensure that a thorough inspection of KSBL was conducted: (i) to ensure that a holistic assessment of the member being inspected is undertaken, a branch inspection and authorized person inspection of KSBL was conducted by BSE in tandem with the FY 2016-17 BSE Inspection for BSE Inspection Period. The branch inspection

report and authorized person inspection report of KSBL for BSE Inspection Period is annexed as Exhibits I and J, respectively; and (ii) from BSE's records, a total of 38 complaints received against KSBL during FY 2015 – 16, only 18 complaints pertained to securities (such as mis-utilization of securities). Out of these 18 complaints, 12 complaints were resolved by KSBL, while the remaining 6 complaints (having a meagre claim of Rs. 6.90 lakhs approximately) were resolved through the investor grievances redressal committee/ arbitration. None of these raised any red flags warranting deeper scrutiny and/or gave any indication as to the nature/magnitude of the issue which, as mentioned in this Response, was only unearthed after the joint inspection in 2019.

49. Other authorities/ bodies which conducted inspections of KSBL around the same time period and thereafter did not make any adverse observations concerning verification of client securities: Around the same time period as BSE Inspection Period and thereafter, KSBL was subject to inspections conducted by several experts in the field / authorities which were responsible to exercise and supervise the functioning of KSBL. It is pertinent to note that the inspection reports submitted by these authorities did not record any adverse observation with respect to the reconciliation of the details of client securities as submitted by KSBL. The submissions below briefly describe the inspection reports submitted by each of the aforementioned authorities.

50. The internal auditors of KSBL, M/s V. Narayanan and Co. (Chartered Accountants) and M/s JB & Co. (Chartered Accountants), conducted a mandatory half-yearly audit of KSBL for the half year ended on March 31, 2015, September 30, 2015, and March 31, 2016. Internal auditors are obligated to conduct an extensive inspection of the member. The wide-ranging and extensive scope of such inspection is described at paragraph 8 of the SEBI Master Circular SEBI/MIRSD/Master Cir-04/2010 dated March 17, 2010 and includes inter alia compliance with all relevant SEBI regulations and the discharge of various obligations towards clients. Covering the same time period as BSE Inspection Period, despite the comprehensive scope and detailed nature of the inspection to

be conducted, none of the internal audit reports record any adverse findings with respect to misutilization of client securities. The internal audit report of KSBL prepared by M/s V. Narayanan and Co. (Chartered Accountants) dated June 18, 2015 and M/s JB & Co. (Chartered Accountants) dated December 24, 2015 and June 23, 2016 are placed on records.

51. SEBI conducted an inspection of KSBL from March 24, 2015 to March 27, 2015 covering an inspection period from April 1, 2014 to January 30, 2015. The inspection period almost immediately precedes BSE Inspection Period. As a part of the findings recorded in the inspection report, there is a separate section concerning the segregation of client funds and securities. There are no adverse findings made in this regard. SEBI's inspection report of KSBL dated April 12, 2016 are placed on records.

52. NSE had also conducted inspection of KSBL for period between September 01, 2015 and August 31, 2016, and the period between October 01, 2016 and September 30, 2017.

53. Further, SEBI had inspected KSBL during February 01, 2018 to February 07, 2018, and KSBL vide its letter dated October 12, 2018 responded to SEBI's observation which indicates that the said inspection was done on sample basis and that few instances of non-settlement of accounts or delay in settlement of accounts were observed. A copy of KSBL's reply dated October 12, 2018 to SEBI's letter dated September 17, 2018 is placed on records.

54. NSDL and CDSL also conducted inspections of KSBL around a similar time period. Neither of their reports discloses any adverse findings in relation to KSBL's client securities. NSDL and CDSL inspection reports of KSBL are placed on records.

55. <u>The standard of inspection applicable to the Joint Inspection and the FY 2016-17 BSE Inspection were different</u>: BSE holds compliance with securities regulations in the highest regard. As described in paragraphs 21 and 22 above, in conducting

the FY 2016-17 BSE Inspection, BSE duly fulfilled its obligations regarding each of the parameters required to be inspected as per the policies applicable to a full-fledged inspection. The standard against which the efficacy of an inspection undertaken by BSE should be assessed based on the Annual Inspection Policy and the information provided by KSBL and not against the special inspection which was triggered after discovery of actions/events pertaining to KSBL. In this regard, a distinction is sought to be made between a joint inspection which is undertaken collectively by SEBI, stock exchanges and depositories and a general inspection undertaken by a stock exchange. A special inspection triggered after the discovery of actions/events which unearth the gross misconduct, would be expected to adhere to a far higher standard than a general inspection routinely conducted at regular intervals without knowledge/notice of any wrongdoing. This view is supplemented by the following judicial authorities.

56. In Tri-Sure India Ltd. v. A.F. Ferguson & Co. & Ors. (1985 SCC Online Bom 342), while determining the standard of care to be imposed on auditors, the Hon'ble Bombay High Court held that:

"*39. … It is not fair to consider the case with hindsight and hold that the auditors were negligent in discharge of their duties. The court must bear in mind the facts available at the time of alleged negligence by the auditors, and it is not fair to determine the fact of negligence by taking into consideration what has come to light after true scrutiny carried out in the special audit.…*

45. The auditor is required to employ reasonable skill and care, but he is not required to begin with suspicion and to proceed in the manner of trying to detect a fraud or a lie, unless some information has reached which excites suspicion or ought to excite suspicion in a professional man or reasonable competence … In judging whether an auditor exercises reasonable care and skill, it would not be appropriate to proceed on matters which have subsequently transpired, but one must place oneself in the position of the auditor as and when the accounts were *audited and find out how the matters appeared or ought to have appeared to a man reasonable care and skill."*

57. In Sari & Co. v. The Adjudicating Officer, SEBI (Appeal No. 213 of 2011, SAT order dated May 18, 2012) while discussing the liability of a sub-broker for the wrong doing of his client, it was held that:

"*9. With respect to the allegation regarding non-compliance with the code of conduct of brokers we find that the appellant had taken all reasonable precautions to avoid possible malpractices in the market. We have already observed above that the appellant was not a party to the reversal/circular trades. There is considerable merit in the argument of the appellant that the allegation of reversal could be levelled by the Board only after perusing the trade and order logs i.e. in hindsight. …"*

58. The joint inspection of KSBL conducted by SEBI, the exchanges, and the depositories in June, 2019 was a special inspection initiated after SEBI discovered the mismatch in client securities of KSBL pursuant to transaction level client securities reconciliation exercise. The joint inspection was a targeted exercise conducted after preliminary information about the diversion of securities by KSBL was already available. Further, during the course of the joint inspection, among the other forms of inquiry used, NSE appointed Ernst and Young LLP to conduct a forensic audit of KSBL, and a report dated January 9, 2020 was submitted in pursuance of the same. The appointment of a forensic auditor by NSE in the course of the joint inspection also supplements the argument that the joint inspection was a special inspection prompted by the existence of prima facie adverse factual information, which raised suspicion of wrongdoing, which admittedly was not within the knowledge of BSE during the FY 2016-17 BSE Inspection.

59. The FY 2016-17 BSE Inspection was a general inspection, and at the time it was conducted, there was no indication of KSBL's misconduct. In fact, as mentioned in paragraphs 25 to 31 above, inspections of KSBL conducted by other authorities also did not highlight its misutilisation of securities. Given the significant differences

in the availability of information, purpose and scope at the time of conducting the inspections, the standard to assess the efficacy of the joint inspection and the FY 2016-17 BSE Inspection are also extremely different. It would not be reasonable to expect BSE to adhere to the higher level of focused scrutiny adopted in the joint inspection based on certain adverse information, which is not mandated by any of the circulars, which BSE is alleged to be in breach of. The allegations in the Notice are a result of the in-depth investigation conducted by SEBI, the exchanges, and the depositories and the level of scrutiny which was involved in the joint inspection was not expected from BSE (or any exchange) in its dealings with a trading member. Therefore, it would be extremely unreasonable to expect BSE to undertake such a specialized analysis during the course of a general inspection.

60. In any event, it would not have been feasible for BSE to conduct an inspection adhering to the high standards of focused scrutiny as undertaken during the joint inspection of KSBL in 2019 for each member it selects for inspection in accordance with its inspection policy for the following reasons: (i) Given the fact that BSE has more than 1,000 trading members with over 4 crore clients, the scale of such an exercise would be monumental and one which cannot be done on a routine basis in the absence of a specific requirement or adverse material; (ii) It is mandatory for BSE to annually conduct a full-fledged inspection of one third of its trading members (i.e., nearly more than 300 members are inspected on an annual basis) in addition to the inspections of trading members who have been selected to be inspected on account of various reasons. This would result in an extensive and extremely time consuming exercise; and (iii) as mentioned in paragraph 12 above, NSDL and CDSL treated information in relation to pledged shares in demat accounts with utmost confidentiality, only agreeing to share the same if directions in this regard are received from a regulatory authority. Further, for reconciliation of client securities to be meaningful, BSE would also require data from stock exchanges as well. Therefore, BSE did not have all the relevant data to conduct this exercise effectively.

61. In summary, the FY 2016-17 BSE Inspection was in compliance with all relevant regulations and policies. In Chander Kanta Bansal v. Rajinder Singh Anand (2008 5 SCC 117), it was held that *"'due diligence' in law, means doing everything reasonable, not everything possible. …it means such diligence as a prudent man would exercise in the conduct of his own affairs."*

62. Accordingly, given the absence of adverse factual information which led to the joint inspection of KSBL in 2019 which, in turn, forms the basis of the Notice and the Supplementary Notice, and the fact that there was no regulatory requirement at the time of the FY 2016-17 BSE Inspection for stock exchanges to reconcile the details of client securities submitted by a trading member with the depository account details available with the depositories, it is submitted that BSE acted with requisite due diligence and complied with all relevant circulars / provisions of law with respect to inspection of KSBL and is not in breach of any of the circulars as alleged in the Notice.

63. <u>Submissions with regard to allegation 2:</u>
The Enhanced Supervision Circular, inter alia, requires (i) stock brokers to follow a uniform nomenclature for naming/tagging of bank and demat accounts and the reporting of such accounts to the Stock Exchanges/Depositories; and (ii) stock exchanges to reconcile the details of demat accounts uploaded to the stock exchange by the stock brokers with the details of demat accounts provided by the depositories.

64. The allegation that BSE failed to correspond with the depositories regarding the demat accounts of KSBL in terms of the provisions of the Enhanced Supervision Circular is factually incorrect. In its efforts to give effect to the provisions of the Enhanced Supervision Circular, BSE requested the details of the members' demat accounts from both CDSL and NSDL. BSE's first communication to NSDL in this regard was on April 6, 2017, within a week from the date on which certain provisions of the Enhanced Supervision Circular became effective, thus evidencing BSE's intent to promptly comply with the regulatory requirements. In response to

this request for information, NSDL provided the necessary details only on June 13, 2017, almost 2 months following the date of request by BSE. Thereafter, BSE called for data from NSDL and CDSL once again on August 16, 2018 and received a response from NSDL on August 21, 2018 and CDSL on August 25, 2018. In fact, this is also corroborated by the email dated January 27, 2021, where NSDL had informed SEBI that BSE has provided the PAN numbers of trading members to NSDL for obtaining the requisite information. A copy of the email dated January 27, 2021 is placed on records.

65. Separately, BSE submits that the Enhanced Supervision Circular does not prescribe any timeline or frequency in which stock exchanges should request necessary information from depositories, and accordingly BSE's actions were in compliance with the Enhanced Supervision Circular. BSE's emails dated April 6, 2017 and August 16, 2018 calling for details of demat accounts; NSDL's emails dated June 13, 2017 and August 21, 2018; and CDSL's email dated August 25, 2018 are placed on records.

66. Given the recent introduction of the Enhanced Supervision Circular, BSE was in the process of organizing internal systems necessary for handling the voluminous data from NSDL and CDSL that forms a part of the reconciliation process for demat accounts. Accordingly, while NSDL had provided the necessary information requested by BSE by way of its emails dated June 13, 2017 and August 21, 2018 (which included the 979 Demat Account), given the volume of data and the ongoing transition to a semi-automated data processing system, the discrepancy with respect to 979 Demat Account did not come to light.

67. The same was inadvertent and not owing to any deliberate act/omission on BSE's part. In fact, BSE's actions in promptly requesting the depositories for the required data i.e., within just 6 days after the Enhanced Supervision Circular became effective; and overhauling its internal systems in order to comply with the provisions of the Enhanced Supervision Circular, reflect the reasonable efforts made by BSE to meet the newly introduced regulatory framework.

68. *Arguendo*, for the sake of discussion, that BSE identified the non-disclosure of the 979 Demat Account by KSBL, such non-disclosure would have resulted in a minor monetary penalty of Rs.5,000 being imposed on KSBL and would not have resulted in a requirement for reconciliation of client securities. This is because the reconciliation exercise of demat account envisaged under the Enhanced Supervision Circular does not extend to verification of the quantum of securities of clients held by the broker. Even if BSE had undertaken reconciliation of details of demat accounts as required by the Enhanced Supervision Circular, the information so provided is insufficient for BSE to make any finding regarding the mismatch of client securities.

69. Further, the allegation that BSE failed to comply with nomenclature/ tagging of demat accounts in line with Paragraphs 1.1 and 1.2 to the annexure of the Enhanced Supervision Circular is unsubstantiated and incorrect. Pursuant to Paragraph 2.3.1 of the Enhanced Supervision Circular, the depositories are required to ensure that demat accounts of stock brokers are appropriately tagged in accordance with the nomenclature specified in the Enhanced Supervision Circular and in the time specified therein viz., 3 months. Further, no intimation was provided by the depositories to BSE specifying any action taken against KSBL for not assigning the appropriate nomenclature with respect to the 979 Demat Account. Notably, SEBI vide Circular No. CIR/HO/MISRD/MISRD2/CIR/P/2017/64 dated June 22, 2017 issued a clarification stating that Paragraph 1.2.4 of the Enhanced Supervision Circular with respect to naming of demat accounts which hold own securities of the stock broker stands deleted, making tagging of proprietary account (such as the 979 Demat Account) as 'Stock Broker – Proprietary Account' voluntary for stock brokers. This is further substantiated by the email dated November 17, 2020 addressed by NSDL to SEBI stating that all demat accounts by KSBL are tagged in compliance with SEBI circulars/ regulatory norms for tagging of accounts. A copy of the email dated November 17, 2020 is placed on records.

70. <u>Submissions with regard to allegation 3</u>:

The Early Warning Mechanism Circular was formulated with the intention of detecting instances of diversion of client securities by the stock broker at an early stage, so that appropriate preventive measures may be taken. It, inter alia, broadly contemplates the development of a framework under which the depositories/clearing corporations are required to generate and send 'alerts' to the stock exchanges based on the occurrence of identified trigger events. The Early Warning Mechanism Circular was introduced on December 17, 2018, and made effective shortly thereafter, from February 1, 2019. Accordingly, market infrastructure institutions, including BSE, had a short window of time to implement its provisions, and to put in place a mechanism to generate alerts and analyze the voluminous amount of information received pursuant to the alerts, which otherwise was not possible manually. Nevertheless, with the earnest intent of ensuring scrupulous regulatory compliance, BSE, along with other market infrastructure institutions, formulated a standard operating procedure prescribing the parameters, thresholds, action items on trigger of such thresholds and periodicity with which the alerts are required to be generated, pursuant to its meeting dated January 2, 2019 ("SOP"). A copy of the SOP is placed on records.

71. Pursuant to the SOP, NSDL shared certain alerts with BSE on the following dates: (i) March 11, 2019; (ii) April 15, 2019; (iii) May 17, 2019; (iv) June 14, 2019; (v) July 12, 2019; (vi) August 22, 2019; (vii) September 20, 2019; and (viii) October 29, 2019 (collectively, the "Specified Dates") which is stated in Supplementary Notice.

72. <u>No breach/violation of Paragraph 5 of the Early Warning Mechanism Circular</u>: At the outset, it is submitted during the period March, 2019 to October, 2019, BSE has not received any alerts regarding mismatch of securities pursuant to Paragraph 5 of the Early Warning Mechanism Circular and accordingly, no action was warranted by BSE under Paragraph 5 read with Paragraph 8.1 of the Early Warning Mechanism Circular. In fact, in its email dated January 27, 2021, NSDL has submitted to SEBI that NSDL had only provided certain alerts to the stock

exchanges in respect of the 979 Demat Account pursuant to Paragraph 3.2 of the Early Warning Mechanism Circular. Therefore, the allegation against BSE regarding non-compliance with paragraph 5 of the Early Warning Mechanism Circular in the Supplementary SCN is completely unfounded and unsubstantiated. A copy of the email dated January 27, 2021 is placed on records.

73. It is submitted that having received alerts under paragraph 3.2 of the Early Warning Mechanism Circular, it cannot be plausibly alleged that BSE has not complied with paragraph 5 read with paragraphs 2 and 8.1. of the Early Warning Mechanism Circular. Further, as demonstrated below, there could not in any event have been any noncompliance of paragraph 3.2 of the Early Warning Mechanism Circular.

74. <u>Alerts generated under Paragraph 3 of the Early Warning Mechanism Circular not linked to submission made by KSBL regarding demat account no. 12691085:</u> It is submitted that the Supplementary Notice fails to elucidate any basis for linking the submissions made by KSBL with BSE regarding demat account no. 1261085 ("1085 Demat Account") with the alerts for off market transfers provided by NSDL since the Early Warning Mechanism Circular does not deal with nomenclature of demat accounts. The allegation that BSE has failed to verify the submission of KSBL regarding 1085 Demat Account with the depositories and did not act diligently on the said alert is incorrect.

75. It is submitted that once the data is generated under the alert, the SOP prescribes a single and uniform course of action for the stock exchange to take. Accordingly, KSBL's submission to BSE that the 1085 Demat Account was a collateral account does not bear any weightage.

76. <u>Insufficiency of data generated pursuant to SOP in terms of Paragraph 3.2 of the Early Warning Mechanism Circular on the Specified Dates to prompt BSE to take action:</u> At the outset, the data provided to BSE by way of the early warning signals generated by NSDL pursuant to Paragraph 3.2 of the Early Warning Mechanism Circular on the Specified Dates was insufficient for BSE to infer the misutilisation

of client securities by KSBL. While the shortcomings of each of the alerts which contributed to this insufficiency are discussed in detail in paragraphs below, broadly, it may be noted that the criteria for alerts (which were at initial stage and still evolving) provided voluminous sets of system generated raw data that pertained to all the stock brokers registered with BSE. The information about KSBL was interspersed at random within the same. Further, the generation of information simpliciter does not imply that the triggering action is per se illegal. There are legitimate reasons/purposes to justify such actions. In fact, in some cases, the triggering actions are almost routinely undertaken in the ordinary course of business. From the sheer volume of the data generated, coupled with the inadequacies of the same and non-co-operation from the relevant stakeholders, it follows that it would be extremely unreasonable to expect BSE to meaningfully analyse the information, and subsequently conduct follow-on inquiries into the alerts received against each entity. Notwithstanding the above, BSE has made persistent and pro-active efforts to engage with the relevant stakeholders to resolve the abovementioned issues, as indicated hereinafter:

a) Pursuant to joint meeting on February 21, 2019, NSE circulated the minutes and revised SOP vide its email dated February 22, 2019, which was commented upon by MCX on March 26, 2019.
b) Soon after the first set of alerts was received from NSDL on March 11, 2019, BSE noted that they did not contain the desired information. With a view to expeditiously resolving this issue, BSE participated in a meeting held between stock exchanges, clearing corporation and depositories regarding the information provided as part of the Early Warning Mechanism Circular on April 10, 2019. Correspondence exchanged in this regard, and the minutes of this meeting, are placed on records;
c) In furtherance to the aforementioned meeting held on April 10, 2019, NSE through email dated May 20, 2019, clarified and confirmed CDSL's understanding regarding the kind of information to be provided in response to the alerts generated. NSDL was also required to take note of the same. Correspondence exchanged in this regard is placed on records;

d) Subsequently, BSE and NSE escalated this issue to SEBI, vide email dated June 11, 2019, clearly highlighting that they would be unable to take any action pursuant to the alert relating to transactions in dormant accounts, unless necessary information from the depositories was received. However, no response to this communication was received by BSE.;

e) On account of persistent issues with the alerts received from the depositories, NSE, vide its email dated September 3, 2019 had, after discussions with BSE, intimated the depositories regarding additional data fields required for certain alerts generated under the Early Warning Mechanism Circular;

f) BSE vide its email dated July 15, 2020 to NSDL, inter alia re-iterated the information gaps in the data received from certain alerts; and

g) BSE subsequently participated in a meeting held as recently as June 16, 2021 with depositories to discuss alerts generated pursuant to the Early Warning Mechanism Circular. Therefore, BSE continues to remain in discussions on the alerts with the depositories, in order to bolster the operational parameters. Correspondence exchanged in this regard, and the minutes of this meeting, are placed on records.

77. In this context it is also pertinent to note that pursuant to paragraph 7 of the Enhanced Supervision Circular, BSE issued notices dated July 28, 2017 and January 30, 2018 requiring stock brokers to upload data pertaining to clients' funds and securities balance on a monthly basis. Such data includes the particulars of the client, and the fund balance, net across exchange, quantity of securities, quantity of securities pledged, and funds raised for the client. Thereafter, from August, 2017 onwards, BSE started intimating clients information about their funds and securities by way of SMS and/or email for the purpose of cross verification.

78. In this context, it is relevant to note that for over a period of 5 years prior to the initiation of the joint inspection of KSBL coupled with the fact that BSE was periodically intimating clients, information about their funds and securities by way of SMS and/or email, the aggregate number of complaints received by BSE against

KSBL for misuse of client securities were miniscule and majority of such complaints were resolved by KSBL as evident from the chart below:

Year	Total no. of complaints with respect to securities such as misutilization, non-availability of securities	Aggregate Claim Value (in Rs.)	No. of complaints resolved by KSBL out of total no. of complaints dealing with misutilization, non- availability as mentioned in column 3	Aggregate Claim Value (in Rs.)	No. of complaints which were resolved vide IGRC and arbitration in relation to complaints mentioned in column 3	Aggregate Claim Value (in Rs.)
2014 - 15	16	4,19,200	15	4,05,000	1	14,200
2015 - 16	18	7,12,583	12	26,300	6	6,86,283
2016 - 17	12	25,08,898.40	8	17,70,000	4	7,38,898.40
2017 - 18	23	27,35,643	13	12,22,906	10	15,12,737
2018 - 19	37	1,19,58,789.23	28	55,68,802.23	9	63,89,987

79. Therefore, considering all the factors supra collectively, it was not possible for BSE to have identified and traced the diversion of securities by KSBL from the voluminous, opaque and scattered data received from NSDL on the Specified Dates.

80. <u>Alert in relation to off-market transfers other than for settlement purposes</u>
Paragraph 3.2(c) of the Early Warning Mechanism Circular sets out the “transfer of large value of shares through off-market transfers other than for settlement purposes” as an early warning signal of misutilisation of client securities. As per the SOP, the depositories would provide the data of off-market transfers crossing the following thresholds to the stock exchanges on a monthly basis: (i) top 20 ISINs based on quantity of off-market transfers with the top 10 clients entering such transactions; and (ii) top 20 ISINs based on number of off-market transfers above a threshold quantity/value (i.e. 1,00,000 in quantity or Rs. 10,00,000 in value, whichever is less) with the top 10 clients entering such transactions the information generated as part of this alert on the Specified Dates includes details of the source demat account and target demat account (inter alia PAN numbers, and demat

account numbers); name of scrip transferred; date of transfer; quantity transferred; reason/purpose for transfer; and consideration (if any). A copy of the data received pursuant to this alert on the Specified Dates is placed on records.

81. The alerts generated on the Specified Dates inter alia reflected the transfers between the 979 Demat Account and the 1085 Demat Account ("KSBL Off Market Alerts"). The system of generating alerts under the Early Warning Mechanism Circular was designed to prevent misutilisation of client securities. It follows that the off market transfer alert seeks to identify diversion of client securities to a non-client, third party demat account. From the data fields generated by this alert, the parameters that may be used to identify such diversion of securities are: (i) the PAN numbers of the source demat account (transferor) and target demat account (transferee), from which the identity of the transferor and transferee may be inferred; and (ii) the reason/purpose of the transfer. In this context, the PAN number of the source demat account and target demat account for each of the KSBL Off Market Alerts is the same (i.e. AABCK5190K). Additionally, it may be noted that the importance of the PAN numbers of the source and target demat accounts being different to identify the circumstances in which there may be misutilisation of client securities is the collective view of the market infrastructure institutions. This is evidenced by email from NSE (on behalf of the exchanges) to CDSL and NSDL dated September 3, 2019 through which the stock exchanges instructed the depositories to share only those off market transactions where the 'source name/PAN' and 'target name/PAN' are different. Further, for a significant majority of the KSBL Off Market Alerts, the reason for the transfers was recorded as being "Transfer to own account". Moreover, the data provided by NDSL also included transfers for settlement purposes which were to be excluded from the purview of this alert. A copy of the email from NSE dated September 3,2019 is placed on records. Therefore, an analysis of the data received from NSDL in relation to this alert clearly indicates that the transfers were being made inter-se the internal demat account holdings of KSBL, and consequently, did not warrant any action on part of BSE.

82. <u>Alerts in relation to movement of shares to / from a large number of clients' demat accounts or large value shares to stock broker proprietary accounts and vice a versa:</u> Paragraph 3.2(b) of the Early Warning Mechanism Circular describes the alert regarding the "movement of shares to/from a large number of clients' demat accounts or large value of shares to stock broker proprietary accounts and vice versa". The SOP provides that an alert will be generated on the movement of shares to/ from client accounts and proprietary accounts when the following thresholds are met in a particular month: (i) transfer of securities to/from stock brokers proprietary accounts from/to 10 or more clients (having different PANs); and (ii) transfer of securities to/from stock brokers proprietary accounts having value of Rs.25 lakh or more (consolidated value of all transaction). The data fields under which information was generated pursuant to this alert on the Specified Dates included the name and PAN number of the stock broker; the value of the securities debited/credited to/from the stock broker proprietary account; number of client demat accounts to which securities are credited from the stock broker proprietary account and vice-versa. A copy of the data received pursuant to this alert on the Specified Dates is placed on records.

83. Firstly, the data provided by the depositories pursuant to this alert was insufficient for the stock exchanges to conduct any meaningful analysis. This is because, for the threshold mentioned at (i) at paragraph 57 above, the data provided was restricted to the number of client accounts to/from which transfers were made, without including the particulars of these accounts, and for the value- based threshold mentioned at (ii) at paragraph 57 above, the information only provided a summary of the values involved in the transactions. In fact, since these alerts did not contain a data field for the details of the account to/from which the transfers were made, no information relating to the 979 Demat Account and the 1085 Demat Account were provided under this alert on the Specified Dates. Through emails dated September 3, 2019 and July 15, 2020, the stock exchanges instructed the depositories to incorporate additional details, including inter alia the depository ID of the source and the counterparty, the PAN of the counterparty and other transaction details which, in itself, is reflective of an attempt to enhance the

efficiency of the process and to ensure that the object of the Circular was achieved. In fact, pursuant to a joint meeting of the market infrastructure institutions on April 10, 2019, CDSL vide its email dated May 11, 2019 had even confirmed that it would provide such details as a part of this alert. However, none of the alerts on any of the subsequent Specified Dates incorporated the relevant information. Accordingly, the concern that data generated by this alert "does not contain transactional level data which is required for further analysis by the Exchanges" was once again expressed by NSE at meeting of the market infrastructure institutions held on June 16, 2021. The lack of sufficient information to conduct an analysis hindered BSE from engaging with KSBL to pursue any effective line of inquiry. The copies of email from NSE dated September 3, 2019, email from BSE dated July 15, 2020, and CDSL dated May 11, 2019 are placed on records.

84. Additionally, even in the context of the spirit of the Early Warning Mechanism Circular to prevent the diversion of client securities, it is important to note that there are certain legitimate purposes for which shares may move from a stock broker - client demat account to a stock broker proprietary account which is permitted in various instances such as implementation of any order/direction, erroneous transfers and satisfying the dues of the client.

85. <u>Alerts in relation to sudden activation of a significant number of dormant client accounts and/or significant activity in the dormant accounts:</u> Pursuant to Clause 3.1(h) of the Early Warning Mechanism Circular, the SOP prescribes that alerts would be generated in the event either at least 25% or more of the total dormant accounts, or 25 dormant demat accounts, of a particular depository participant, have a client initiated transaction in a particular month. A copy of the data received from NSDL pursuant to this alert is placed on records.

86. This alert only contained the exchange flag, DP ID number, member name, total demat accounts held under the DP ID number, and the number of dormant accounts witnessing activity under this DP ID. Therefore, it is submitted that: (i) BSE did not receive any information regarding the beneficial owner IDs or demat

account numbers of the accounts which were part of the alert; and (ii) the alerts were generated without considering any monetary threshold and even a transaction for Re. 1, or for 1 share, would be considered by this alert. This is in contrast with the alerts generated by CDSL, where a monetary threshold of Rs. 10 lakhs was considered prior to generation of the alerts (i.e. in the event at least 25% of the total dormant accounts were activated, with a minimum threshold of 10 demat accounts, such accounts would be tracked for the debit transactions over the next one month, and in case the consolidated value of such transactions is in excess of Rs. 10 lakhs, an alert in this regard would be generated in the following month). The inadequacy in the data pertaining to dormant accounts was discussed with the depositories in the joint meeting held on April 10, 2019 and the depositories agreed to provide the revised data. However, the same was not rectified in the subsequent alerts received from the depositories. Further, the differences in the trigger thresholds and procedures followed by CDSL and NSDL for this alert also compounded BSE's difficulty in processing the information. In light of these limitations, NSE had, after discussions with BSE, also informed the depositories, vide its email dated September 3, 2019, that the following information would also be required as part of these alerts: (i) list of beneficial owner IDs/account numbers, along with their PAN and the value of the transaction initiated for each DP ID/Name. Further, NSE had also informed SEBI, vide its email dated June 11, 2019, that it would not be able to take any action pursuant to these alerts until adequate information was provided. A copy of email from NSE dated September 3, 2019 and a copy of email to SEBI dated June 11, 2019 is placed on records.

87. Further, it is also submitted that no alerts were generated in this regard, with reference to the 1085 Demat Account or the 979 Demat Account.

88. In any event, an analysis of the data received from these alerts reveals that only a minor percentage of the total demat accounts of KSBL (less than 1% as highlighted below) witnessed activity. Accordingly, in view of the above, this alert did not

provide BSE sufficient basis as mentioned above to initiate any action against KSBL. For ease of reference, a summary of this data is set out below:

Date of Email received from NSDL	Karvy - Total Demat Account held (Under 4 DP	Karvy - No. of Dormant Account having Activity	% to total Account held by Karvy
March 11, 2019	698409	5217	0.75
April 15, 2019	699927	6782	0.97
May 17, 2019	700349	5078	0.73
June 14, 2019	701923	6691	0.95
July 12, 2019	701758	6187	0.88
August 22, 2019	703590	4827	0.69
September 20, 2019	708813	2739	0.39
October 29, 2019	712580	3796	0.53

89. Stock brokers maintaining multiple proprietary demat accounts and opening any new demat account in the name of the stock broker for client purpose: Pursuant to Clause 3.2(a) of the Early Warning Circular, the SOP prescribes that alerts will be generated on a monthly basis with details of the proprietary accounts held by a stock broker (after excluding the accounts opened under category - Clearing Member (pool) and sub-types 'Stock Broker- Client Account' and 'Stock Broker- Collateral Account') and new demat accounts opened under the sub-type 'Stock Broker- Client Account'. A copy of the data received pursuant to this alert is placed on records

90. At the outset, the act of a stock broker maintaining multiple proprietary accounts is not per se illegal, and is in fact, standard market practice. Further, this alert served the limited purpose of only listing out the demat account numbers of proprietary demat accounts held by the member without the value of securities held under these accounts and therefore did not provide any information basis which BSE could take any action against the member.

91. Further, in order for BSE to differentiate between proprietary accounts and client accounts of the stock broker, BSE had requested NSDL to exclude Client Collateral Account, Client Unpaid Securities Account, Client Margin Trading Securities

Account, as these accounts pertained to clients vide email dated July 15, 2020. However, this was not implemented by NSDL. A copy of email from BSE dated July 15, 2020 is placed on records.

92. Miscellaneous alerts generated : In addition to the alerts described in paragraphs 51 to 66 above, no alerts were generated in respect of the 979 Demat Account or the 1085 Demat Account, in the context of: (i) invocation of pledge over securities by lenders against the stock broker or his client; (ii) depletion in value in the Stock Broker – Client Account; and (iii) new demat account of stock broker opened for client purposes for the Specified Dates. A copy of these alerts has been included in documents placed on records. In respect of the alert for depletion in value, an alert was generated on October 29, 2019 for depletion in value in two of the accounts held with KSBL: (i) Account IN300394/10014644, where a depletion in value from Rs. 14.11 crores to Rs. 0.09 crores had taken place; and (ii) Account IN300394/11832204, where a depletion in value from Rs. 32.17 crores to Rs.13.93 crores was observed. No additional actions were warranted by BSE since the joint inspection of KSBL had already been initiated on June, 2019 whereby detailed inspection of KSBL was carried out. Further, this alert did not feature or pertain to either the 979 Demat Account or the 1085 Demat Account.

93. It is submitted that the aforementioned alerts under the Early Warning Mechanism Circular would have arguably been the most appropriate in the context of the investigation involving KSBL. However, since no alerts of this nature were generated, the allegation that BSE did not act upon alerts is incorrect and untenable.

94. **Charges leveled against BSE are unsustainable and no penalty is warranted**

Delay in providing relevant information: Through the Notice and the Supplementary Notice, SEBI has not provided adequate details and particulars in relation to the matter at hand to BSE. The Hon'ble Supreme Court in Gorkha Security Services v. Government (NCT of Delhi) & Ors. ((2014) 9 SCC 105), which was followed in UMC Technologies Private Limited v. Food Corporation of India and Anr. (AIR 2021 SC 166), stated that the *"fundamental purpose behind the serving of Show*

Cause Notice is to make the noticee understand the precise case set up against him which he has to meet. This would require the statement of imputations detailing out the alleged breaches and defaults he has committed, so that he gets an opportunity to rebut the same." The information provided in the Notice and Supplementary Notice is couched in a generic and broad manner, which does not sufficiently inform BSE to equip them to build an effective defense.

95. Further, the importance of making available all documents relied upon by SEBI to the noticee has been highlighted by the Securities Appellate Tribunal ("SAT") in Mayrose Capfin Pvt. Ltd. v. SEBI (Appeal No. 20 of 2012, Order dated March 30, 2012) wherein it was held that "*the principles of natural justice require that the inquiry officer should make available such document and material to the delinquent on which reliance is being placed in the inquiry. It is not necessary for the inquiry officer to make available all the material that might have been collected during the course of investigation but has not been relied upon for proving charge against the delinquent.*" Since receipt of the SCN, BSE has made repeated and continuous efforts to engage with SEBI in order to obtain the relevant information. In fact, after the inspection held on February 10, 2021 was found to be incomplete, BSE sent SEBI numerous letters dated February 16, 2021, July 8, 2021, August 19, 2021, and November 11, 2021 requesting for an inspection in regards to the documents relied upon by SEBI in the Notice and the Supplementary Notice. However, it was only almost a year after the date on which the Notice was issued, that SEBI provided certain documents it relied upon through the Notice of Hearing. Moreover, BSE has not received responses to all queries raised in the said letters nor has it been provided with the complete documents / records requested for, in violation of the principles of natural justice and which has prejudiced BSE and its submissions.

96. <u>The Notice and Supplementary Notice have been issued raising allegations which are not substantiated in law:</u> It is submitted that the Notice and the Supplementary Notice have been issued with disregard to law inter alia for the following reasons:

a) At the time at which the FY 2016-17 BSE Inspection was conducted, there was no regulatory requirement for stock exchanges to reconcile the details of client securities as submitted by a trading member with the details available with the depositories. Contrary to the legal position, SEBI in the Notice and the Supplementary Notice have alleged that BSE was under an obligation to do such reconciliation;

b) Additionally, the allegation that BSE failed to correspond with the depositories regarding the demat accounts of KSBL is also incorrect to the knowledge of SEBI as borne out from the email dated January 27, 2021 addressed by NSDL to SEBI; and

c) Similarly, it is evident from the email dated January 27, 2021 addressed by NSDL to SEBI that NSDL had only provided certain alerts to the stock exchanges in respect of the 979 Demat Account pursuant to Paragraph 3.2 of the Early Warning Mechanism Circular which were insufficient for the reasons outlined above. No alerts were received by BSE pursuant to Paragraph 5 of the Early Warning Mechanism Circular, as alleged by SEBI in the Supplementary Notice.

97. The Notice and the Supplementary Notice have been issued raising allegations which are not substantiated in law and are in any event contrary to the record, which was available with SEBI. Therefore, the Notice and the Supplementary Notice ought to be dismissed for this reason as well as the other reasons set on in this Response.

98. **<u>Considerations made by SEBI while imposing a penalty</u>**

Under Chapter-VIA of the SEBI Act, imposition of a penalty is not a compulsion but is discretionary. Section 15I(2) of the SEBI Act confers on the adjudicating officer the discretion to impose a penalty. The use of the words "he may impose such penalty as he thinks fit…" in Section15I(2), underscores the existence of discretion not to impose a penalty. The Hon'ble Supreme Court in Bharjatiya Steel Industries v. CST ((2008) 11 SCC 617) held that where a statute confers on an authority the discretion to impose a penalty, it is open to the authority not to impose a penalty. This has been reiterated in SEBI v. Bhavesh Pabari ((2019) 5 SCC 90) (see below), which occupies the domain apropos the scope of discretion under Chapter VI-A of the SEBI Act.

99. Pursuant to Section 15J of the SEBI Act, while adjudging quantum of penalty under Section 15I, the adjudicating officer is required to give due regard to (among others) the following factors, namely:
    a) the amount of disproportionate gain or unfair advantage, wherever quantifiable, made as a result of the default;
    b) the amount of loss caused to an investor or group of investors as a result of the default; and
    c) the repetitive nature of the default.

100. The law is well-settled that these factors are merely illustrative and not exhaustive. In the instant case, the other factors that should be taken into account include:
    a) BSE conducted the FY 2016-17 BSE Inspection in full compliance with all applicable regulations, circulars and regulatory directions, which did not mandate verification of client securities as submitted by the stock broker with the depository participant account details available with the depositories;
    b) BSE Inspection Period and afterwards did not record any adverse observation with respect to the reconciliation of the client securities;
    c) BSE proactively interacted with the depositories and shared the PANs of trading members for the purpose of the reconciliation exercise pursuant to Enhanced Supervision Circular as evidenced by BSE's emails dated April 6, 2017 and August 25, 2018;
    d) BSE undertook reasonable efforts to comply with the Enhanced Supervision Circular, and the discrepancy with respect to the 979 Demat Account was not on account of any mala fide intent of BSE, and would have only led to a minor penalty on KSBL and would not have resulted in a requirement for reconciliation of client securities;
    e) During the period March, 2019 to October, 2019, BSE has not received any mismatch alerts regarding diversion of pay-out of securities to non-

client accounts or any reports of mismatches between gross (client wise) securities and actual transfer of securities to/from the client's depository accounts pursuant to Paragraph 5 of the Early Warning Mechanism Circular. Accordingly, BSE was not in any position to take any actions pursuant to Paragraphs 5 read with Paragraph 8.1 of the Early Warning Mechanism Circular;

f) Data/ alerts provided by NSDL pursuant to Paragraph 3 of the Early Warning Mechanism Circular were insufficient and lacked relevant information for BSE to undertake any actions against KSBL with respect to the 979 Demat Account or 1085 Demat Account. Relevant data/alerts in relation to client's securities was not received by BSE as outlined above;

g) BSE has taken pro-active steps to implement the Early Warning Mechanism Circular;

h) There were overlaps between the actions undertaken pursuant to the joint inspection of KSBL, and the actions set out in the Early Warning Mechanism Circular. Further, pursuant to the joint inspection of KSBL, BSE has taken the following actions: (i) disablement of Unique Client Code of KSBL on November 11, 2019; (ii) suspension of trading operations of KSBL from all segments on December 2, 2019; (iii) declaration of KSBL as defaulter and also expulsion of KSBL with effect from November 24, 2020; and (iv) invocation of collaterals of KSBL; and

i) BSE has taken robust steps to bolster its supervisory systems in response to the evolving regulatory framework.

101. Therefore, it is submitted that for reasons mentioned above, the charges levelled against BSE are unsustainable and thus, the proceedings against BSE ought to be dropped, in the interest of justice. Further, considering the mitigating factors mentioned above, a penalty is not warranted. A number of judicial rulings of the Supreme Court and SAT (set out below) have frowned upon the mechanical imposition of penalties, without regard to attendant facts. The mere existence of a power to impose a penalty is not a ground for its exercise.

102. The Hon'ble Bombay High Court in Securities and Exchange Board of India v. Cabot International Capital Corporation ((2005) 123 CompCas 841 (Bom)) has held: "*Though looking to the provisions of the statute, the delinquency of the defaulter may itself expose him to the penalty provision yet despite, that in the statute minimum penalty is prescribed, the authority may refuse to impose penalty for justifiable reasons like the default occurred due to bona fide belief that he was not liable to act in the manner prescribed by the statute or there was too technical or venial breach, etc.*"

103. The Hon'ble Supreme Court has held in Hindustan Steel Ltd. v. State of Orissa (AIR 1970 SC 253):

"But the liability to pay penalty does not arise merely upon proof of default in registering as a dealer. An order imposing penalty for failure to carry out a statutory obligation is the result of a quasi-criminal proceeding, and penalty will not ordinarily be imposed unless the party obliged either acted deliberately in defiance of law or was guilty of conduct contumacious or dishonest, or acted in conscious disregard of its obligation. Penalty will not also be imposed merely because it is lawful to do so. Whether penalty should be imposed for failure to perform a statutory obligation is a matter of discretion of the authority to be exercised judicially and on a consideration of all the relevant circumstances. Even if a minimum penalty is prescribed, the authority competent to impose the penalty will be justified in refusing to impose penalty, when there is a technical or venial breach of the provisions of the Act or where the breach flows from a bona fide belief that the offender is not liable to act in the manner prescribed by the statute."

104. It has also been held that while considering the factors enumerated in Section 15J of the SEBI Act, the competent authority should also give due weightage to the aim and object of the SEBI Act, the impact of the violation and other mitigating factors which depend on the facts and circumstances of each case and include absence of market manipulation, no investors' interest having been adversely affected, no change in management,1 and inordinate delay in issuance of show cause notice and for completion of adjudication proceedings. In Piramal Enterprises v. SEBI

(Appeal No. 466 of 2016, SAT Order dated May 15, 2019), SAT held that *"the object of the Act is not only to protect the investors but also the securities market…SEBI is the watchdog and not a bulldog. If there is an infraction of a rule, remedial measures should be taken in the first instance and not punitive measures…a reasonable benefit of doubt should be extended to the PEL instead of mechanically imposing a penalty. Other factors should be considered...".*

105. In light of the above, it is submitted that it is not mandatory for the adjudicating officer to impose a penalty in all cases of violation of the applicable regulations. It is submitted that Section 15I read with Section 15J confers discretion of the adjudicating officer to determine whether a penalty should be levied or not as well as determine the quantum of such penalty.

106. In Siddharth Chaturvedi v. SEBI ((2016) 12 SCC 119), it was held with respect to the SEBI Act that:

"It is very difficult, keeping in view, particularly, two important legal facets-one the doctrine of harmonious construction of a statute; and two, the fact that we are construing a penalty provision of a statute which is to be strictly construed, Section 15A, post amendment in 2002, is suddenly given a pride of place, and Section 15J is made to yield entirely to it. The familiar expression "notwithstanding anything contained" does not appear in the amended Section 15A. This being the case, it is a little difficult to appreciate as to how one can construe Section 15A, as amended, in isolation, without regard to Section 15J. In fact, the facts of the present case would go to show that where there is allegedly only a technical default, and the three parameters of Section 15J would allegedly be satisfied by the Appellants, namely, that no disproportionate or unfair advantage has been made as a result of the default; no loss has been caused to an investor or group of investors as a result of the default; and there is in fact, no repetitive nature of default, no penalty at all ought to be imposed."

107. In Adjudicating Officer, SEBI v. Bhavesh Pabari ((2019) 5 SCC 90), it was held:

“if the penalty provisions are to be understood as not admitting of any exception or discretion and the penalty as prescribed in Section 15A to Section 15HA of the SEBI Act is to be mandatorily imposed in case of default/failure, Section 15J of the SEBI Act would stand obliterated and eclipsed. Hence, the question referred. Sections 15A(a) to 15HA have to be read along with Section 15J in a manner to avoid any inconsistency or repugnancy. Provision of one section cannot be used to nullify and obtrude another unless it is impossible to reconcile the two provisions…

We, therefore, deem it appropriate to hold that the provisions of Section 15J were never eclipsed and had continued to apply in terms thereof to the defaults under Section 15A(a) of the SEBI Act.”

108. Further, in PG Electroplast & Ors. v. SEBI (Appeal No. 281 of 2017, SAT Order dated August 2, 2019), relying on Hindustan Steel (above), it has been specifically section cannot be used to nullify and obtrude another unless it is impossible to reconcile the two held *that “if it is found that a party has not acted deliberately, then the authority has a discretion, to be exercised judicially, whether in a given case, after taking into consideration of all the relevant circumstances, as to whether a penalty should be imposed or not. Even if a minimum penalty is prescribed, the authority, after considering the circumstances of the case and other factors enumerated in Section 15J would be justified in refusing to impose penalty when there is a technical or venial breach of the provisions of the SEBI Act.”*

109. In Shree Bhagwati Steel Rolling Mills Limited v. Commsr of Central Excise & Anr. ((2016) 3 SCC 643), it was laid down that imposing a mandatory minimum penalty without regard to conduct of the relevant party, would amount to treating un-equals, equally and would be arbitrary and excessive:

“The High Court is, therefore, correct in saying that an Assessee who pays the delayed amount of duty after 100 days is to be on the same footing as an Assessee who pays the duty only after one day's delay and that therefore such rule treats unequals as equals and would, therefore, violate Article 14 of the Constitution of India. It is also correct in saying that there may be circumstances of force majeure

which may prevent a bonafide Assessee from paying the duty in time, and on certain given factual circumstances, despite there being no fault on the part of the Assessee in making the deposit of duty in time, a mandatory penalty of an equivalent amount of duty would be compulsorily leviable and recoverable from such Assessee. This would be extremely arbitrary and violative of Article 14 for this reason as well. Further, we agree with the High Court in stating that this would also be violative of the Appellant's fundamental rights Under Article 19(1)(g) and would not be saved by Article 19(6), being an unreasonable restriction on the right to carry on trade or business. Clearly the levy of penalty in these cases of a mandatory nature for even one day's delay, which may be beyond the control of the Assessee, would be arbitrary and excessive."

110. In UPSE Securities Ltd. V/s SEBI (Appeal No. 109 of 2011 Order dated July 25,2011), the Hon'ble SAT observed as follows:

"5. … the object of carrying out inspection of the books of accounts and records of any intermediary including a stock exchange or its subsidiaries is to ensure compliance with the provisions of the Act, Rules, Regulations, By-laws and circulars issued from time to time which are meant to regulate the securities market. Every little irregularity/deficiency noticed during the course of the inspection is not culpable and does not call for initiation of penalty proceedings. The purpose of inspection in quite a few cases could be better achieved if the inspecting team at the time of the inspection were to advise the erring entity..."

111. Besides, any penalty imposed for conduct which is not mala fide would be disproportionate. It is settled law that the principle of proportionality would require the administrative authority to "*maintain a proper balance between the adverse effects, which the legislation or the administrative order may have on the rights, liberties or interests of persons keeping in mind the purpose, which they were intended to serve.",* as was held by the Supreme Court in Om Kumar v. Union of India (2000 Supp 4 SCR 693).

112. **Submissions in relation to the queries:** At the Hearing, the Learned Adjudicating Officer raised queries in relation to:

a) the chain of events leading up to the joint inspection of KSBL by SEBI, BSE, NSE, NSDL and CDSL in June, 2019 ("Joint Inspection");

b) the differences in the scope of inspection between a full-fledged inspection conducted by a stock exchange and the Joint Inspection.

113. With respect to the query set out in sub para a) above, the Noticee submits that prior to the commencement of the Joint Inspection of KSBL, SEBI had initiated the transaction level client reconciliation exercise. In summary, the key events leading up to the Joint Inspection were as follows:

a) Email dated May 6, 2019 from SEBI to BSE, NSE, stating that, inter alia, a second meeting has been scheduled on May 30, 2019 to review the pilot exercise of reconciliation of holding statements with depository data. SEBI also communicated that the mismatch reports for the reporting week of April 15-20, 2019 will be provided to the stock exchanges by May 13,2019. A copy of this email is placed on records.

b) On May 16, 2019, SEBI shared the mismatch reports for April 15 - 21, 2019 with BSE which, among others, contained the mismatch details for KSBL. A copy of this email and an extract of the mismatch data relating to KSBL received from SEBI is placed on records.

c) Thereafter, as evidenced from the minutes of meeting dated May 30, 2019 inter alia between SEBI, stock exchanges, clearing corporations and the depositories, a pilot exercise was contemplated for 10 common stock brokers (5 stock brokers each would be assigned to BSE and NSE) wherein: (a) SEBI was to perform reconciliation of securities at a client level for each of these 10 stock brokers and share the mismatch reports with NSE and BSE; and (b) subsequently, NSE and BSE were to ascertain the reasons for the mismatches. The minutes of the meeting are placed on records.

d) On the same date, NSE sent an email to SEBI in response to SEBI's email dated May 30, 2019, setting out the top 10 common stock brokers for the client level reconciliation exercise, wherein KSBL was assigned to NSE. The email from NSE dated May 30, 2019 is placed on records.

114. With respect to the query set out in sub para b) above, the joint inspection was a targeted exercise conducted after preliminary information about mismatch in client securities of KSBL was already available. In contrast, the FY 2016-17 BSE Inspection was a general inspection, and at the time it was conducted, there was no indication whatsoever of KSBL's misconduct. Notably, the scope of inspection in a joint inspection is distributed amongst various agencies unlike in full-fledged inspection wherein the inspection is undertaken by a stock exchange basis limited information (in comparison to a joint inspection) and is restricted only to the trades done on the concerned stock exchange. The full-fledged inspection does not involve the trades undertaken on other stock exchanges and fund/securities position thereof or complaints received against the trading member by other stock exchanges. It is worthwhile to mention that a client may deal on any of the stock exchanges through KSBL. Thus, a joint inspection enables a holistic and complete view of the entire fact pattern of dealing of a client with a trading member, which is absent in case of full- fledged inspection.

115. In a nutshell, the major elements of differentiation between the Joint Inspection vis-a-vis a full-fledged inspection conducted by a stock exchange are:

   a) Misutilization of securities: During a full-fledged inspection, the trade log /exchange net position file is verified with the pool transaction statements, statement of demat accounts of the trading member used for holding client's securities and client wise securities holding file obtained from the trading member's from the back office for trades undertaken on the relevant stock exchange conducting such inspection. However, during the Joint Inspection, this exercise covers trades undertaken on both the stock exchanges in addition to books of account, back office records and information such as securities / fund statement maintained by a stock broker across stock exchanges. Further, during the course of the joint inspection, a forensic audit may also be undertaken, as evidenced from the appointment of Ernst and Young LLP to conduct a forensic audit of KSBL.

b) Misutilization of funds: While in a full-fledged inspection, the pay in I pay out of funds is verified by taking trade files of the stock exchange conducting the inspection, in a joint inspection, this extends to verification of trade files across stock exchanges which facilitate reconciliation of client's position at a consolidated level.

c) Sharing of information between stock exchanges and depositories: In comparison to a full-fledged inspection, during the Joint Inspection, the depositories and the stock exchanges share information/findings with each other which assists in establishing a complete picture of a client's dealing with his broker and ensures that the verification/reconciliation exercise is undertaken in a manner resulting in access to crucial information such as trades files, margin files, etc., from other exchanges and depositories.

116. As demonstrated at the Hearing, in the Response and herein, in these circumstances, it is inexorable that the allegations in the Notice and the Supplementary Notice are wholly unfounded. It is respectfully submitted that the facts and circumstances present a compelling case for the Notice and the Supplementary Notice to be discharged with no penalty being imposed, on a number of grounds.

117. As the inquiry in the matter has been completed, I now proceed to decide the case on the basis of SCN issued, replies made by the Noticees and material available on record.

CONSIDERATION OF ISSUES AND FINDINGS

118. The issues that arise for consideration in the instant matter are:

Issue No. I (a) Whether Noticee violated provisions of para 4(a) of the SEBI Master Circular SEBI/MIRSD/Master Cir-04/2010 dated March 17, 2010 **(2010 circular)** read with para 2 of the Circular SMD/SED/CIR/93/23321 dated November 18, 1993 **(1993 circular)**

(b) Whether Noticee violated Provisions of with Para 2.3 to the annexure of the SEBI Circular SEBI/HO/MIRSD/ MIRSD2/CIR/P/2016/95 dated September 26, 2016 read with para 1.1 and 1.2 of the annexure to SEBI Circular SEBI/HO/MIRSD/MIRSD2/CIR/P/2016/95 dated September 26, 2016 **(2016 circular)**

(c) Whether Noticee violated provisions of para 5 read with para 8.1 and para 2 of the SEBI Early Warning Mechanism Circular dated December 17, 2018 **(2018 circular)**.

Issue No. II If yes, whether the failure, on the part of the Noticees would attract monetary penalty under Section 15HB of SEBI Act,1992? And

Issue No. III If yes, what would be the monetary penalty that can be imposed upon the Noticees taking into consideration the factors stipulated in Section 15J of the SEBI Act read with Rule 5(2) of the Adjudication Rules?

Issue No. I **(a) Whether Noticee violated provisions of para 4(a) of the SEBI Master Circular SEBI/MIRSD/Master Cir-04/2010 dated March 17, 2010 read with para 2 of the Circular SMD/SED/CIR/93/23321 dated November 18, 1993**

119. Before going into merits of the case, I note that Noticee has contended that there was delay in providing relevant information to the Noticee which has hampered Noticee to build up an effective defense. In this regard, I note that Noticee was provided with all the relevant information and documents relied upon in the

proceedings through annexures to SCN, SSCN and letter dated December 14, 2021. Further, Noticee was given sufficient time to file its reply to the Notices in the matter. Noticee filed its reply on February 07, 2022 and also filed supplemental submission dated February 17, 2022. In view of the above, I find that the Noticee had sufficient time and information to submit reply to the notices. Thus, the aforesaid contention of the Noticee is not tenable.

120. Noticee has also stated that it did not receive responses to all its queries raised vide letters dated February 16, 2021, July 8, 2021, August 19, 2021 and November 11, 2021. In this regard, I note that point-wise reply was given to the queries raised including seeking of documents by Noticee vide letter dated December 14, 2021.

121. The allegations against the Noticee arise from findings pursuant to joint inspection of KSBL conducted from June 2019 by SEBI, NSE and BSE which was followed by an interim order by SEBI against KSBL. It was found during the joint inspection that KSBL unauthorizedly transferred the securities worth Rs. 2300 crores of more than 95,000 clients to one demat account no. 11458979, named Karvy Stock Broking Ltd (BSE), and securities from these accounts were unauthorizedly pledged and misused by KSBL.

122. In terms of para 4(a) of 2010 circular, Noticee was required to carry out inspection of brokers to, inter alia, confirm compliance with provisions of rules, regulations of stock exchange and circulars issued by SEBI. Para 2 of 1993 circular requires brokers to keep client securities separate from own securities. Thus, brokers are prohibited from holding client securities in their own accounts. Para 2(d) and € of 1993 circular provides that for holding securities of clients as security / margin by brokers, proper authorization shall be obtained by broker. Securities held in name of member as margin requirements of clients shall be segregated from own securities. Para 1 of the 1993 circular prohibits broker from using client funds beyond the indebtedness of the clients to the broker. Thus, stock brokers were required to ensure that client collateral/securities is not used for any purposes other than meeting the respective client's margin requirements/pay-ins, and funds raised

against client securities are not used for obligations beyond client indebtedness. This was emphasized in Circular No. MRD/DOP/SE/Cir – 11/2008 dated 17 April 2008, wherein SEBI inter-alia specified that 'brokers should have adequate systems and procedures in place to ensure that client collateral is not used for any purposes other than meeting the respective client's margin requirements / pay-ins.'

123. It was incumbent upon Noticee to check and confirm compliance with the stipulations relating to client securities maintained by broker. During inspection there was obligation upon Noticee to examine if client securities are misused by a Stock Broker, for which following needs to be verified in respect of client securities:
    a) that client collateral/securities are not used for any purposes other than meeting the respective client's margin requirements/pay-ins,
    b) that Stock broker has pledged securities only of those clients who have indebtness to the stock broker and that too only up to the extent of indebtness.

124. Noticee conducted inspection of KSBL from November 09, 2016 to November 10, 2016 covering period from April 2015 to March 2016 (hereinafter referred as "Inspection 2016-17"). The Inspection 2016-17 was a full-fledged inspection of KSBL by Noticee, as noted from its submissions. I further note that during Inspection 2016-17, for inspection area of Client Securities, Noticee checked sample of Top 50 transactions for five dates for pay-in and pay-out of securities data, by verification of the trade log/exchange net position file with the pool transaction statements, statement of demat accounts of the trading member used for holding client securities and client wise securities holding file obtained from the trading member's back office. However, at Point 5 of aforesaid Inspection report of Inspection 2016-17, which is in respect of *'pledging of client securities*', the observation mentioned is '*not applicable'.* The observation reflects that the Noticee did not inspect the area of pledging of client securities by KSBL during the aforesaid inspection, leaving a void in ascertaining if client securities are misused by KSBL. Further, there are no submissions from the Noticee, as to why pledging

of client securities was not verified by it during the said inspection, and how it was 'not applicable' to KSBL during the said inspection.

125. I also note from the inspection report of Inspection conducted in 2016-17 that BSE had received an email from SEBI stating inter alia that '*there is a complaint against Karvy for breaching the networth norm laid by SEBI….Karvy has been investing in group companies as debt and equity through indirect routing….Karvy has a very high debt of Rs.1000 crores debt on very low equity bases. All this debt money invested group companies as debt and equity which should be deducted from net-worth as per the rules. Then the net worth would be negative…..In view of the above facts you are requested to provide details/ clarification regarding networth of the captioned entity*'. I find that the inspection report contains observations on advances, corporate guarantees, commercial paper issued by KSBL but no finding on networth of KSBL, as to whether it was negative, or raised any concern, nor any further action taken by it on negative networth. The inspection report mentions that '*under information sharing framework, NSE has levied a penalty of Rs. 25 lakhs and directed to close the outstanding corporate guarantee'.*

126. Despite the reference from SEBI and being aware of the information that NSE has levied penalty on KSBL, no action on this count was taken by Noticee. Erosion of networth of KSBL and plunging of same into negative territory was a crucial red flag for the Noticee regarding the loss of financial assets of KSBL. However, there is nothing on record to show any action taken by Noticee against KSBL in this regard, and as mentioned above, Noticee did not even include pledging of client securities by KSBL in its inspection. It is contended by Noticee that there was no mandate for it to seek information from depositories in 2016-17. I find that this statement circumvents the fact that exchanges were verifying pledging of securities by brokers on sample basis by seeking information of pledged securities from the broker, and examining it against clients' indebtedness. Noticee did not include such verification in its 2016-17 inspection and has not explained why it did not do so.

127. Noticee also contended that it acted with reasonable due diligence while inspecting KSBL, and that their inspection was based on annual inspection policy. In regard to the annual inspection policy, I note that the Noticee's annual inspection policy 2016-17 only lays down the criteria for selection of its members who will be inspected during that year, and it does not provide the inspection areas to be covered and the methodology to be adopted by Noticee while conducting the inspection. Further, it does not lay down any boundaries in inspection areas beyond which the inspection team shall not go, and does not limit scope of inspection.

128. While Noticee has explained that it carried out its duties with due diligence as per its annual inspection policy, it is necessary to appreciate that Noticee performs the role of a frontline regulator and its obligation to conduct inspection of brokers cannot be merely checklist based, particularly when a red flag was highlighted to it by SEBI and Noticee was aware of imposition of penalty on KSBL by NSE. However, from the inspection report of 2016-17 and from the submission of the Noticee, I find that the inspection was carried out in a routine and mechanical manner, without taking into consideration reference from SEBI and findings of NSE.

129. Noticee is a stock exchange, and in terms of Rule 8 of Securities Contract (Regulation) Rules,1957, Noticee is responsible for framing rules relating to members of stock exchange, and in ensuring compliance with such rules. The object of the Noticee as per its Memorandum of Association is to, inter alia, carry on business as a stock exchange, to assist, regulate, control and/or otherwise associate with the business of buying, selling and dealing in securities, and to carry on business as a self-regulatory organization. Noticee has framed Rules Regulations and Bye-Laws for conduct of the business of trading, admission and regulation of members, listing of companies etc. The Noticee thus performs a regulatory function including with regard to ensuring compliance of applicable rules and regulations by its members. Considering the function of Noticee as a frontline regulator, its responsibility to conduct inspection of brokers in order to ensure

compliance of applicable rules and regulations arises not only from the 2010 circular but rests on the Noticee under the framework of its recognition as a stock exchange. As a frontline regulator, the responsibility for conducting inspection does not end at inspecting checklist items. Checklists are indicative and the starting point to detect irregularities. Further, upon being made aware of potential irregularity, it is incumbent upon Noticee as a frontline regulator to examine it thoroughly and take appropriate action till a point of satisfaction regarding compliances by the trading member is achieved. I find that Noticee failed in examining the issue of negative networth of KSBL and also failed to include verification of pledging of securities in its annual inspection despite a potential red flag of negative networth.

130. Notice has claimed that FY 2016-17 BSE Inspection was in compliance with all relevant regulations and policies and quoted from Chander Kanta Bansal v. Rajinder Singh Anand (2008 5 SCC 117) to state that *"'due diligence' in law, means doing everything reasonable, not everything possible. …it means such diligence as a prudent man would exercise in the conduct of his own affairs*. From the preceding paragraphs, I find that it was reasonable to expect the Noticee to look into pledging of client securities by KSBL in 2016-17, particularly in the context of reference of negative networth and penalty levied by NSE for the same. That it was reasonable to do so can also be concluded from the fact that NSE, also a stock exchange, examined the issue, sought pledge details from depositories and levied a penalty on KSBL, which information was available with Noticee.

131. Therefore, as detailed in aforesaid paragraphs, I find that in respect of verification of the client securities, potential misuse of client securities by KSBL through pledging was not looked into by the Noticee, which is an essential part of verification of client securities during inspection. I find that Noticee did not take seriously the information on networth of KSBL and did not take any action to either verify or determine potential risks from negative networth. Hence, I find that the Noticee did not carry out inspection with the due diligence expected of it as a front line regulator.

132. **In view of the above, I find that allegation of violation of para 4(a) of the SEBI Master Circular SEBI/MIRSD/Master Cir-04/2010 dated March 17, 2010 read with para 2 of the Circular SMD/SED/CIR/93/23321 dated November 18, 1993 by Noticee is established**.

(b) Whether Noticee violated provisions of para 2.3 read with 1.1 and 1.2 of the annexure to the Circular SEBI/HO/MIRSD/MIRSD2/CIR/P/2016/95 dated September 26, 2016.

133. In terms of para 2.3 of the annexure to the Circular SEBI/HO/MIRSD/MIRSD2/CIR/P/2016/95 dated September 26, 2016 (hereinafter referred as 2016 Circular), the Stock Exchanges and/or Depositories, as the case may be, shall ensure that all banks and demat accounts maintained and/or opened by the Stock Brokers shall be assigned appropriate nomenclature and details of the same shall be communicated to Stock Exchanges by the stock brokers in the format specified. Further, para 1.1 of aforesaid annexure prescribes that Bank accounts and Demat accounts maintained by all stock brokers shall have appropriate nomenclature to reflect the purpose for which those bank/demat accounts are being maintained. The para 1.2 of the aforesaid annexure prescribes the nomenclature for bank accounts and demat accounts to be followed, and it *inter alia* prescribes '…..*Para 1.2.3. Demat account(s) which hold clients' securities shall be named as "Name of Stock Broker-Client Account* "… *Para 1.2.5. Demat account(s), maintained by the stock broker for depositing securities collateral with the clearing corporation, shall be named as "Name of Stock Broker-Collateral Account*."

134. It was observed that KSBL pledged client's shares in KSBL's DP Account No. 11458979 with name "Karvy Stock Broking Limited (BSE)", to generate funds for its own/group entities use.

135. I note from submission of the Noticee that on April 06, 2017, Noticee sought information on details of the member's (including KSBL) demat accounts from both CDSL and NSDL, subsequent to which it received information from NSDL on June 13, 2017. However, Noticee is silent on whether it received information from CDSL. Noticee has also submitted nothing on what it did with this information. Further, Noticee again sought information on details of the member's (including KSBL) demat accounts from NSDL and CDSL after almost one year, on August 16, 2018 which it received on August 21, 2018 and August 25, 2018 respectively.

136. In the information provided by NSDL on June 13, 2017 there were total 57 demat accounts of KSBL reported by NSDL, out of which only 7 were tagged and 50 were yet to be tagged. The details of untagged accounts included untagged Demat Account no. 11458979 named 'KARVY STOCK BROKING LTD (BSE)' (hereinafter referred to as BSE tagged account) which was categorized as 'Beneficiary Client'; and Demat Account no. 12691085 named 'KARVY STOCK BROKING LTD' which was categorized as 'Beneficiary Client'. Similarly, in alert dated August 21, 2018 there were total 68 demat accounts of KSBL reported by NSDL, out of which only 16 were tagged and 52 were yet to be tagged including accounts no. 11458979 and 12691085 which were still categorized as 'Beneficiary Client'. Further, in alert dated August 25, 2018 provided by CDSL there were 20 KSBL's demat accounts untagged.

137. The DP account details of KSBL as received by Noticee from NSDL indicated separately account type/category as 'beneficiary client', 'house client' etc., and from the names of the demat accounts, it was observed that the nomenclature of many of the demat accounts of KSBL was not in accordance with the 2016 Circular. It was alleged in the SCN that Noticee failed to ensure that the demat accounts of KSBL were in accordance with the nomenclature guidelines of 2016 circular.

138. I note that SEBI vide Circular no SEBI/HO/MIRSD/MIRSD2/CIR/P/2016/138 dated December 20, 2016 made the 2016 Circular effective from April 1, 2017 and accordingly the various timelines mentioned in the 2016 circular for different

activities were consequently postponed. Further, vide Circular no. CIR/HO/MIRSD/MIRSD2/CIR/P/2017/64 dated June 22, 2017, SEBI clarified that Clause 1.2.2 and 1.2.4 of 2016 Circular stands deleted; accordingly naming proprietary bank/demat accounts of the stock broker as 'Stock Broker-Proprietary Account' was made voluntary. Further, the bank/demat account which do not fall under the Clauses 1.2.1, 1.2.3, 1.2.5, 1.2.6 and 1.2.7 of 2016 circular were deemed to be proprietary.

139. As per 2016 circular and subsequent clarifications, tagging of only proprietary demat account of stock Broker was made voluntary, and the demat accounts type other than those which held clients' securities or were maintained by the stock broker for depositing securities collateral with the clearing corporation or held securities for the purpose of settlement, would be deemed to be proprietary. Accordingly, only proprietary accounts of Stock broker could remain untagged, hence, all untagged accounts should have been considered as deemed proprietary account by stock exchange, till they were examined and found otherwise by the exchange.

140. Despite the said demat account no. 11458979 being tagged as a BSE account, and categorized as a beneficiary client account, Noticee did not take any action for non-tagging of this account by KSBL. This made it a deemed proprietary account because it was not tagged. However, in reality it was holding client securities. Such laxity in ensuring the tagging of demat accounts of KSBL left gap in monitoring of demat accounts of KSBL.

141. Noticee has submitted that it received voluminous data regarding information of demat accounts of members of BSE from Depositories, which required semi-autonomous processing entailing overhauling of system transition, due to which inadvertently the discrepancy with respect to account no. 11458979 not came to light before it. Here I note that Noticee has attempted to free itself of the obligation of monitoring tagging of demat accounts by blaming it on need for autonomous

processing. This claim makes light of the responsibility placed on exchanges in the 2016 circular regarding tagging of accounts.

142. As detailed in preceding paragraphs the data/information received in respect of KSBL was not so voluminous (50 and 52 non tagged demat accounts of KSBL) that it required semi-autonomous processing to come to logical inferences. These non-tagged accounts should have been taken up by Noticee with KSBL for compliance of 2016 circular. However, the Noticee has not been able to produce any records of any action taken by it in respect of non-tagging of demat accounts upon receipt of information from depositories. This lapse is glaring in view of the fact that demat account no. 11458979 was a BSE tagged account lacking appropriate nomenclature.

143. I also note that NSE vide email dated September 04, 2017 (who also received the alerts from NSDL) had advised KSBL with respect to non-reporting/tagging of certain accounts (including the demat account no. 11458979), to which KSBL responded vide email dated September 08, 2017, and informed NSE that the list of accounts consist of either demat accounts not presently used for broking operations, demat accounts not pertaining to broking operations, demat accounts tagged and reported to other Exchanges and inactive demat accounts for which KSBL is initiating closure. Further, KSBL reported to NSE that the demat account no. 11458979 was a BSE tagged account and reported to the respective exchange. NSE claimed that since this was reported as a BSE margin account, it did not examine this account further. As brought out above, BSE did not examine this account at all, leading to a gap in supervision which allowed KSBL to continue pledging client securities through this account.

144. Further, the Noticee has contended that pursuant to paragraph 2.3.1 of 2016 circular, depositories are required to ensure that demat accounts of stock brokers are appropriately tagged. I find that this contention is misleading, as a stock exchange is expected to monitor all its brokers as part of its supervisory role over brokers. Further, responsibility for penal action in case of non-compliance is clearly

placed on stock exchange in para 2.3.7 of the said circular. Para 2.3.7 of annexure to 2016 circular prescribes that *“Any non-compliance/non-reporting in this regard by the stock broker shall attract penal action as per the provisions of Stock Exchanges*”. Para 2.3 addresses both depositories and stock exchanges. While depositories were required to create the enabling structure for tagging accounts, the obligation of stock exchanges in ensuring compliance of nomenclature is clear from para 2.3.7.

145. Hence the Noticee being the first level regulator had the power to take penal action upon entities deviating from nomenclature guidelines to enforce a deterrence among such defaulting entities. Noticee despite getting the information from depositories and being aware that the several demat accounts (including account no. 11458979) were not tagged in line with the nomenclature guidelines of SEBI circular dated September 26, 2016, did not take any penal action against KSBL to ensure that these guidelines are adhered by KSBL.

146. Further, Noticee has contended that even if the non-disclosure by KSBL in this regard was identified it would have only resulted into minor penalty of Rs.5000 being imposed on KSBL and would not have resulted into requirement of reconciliation of the client securities. In this regard I note that if the non-disclosure and non-tagging was taken up with KSBL and proper nomenclature of account no. 11458979 was ensured, it would have resulted into removal of the misleading BSE tag on the account. Further, the account, if not tagged not tagged as a client account would have been treated as a proprietary account and transfers to this account should have generated alerts on transfer of shares from client account to proprietary account. Without speculating into what could have happened if proper nomenclature of accounts had been monitored and proper tagging done, failure to do so certainly permitted the misleading claim of KSBL that account no. 11458979 was a BSE margin account to continue.

147. In view of the above, I find that Noticee failed to take appropriate action to ensure compliance with **provisions of para 2.3 read with 1.1 and 1.2 of the annexure**

to the Circular SEBI/HO/MIRSD/MIRSD2/CIR/P/2016/95 dated September 26, 2016 regarding appropriate tagging of demat margin accounts of KSBL including demat account No. 11458979 which were not tagged as per nomenclature guidelines.

(c) Whether Noticee violated provisions of para 5 read with para 8.1 and para 2 of the SEBI Early Warning Mechanism Circular dated December 17, 2018.

148. As per para 2 of the SEBI circular dated December 17, 2018 on Early Warning Mechanism, regarding prevention of diversion of client securities, there shall be a mechanism for sharing of information between Stock Exchanges, Depositories and Clearing Corporations to detect the diversion of client's securities by the stock broker at an early stage so as to take appropriate preventive measures. Further, as per para 5 of the said circular, Stock Exchanges, Depositories and Clearing Corporations shall devise a mechanism to detect diversion of client's securities and to share information among themselves. Accordingly, a Standard Operating Procedure (SOP) in this regard was framed by Market Infrastructure Institutions (MIIs), detailing the sequence of steps to be followed by MIIs based on the type of alert generated, which was finalized and agreed upon by Market Infrastructure Institutions (MIIs) vide minutes of the meeting held on January 24, 2019. The provisions of the circular came into force from February 01, 2019.

149. Pursuant to the SOP, NSDL shared alerts like off-market transfers other than settlement, multiple proprietary demat accounts and opening new account for client purpose, sudden activation of significant number of dormant accounts etc. to Noticee (from February 2019 to November 2019). A brief summary of the number of alerts received from Feb-19 to November 22, 2019 is tabulated below:

Type of alert		**Feb-19 to Nov 22, 2019**
Movement of shares to / from a large number of clients' demat	Transfer of Securities to/from > 10 clients	9

accounts or large value shares to stock broker proprietary accounts and vice a versa.	Transfers where Value of Securities Transferred > 25 lacs	10
Alerts for stock brokers maintaining multiple proprietary demat accounts and opening any new demat account in the name of stock broker for client purpose	Multiple Proprietary Accounts	575
	New Account Opened under Stock Broker-Client	0
Information demat account where Transfer of large value of shares through offmarket transfers other than for settlement purposes	Off-market Transfers observed in Top 10 clients as per Quantity	41
	Off-market Transfers observed in Top 10 clients as per Quantity or value of Rs. 10 lakh	155

150. It is alleged in the SSCN that despite the aforesaid alerts being provided by NSDL to Noticee, it failed to take appropriate action against KSBL for the impugned demat account no. 11458979.

151. Noticee submitted that the information shared by NSDL with respect to alerts was incomplete and not meaningful, further the off market transfers from demat account no. 11458979 largely pertained to demat account no. 12691085 (which was a collateral account as per submissions of KSBL). In this context, Noticee has claimed that the data received from NSDL in regard to demat account no. 11458979 did not trigger alert under 'transfer of large value of shares through off-market transfers other than for settlement purposes' since the off market transfers details reflected transfers from account no. 11458979 to account no.12691085, which was a collateral account. Accordingly, Noticee has contended that in view of the above, no action was warranted as per SOP.

152. In this regard it is noted that the demat account no. 12691085 was not appropriately tagged as per information received from NSDL vide emails dated June 13, 2017 and August 16, 2018. Further the account was categorized as 'Beneficiary Client' in the details provided by NSDL. Noticee treated the aforesaid account as 'Collateral Account' merely on the basis of submission of KSBL, despite

the evident contradiction in the nomenclature and account categorization observed from the data obtained from NSDL.

153. Merely relying on the assertion made by KSBL and not corroborating the same with the available data, shows the laxity on the part of the Noticee as far as proper nomenclature is concerned. Noticee has contended that in their view the alerts on off-market transfers from account no. 11458979 to account no. 12691085 were not actionable as these were own account to own account transfers, and further that alerts should come only where source and target PANs are different. This contention by the Noticee ignores the fact that account no. 11458979 was an untagged account and hence should have been deemed proprietary. Account no. 12691085 is acknowledged by Noticee as a collateral account, even though this is also untagged. Treating off market transfers from account no. 12691085 to account no. 11458979, as non-actionable for the aforesaid reasons overlooks the fact that alerts from properly tagged accounts needed to be examined and may have given some leads on movement of client shares to and from account no. 11458979, through which pledging of client shares was being done by KSBL.

154. The Noticee has contended that the data shared under these alerts was voluminous and there were lots of shortcomings in the information shared by the depositories under these alerts, on account of which the data shared under these alerts were under continuous improvement on the basis of consultation among MIIs. On account of the errors/shortcomings in the data provided under these alerts, these were not meaningful and no action could be taken on the basis of the alerts received. In this regard, I note that there were 77 alerts from NSDL under alert ‘transfer of large value of shares through off-market transfers other than for settlement purposes’ during February- April 2019 which showed transfer of large value of shares in KSBL demat accounts for purposes other than settlement, including for account no. 11458979. As per the SOP Noticee should have initiated surveillance action, including, at the very least examining the accounts from which these transfers were taking place, and whether the accounts were properly tagged. This fact, if examined, would at the very least have resulted in further examination

of impugned account or required treatment of the account no. 11458979 as a proprietary account. Hence, I cannot accept that the alerts received by the Noticee in respect of off-market transfers of KSBL demat accounts were not actionable.

155. Noticee has not produced records of any surveillance action taken by it on receipt of the alerts. There were multiple alerts in each month from February 2019 to April 2019 pertaining to KSBL in regard to 'transfer of large value of shares through off market transfers other than for settlement purposes', pursuant to which in terms of SOP Surveillance Action should have been initiated by Noticee. It is relevant to emphasize here that account no. 11458979 escaped scrutiny by NSE as it was a tagged as BSE account with name "Karvy Stock Broking Limited (BSE). It escaped scrutiny by BSE on 2 counts – first one being failure to check nomenclature of account by BSE and secondly, failure to scrutinize the alerts on off-market transfers pertaining to this account shared by NSDL with BSE.

156. In view of the above, I find that Noticee failed to take appropriate action in respect of alerts received from NSDL on 'transfer of large value of shares through off market transfers other than for settlement purposes' and thereby failed to comply with **provisions of para 5 read with para 8.1 and para 2 of the SEBI Early Warning Mechanism Circular dated December 17, 2018.**

Issue No. II If yes, whether the failure, on the part of the Noticees would attract monetary penalty under Section 15HB of SEBI Act,1992?

and

Issue No. III If yes, what would be the monetary penalty that can be imposed upon the Noticees taking into consideration the factors stipulated in Section 15J of the SEBI Act read with Rule 5(2) of the Adjudication Rules?

157. As it is established that Noticee violated

(i) Provisions of para 4(a) of the SEBI Master Circular SEBI/MIRSD/Master Cir-04/2010 dated March 17, 2010 read with para 2 of the Circular SMD/SED/CIR/93/23321 dated November 18, 1993

(ii) Provisions of with Para 2.3 to the annexure of the SEBI Circular SEBI/HO/MIRSD/ MIRSD2/CIR/P/2016/95 dated September 26, 2016 read with para 1.1 and 1.2 of the annexure to SEBI Circular SEBI/HO/MIRSD/MIRSD2/CIR/P/2016/95 dated September 26, 2016

(iii) Provisions of para 5 read with para 8.1 and para 2 of the SEBI Early Warning Mechanism Circular dated December 17, 2018

the Noticee is liable for monetary penalty under Section 15HB of SEBI Act, 1992, which states as follows

SEBI Act, 1992

Penalty for contravention where no separate penalty has been provided.

15HB. *Whoever fails to comply with any provision of this Act, the rules or the regulations made or directions issued by the Board thereunder for which no separate penalty has been provided, shall be liable to a penalty which may extend to one crore rupees.*

158. While determining the quantum of penalty under Section 15HB of SEBI Act,1992, the following factors stipulated in Section 15J of the SEBI Act have to be given due regard:

SEBI Act, 1992

<u>Factors to be taken into account by the adjudicating officer</u>

15J. *While adjudging quantum of penalty under Section 15-I, the adjudicating officer shall have due regard to the following factors, namely: -*

a) the amount of disproportionate gain or unfair advantage, wherever quantifiable, made as a result of the default;

(b) the amount of loss caused to an investor or group of investors as a result of the default;

(c) the repetitive nature of the default.

159. KSBL misutilised client securities worth Rs. 2300 crores belonging to more than 95,000 client, by unauthorizedly pledging them from just one demat account i.e. KSBL Demat account no. 11458979. The funds raised against the pledge were used by KSBL for itself and its group entities, as established in SEBI order dated November 29, 2019. As per forensic audit report of KSBL, total value of securities pledged by KSBL was Rs.2873 crores against which funds of Rs.851.43 crores were raised from 8 banks/ NBFCs. The scale of misuse by KSBL points to the loss to investors which can potentially be caused when irregular conduct is not detected in a timely manner. It is relevant to note that in aforesaid order, SEBI directed depositories to allow transfer of securities from said demat account to respective beneficial owners who had paid in full against the securities under supervision of NSE. As per NSDL Press Release of December 02, 2019, pursuant to SEBI order, securities were returned to 82,559 clients from the KSBL Demat account no. 11458979. Further, as per NSE press release of November 17, 2020, funds and securities worth Rs.2,300 crore belonging to about 2.35 lakh investors of KSBL were settled, pursuant to SEBI order in the matter. Without doubt, it was KSBL which misused clients securities by unauthorisedly pledging them and was thus responsible for loss caused by pledging securities which it did not own, including loss to investors as well as loss to banks and NBFCs who loaned funds to KSBL against securities which did not belong to KSBL. However, it cannot be ignored that KSBL being member of BSE, was under regulatory supervision of Noticee. As established in foregoing paragraphs, there was laxity on the part of Noticee, which resulted in delayed detection of the misconduct by KSBL and the Noticee needs to be held accountable for the same.

160. The violations by the Noticee, as established, are of (i) para 4(a) of SEBI Master Circular SEBI/MIRSD/Master Cir-04/2010 dated March 17, 2010 read with para 2 of the Circular SMD/SED/CIR/93/23321 dated November 18, 1993; (ii) para 2.3 read with 1.1 and 1.2 of the annexure to the Circular SEBI/HO/MIRSD/MIRSD2/CIR/P/2016/95 dated September 26, 2016, and (iii)

para 5 read with para 8.1 and para 2 of the SEBI Early Warning Mechanism Circular dated December 17, 2018 which attract penalty under Section 15 HB of SEBI Act. Maximum penalty under this provision is Rs.1 crore. In view of the impact of delay in detection of misuse of client securities by KSBL as stated above, I am of the view that maximum penalty is attracted in this case. Hence, on account of the 3 violations by the Noticee, a penalty of Rs. 3 crore shall be commensurate with the violations committed.

ORDER

161. After taking into consideration all the facts and circumstances of the case, in exercise of powers conferred upon me under Section 15-I of SEBI Act read with Rule 5 of the Adjudication Rules, I hereby impose a penalty of Rs. 3,00,00,000/- (Rupees Three Crores only) under Section 15HB of SEBI Act,1992 on BSE Limited for violation of para 4(a) of the SEBI Master Circular SEBI/MIRSD/Master Cir-04/2010 dated March 17, 2010 read with para 2 of the Circular SMD/SED/CIR/93/23321 dated November 18, 1993; para 2.3 read with 1.1 and 1.2 of the annexure to the Circular SEBI/HO/MIRSD/MIRSD2/CIR/P/2016/95 dated September 26, 2016 and para 5 read with para 8.1 and para 2 of the SEBI Early Warning Mechanism Circular dated December 17, 2018.

162. The Noticees shall remit / pay the said amount of penalty within 45 days of receipt of this order either by way of Demand Draft in favour of "SEBI - Penalties Remittable to Government of India", payable at Mumbai, OR through online payment facility available on the SEBI website www.sebi.gov.in on the following path, by clicking on the payment link

ENFORCEMENT → Orders → Orders of AO → PAY NOW

163. The Noticees shall forward said Demand Draft or the details / confirmation of penalty so paid to the Enforcement Department – Division of Regulatory Action – V of SEBI. The Noticees shall provide the following details while forwarding DD/ payment information:

a) Name and PAN of the entity (Noticee)

b) Name of the case / matter

c) Purpose of Payment – Payment of penalty under AO proceedings

d) Bank Name and Account Number

e) Transaction Number

164. Copy of this Adjudication Order is being sent to the Noticees and also to SEBI in terms of Rule 6 of the Adjudication Rules.

MANINDER CHEEMA

Digitally signed by MANINDER CHEEMA
Date: 2022.04.12 20:25:53 +05'30'

DATE: April 12, 2022 **MANINDER CHEEMA**

PLACE: MUMBAI **ADJUDICATING OFFICER**