

SECURITIES AND EXCHANGE BOARD OF INDIA
ORDER

ORDER UNDER REGULATION 13 (4) OF SECURITIES AND EXCHANGE BOARD OF INDIA (PROCEDURE FOR HOLDING ENQUIRY BY ENQUIRY OFFICER AND IMPOSING PENALTY) REGULATIONS, 2002.

IN THE MATTER OF M/S. J. M. MORGAN STANLEY RETAIL SERVICES PVT. LTD., MEMBER, THE STOCK EXCHANGE, MUMBAI, HAVING SEBI REGISTRATION NUMBER INB011054831.

1. BACKGROUND

- 1.1. Morgan Stanley Retail Services Pvt. Ltd. (hereinafter referred to as "JMM") is an incorporated entity and a member of The Stock Exchange, Mumbai (for brevity's sake referred to as "the BSE") having SEBI Registration No. INB011054831. The Securities and Exchange Board of India (hereinafter referred to as "SEBI") carried out an inspection of the books of accounts, documents and other records maintained by JMM in the second week of November 2000. JMM was also asked to furnish information regarding its market activities in the year 1999-2000 and 2000-2001.

2. ENQUIRY PROCEEDINGS

- 2.1 Based on the violations observed during the inspection, vide an enquiry order dated January 22, 2002, SEBI appointed an Enquiry Officer to initiate enquiry proceedings against JMM. The Enquiry Officer issued a show cause notice to the broker on February 03, 2003, in accordance with Regulation 6 of SEBI (Procedure for holding Enquiry by Enquiry Officer) Regulations, 2002 (hereinafter referred to as "the Regulations"), alleging as follows:

- 2.1.1 The member had committed the following irregularities with regard to the contract notes issued :
- i. Contract notes were being issued in Form A.

- ii. Contract notes did not bear pre-printed serial numbers. The numbers were generated through computer software.
- iii. Acknowledgements were not obtained on the duplicates of the contract notes. The contract notes of the outstation clients were being sent through courier.
- iv. No contract notes were issued for “vyaj badla” transactions.
- v. Duplicate copies of bills issued to clients for vyaj badla transactions were not being maintained.

2.1.2 Proper segregation was not being maintained between member’s own account and clients’ accounts.

2.1.3 Client registration forms were not available with respect to some clients.

2.1.4 In some instances, there was delay in giving deliveries to the clients.

2.2 Upon the conclusion of the enquiry proceedings, the enquiry officer submitted his report dated September 11, 2003, in which he recommended a minor penalty of suspension of the certificate of registration of JMM for a period of three (3) months.

3. **SHOW CAUSE NOTICE AND HEARING**

3.1. In view of the findings of the report, SEBI issued a notice dated September 19, 2003 to JMM, advising them to show cause as to why an appropriate penalty, including the penalty as recommended by the Enquiry Officer, should not be imposed upon them. In reply to the same, JMM, vide letters dated September 25, 2003 and October 07, 2003, sought for extension of time to file a detailed reply. They filed a detailed reply vide their letter dated October 22, 2003.

3.2 JMM also requested for an opportunity of personal hearing. Accordingly, JMM was granted an opportunity to appear before me on November 11, 2003 at 04.00 p.m. However, on their request, the hearing was adjourned and rescheduled for November 19, 2003 at 04.00 p.m. On the said date, the representatives of JMM appeared before me and reiterated the submissions brought out in their letter dated October 22, 2003 JMM has also denied having

contravened any of the provisions of law as alleged in the show cause notice and further submitted that they had always complied with and/or substantially complied with the requirements of law. In addition, they also referred to a few instances in the past in which SEBI had taken a lenient stand in a similar set of circumstances.

4. **CONSIDERATION OF ISSUES**

4.1 I have taken into consideration the facts and circumstances of the case, the material available on record, including the show cause notices issued to JMM, the enquiry report, the submissions made by them in reply to the notices and during the hearings and all the documents furnished by them. My findings on the allegations made against the member-broker are as follows :

4.2 **Whether the contract notes were issued properly by the member?**

4.2.1 I have noted that the enquiry officer had arrived at the finding that the issuance of contract notes by JMM, whenever they were issued in Form A, was valid and as prescribed and that there was no violation per se, in the non issuance of pre-numbered contract notes in as much as admittedly JMM used to, issue contract notes from an in-house generated computer software, which had all the control aspects such as no person from the front office having any access to modify the system generated contract number etc. I find that the member has complied with the exchange requirements.

4.3 **Whether contract notes were issued for the vyaj badla transactions and whether the member failed to maintain record of duplicate vyaj badla bills.**

4.3.1 The Enquiry Officer has held that contract notes have to be issued even in case of Vyaj Badla transactions and that the member has failed to do so. He has also held the member guilty of non-maintenance of duly acknowledged duplicate copies of vyaj badla bills issued in lieu of contract notes.

4.3.2 JMM has submitted that being a Type II broker, they were not permitted to carry forward their transactions to the next settlement but were permitted to

undertake vyaj badla transactions. It was stated that a vyaj badla transaction was essentially a financing transaction, in which the vyaj badla Investor-client (“Investor-client”) entered into an agreement with the member-broker with a view to deploy funds in vyaj badla transactions, through the member-broker, in accordance with the market demand for funds, and thus earned returns on the transaction called the badla return. An Investor-client is therefore, neither a purchaser nor a seller of securities in the stock market, but his role is akin to that of a lender/borrower of securities under the Securities and Exchange Board of India approved Securities Lending and Borrowing Scheme.. In a Vyaj Badla Transaction, the investor-client deposits funds with the member-broker, to be utilized by the member-broker in vyaj badla transactions. The Member-broker, acting on behalf of the Investor-client, steps in only where a third party purchaser of securities, prior to the settlement date, finds himself short of funds. In such a scenario, the member broker lends money on settlement date, on behalf of the third party purchaser, in order to enable the purchaser to carry forward his transaction to the next settlement date. In these kind of transactions, the investor client who deposited the funds with the member broker neither intends to acquire/purchase the shares being funded nor does he acquire ownership of the shares at any time in the transaction. The member broker, acting on behalf of the investor-client, merely issues a “badla bill” in favour of the client, showing details of the return earned by him against the funds lent for the said transaction. JMM further added that the contract notes for the purchase/sale of shares are required to be duly issued in respect of the shares to the sellers and purchasers, in the form specified by BSE. However, in a vyaj badla transaction, the actual sellers and purchasers of securities funded/financed by the investor-client were both third parties in so far as the Investor-client was concerned and hence there was no privity of contract between the Investor-client and the third party purchaser and /or seller. As such, the Member-broker of the Investor-client could not, by the very nature of a vyaj badla transaction, issue a contract note to his client. It was submitted that expecting the member-broker of the Investor-client to also issue a contract note to him was likely to result in there being two separate contract notes in respect of the very same transaction.

4.3.3 While acknowledging that clause B(2) of Schedule II of the SEBI (Stock Brokers and sub brokers) Regulations, 1992 (hereinafter referred to as the Regulations) required a stock broker to 'issue without delay to his client a contract note for all transactions in the form specified by the stock exchange, JMM clarified that the only forms specified by the BSE in respect of a contract note were Form A and Form B in terms of Regulation 14.2 of the BSE Rules, Byelaws & Regulations ("BSE Bye-laws") and no other form or forms were at all prescribed under Regulation 14.2 of the BSE Bye-laws by the Governing Board either in addition to Form A and Form B or in substitution or modification thereof. It was further stated that Bye-law 247A (4) of the BSE Bye-laws required Member-brokers to issue the contract note for purchase/sale of securities to a client within 24 hours of the execution of the contract. JMM stated that a contract note presupposed the existence of a 'contract' between the Member-broker and his client. On the said basis, JMM stated that, the obligation on a stock broker under Clause B(2) of Schedule II of the Regulations to issue without delay to his client a contract note for all transactions in the form specified by the BSE must, on a proper construction of the said Clause, be read in the context of the preceding Clause B(1) of Schedule II of the Regulations and not de hors thereof.

4.3.4 It was submitted that on reading the two clauses B(1) and B(2) together, it is clear that the obligation of a stock broker to issue without delay to his client a contract note for all transactions, would only be in relation to all transactions of buying and selling of securities in execution of orders placed by clients for purchase/sale thereof. The expression "all transactions" in Clause B (2) of the said Schedule II, in other words, would relate only to transactions for buying and selling of securities on the basis of orders placed by clients thereof and would not extend to every other transaction between a Member-broker and his Investor-client which were not for buying/selling of securities.

4.3.5 On the said basis, while reiterating that a vyaj badla transaction, was by its very nature not a transaction for buying/selling of securities against orders

placed by the client and hence, not a transaction as envisaged under Clause B (2) of the said Schedule II, JMM stated that, a stock broker was not obliged, in respect of a vyaj badla transaction, to 'issue without delay to his client, a contract note' in Form A or Form B specified by Regulation 14 of the BSE Bye-laws". It was stated that, issuing a contract note in the forms prescribed by the BSE (in respect of a vyaj badla transaction) and suggesting thereby that the securities have been bought/sold for the Investor-client would tantamount to a false, misleading or unfair representation.

4.3.6 JMM further submitted that notwithstanding the above, in respect of each and every vyaj badla transaction, they had invariably issued badla bills in favour of their Investor-clients, which contained substantially all the material data and details required in the contract note and the badla bills were timely and diligently issued by them to Investor-clients and it was after receipt of the badla bills that the Investor-clients deposited funds with JMM. It was submitted that the issue of bills for vyaj badla transactions was a widespread prevailing market practice in force during the relevant period and that BSE accepted the practice followed by JMM and other brokers of issuing badla bills and not contract notes in respect of vyaj badla transactions.

4.3.7 JMM further stated that there was not a single instance, during the relevant period, of any Investor-client having a grievance about the issuance of vyaj badla bills or the inadequacy of data or information therein or of any complaint to the effect that they should have issued a contract note and not a bill in respect of the vyaj badla transactions since all the investor-clients' were wholly satisfied with the issuance of bills for vyaj badla transactions in conformity with the accepted prevalent market practice.

4.3.8 Disclaiming the charge of depriving the investor-clients of the right to arbitration under the exchange mechanism in case of dispute, by not "issuing appropriate contract note" as erroneous, JMM stated that each investor-client was eligible to invoke the benefit of statutory arbitration in accordance with the Bye-laws 248 (a) of the BSE Bye-laws and further that any claim, difference or

dispute between a member-broker and his vyaj badla Investor-client in respect of a vyaj badla transaction evidenced in the badla bill would invariably be referred to and decided by arbitration in accordance with the BSE Bye-laws.

4.3.9 JMM added that as they were under no obligation under Clause B(2) of the said Schedule II of the Regulations to issue contract notes for vyaj badla transactions, they were also not obliged to obtain acknowledgements on duplicate vyaj badla bills issued by them. Without prejudice to the said submission, JMM stated that badla bills were in every case invariably sent by them to the investor-clients either by courier or hand delivery.

4.3.10 With reference to the obligation on a stock broker to maintain duplicates of contract notes, it was stated that although the issue of maintenance of duplicates of contract notes did not extend to vyaj badla bills, they were maintaining duplicates of vyaj badla bills in the electronic form and thus had complied with the requirement of maintaining duplicate bills. It was stated that as there was no statutory requirement that such maintenance of duplicate bills had to be in physical form only. They stated that the maintenance of bills in electronic form constituted adequate compliance with the above requirement and the said argument was strengthened by the overriding provisions of Section 4 of the Information Technology Act, 2000 which provided as follows :

“4 Legal recognition of electronic records

Where **any law** provides that information or any other matter shall be in writing or in the typewritten or printed form, then, **notwithstanding anything contained in such law**, such requirement shall be deemed to have satisfied if such information or matter is –

(a) rendered or made available in an electronic form; and

(b) accessible so as to be usable for a subsequent reference.”(emphasis supplied)

4.3.11 Furthermore, with regard to the allegation that JMM was not obtaining acknowledgements of the clients on duplicate contract notes, the Enquiry

Officer had found that although all the duplicate contract notes were not bearing the acknowledgements of the clients, it could be construed that JMM had substantially complied with the said requirement on the basis of the records submitted by them.

4.3.12 Thus, I find that the enquiry officer arrived at the finding that JMM was issuing contract notes, albeit in a different format. In this regard, I have referred to clause B(2) of Schedule II of the SEBI (Stock Brokers and sub brokers) Regulations, 1992 which requires a stock broker to 'issue without delay to his client, a contract note for all transactions in the form specified by the stock exchange. However I have noted the fact that the only forms specified by the BSE in respect of a contract note are Form A and Form B in terms of Regulation 14.2 of the BSE Rules, Byelaws & Regulations ("BSE Bye-laws"). No other form or forms have been prescribed under Regulation 14.2 of the BSE Bye-laws by the Governing Board either in addition to Form A and Form B or in substitution or modification thereof. I have also taken note of the fact that Bye-law 247A (4) of the BSE Bye-laws requires member-brokers to issue the contract note for purchase/sale of securities to a client within 24 hours of the execution of the contract. Taking the fact into consideration that a contract note would pre suppose the existence of a 'contract' between the Member-broker and his client, I find myself in agreement with JMM's contention that the obligation on a stock broker under Clause B(2) of Schedule II of the Regulations to issue without delay to his client, a contract note for all transactions in the form specified by the BSE must, on a proper construction of the said Clause, be read in the context of the preceding Clause B(1) of Schedule II of the Regulations i.e. in relation to all transactions of buying and selling of securities in execution of orders placed by clients for purchase/sale thereof and further that the expression 'all transactions' in Clause B (2) of the said Schedule II in other words would relate only to transactions for buying and selling of securities on the basis of orders placed by clients thereof and would not extend to every other transaction between a Member-broker and his Investor-client which were not for buying/selling of securities. I have noted that this contention has been advanced on the premise that JMM had entered

into a vyaj badla transaction, which is essentially a financing transaction, in which the vyaj badla Investor-client ("Investor-client") enters into an agreement with the member-broker with a view to deploy funds in vyaj badla transactions, through the member-broker in accordance with the market demand for funds, and thus earns badla returns on the transaction called the badla return. On the said basis, an Investor-client could neither be referred to as a purchaser nor a seller of securities in the stock market. Further since in a vyaj badla transaction, the Investor-client deposits funds with the member-broker to be utilized by such a Member-broker in vyaj badla transactions, the Member-broker, on behalf of the Investor-client steps in only where the third party purchaser of securities, prior to the settlement date, finds himself to be short of funds. The Member-broker of the person who desires to sell shares in the open market (original seller) is required to issue a contract note for sale of those shares to the original seller. In the same manner, the member-broker of the person who desires to purchase shares in the open market (original purchaser) was also required to issue a contract note to such an original purchaser and the contract notes for purchase/sale of shares were required to be duly issued in respect of the shares to the respective original sellers and purchasers, in the form specified by BSE. Keeping these facts in mind, I agree with JMM that the original sellers and purchasers would be third parties in so far as the Investor-client was concerned and that as there was no privity of contract between the Investor-client and the third party purchaser and /or seller, the Member-broker of the Investor-client could not by the very nature of a vyaj badla transaction, issue a contract note to his client.

4.3.13 On the said basis, I am of the opinion that JMM was not obliged, as contended by the enquiry officer, to 'issue a contract note' in Form A or Form B specified by Regulation 14 of the BSE Bye-laws" in respect of a vyaj badla transaction. On the contrary issuing a contract note in the forms prescribed by the BSE (in respect of a vyaj badla transaction) and suggesting thereby that the securities have been bought/sold for the Investor-client would possibly tantamount to a false, misleading or unfair representation.

4.3.14 I have also noted JMM's contention that in respect of each and every vyaj badla transaction, they had invariably issued badla bills in favour of their Investor-clients. I have compared the two and find that the said bills contain substantially all the material data and details required in the contract note. Moreover the said bills were issued by them to Investor-clients in a timely manner and it was after receipt of the badla bills that the Investor-clients deposited funds with JMM. Most importantly, I have not received notice in any single instance, during the relevant period, of any Investor-client having a grievance about the issuance of vyaj badla bills or the inadequacy of data or information therein or of any complaint to the effect that JMM should have issued a contract note and not a bill in respect of the vyaj badla transactions. More relevantly, I have noted that the issue of bills for vyaj badla transactions was a widespread prevailing market practice in force during the relevant period and that the BSE have never protested the practice followed by JMM of issuing badla bills and not contract notes in respect of vyaj badla transactions.

4.3.15 As regards the charge of depriving the investor-clients of the right to arbitration under the exchange mechanism in case of dispute, I am of the opinion the any investor-client would be eligible to invoke the benefit of statutory arbitration in accordance with the Bye-laws 248 (a) of the BSE Bye-laws and any claim, difference or dispute between a member-broker and his vyaj badla Investor-client in respect of a vyaj badla transaction evidenced in the badla bill would invariably be referred to and decided by arbitration in accordance with the BSE Bye-laws. The right to arbitration of an Investor-client is clearly a statutory right and would in no way be affected or prejudiced by the absence of the contract note or any relevant details therein.

4.3.16 In view of the same, JMM would not be obliged to obtain acknowledgements on duplicate vyaj badla bills issued by it. I have been given to understand by the representatives who appeared on behalf of JMM that badla bills were invariably sent by them in a timely manner to the investor-clients either by courier or hand delivery and that they were maintaining duplicates of vyaj badla bills in the electronic form and thus they had complied with the

requirement of maintaining duplicate bills. This argument has been sought to be strengthened by referring to provisions of Section 4 of the Information Technology Act, 2000 which dealing with the legal recognition of electronic records inter alia provides that where any law requires any information or any other matter to be in writing or in the typewritten or printed form, then, notwithstanding anything contained in such law, such requirement shall be deemed to have satisfied if such information or matter is rendered or made available in an electronic form; and accessible so as to be usable for a subsequent reference.

4.3.17 Having perused the relevant provision of law I am in agreement with the contention of JMM that there is no statutory requirement that such maintenance of duplicate bills had to be in physical form only, and that the maintenance of bills in electronic form constitutes adequate compliance with the above requirement.

4.3.18 Finally and most relevantly, the issues relating to vyaj badla are entirely academic in as much as vyaj badla was abolished as far back as in the year 2001.

4.4. Whether the member obtained client registration forms and agreements from all their clients as required?

4.4.1 JMM stated that the omission to obtain Member-client agreements and/or client registration forms was a purely “technical or venial” lapse or irregularity which could not warrant or justify the harsh recommended penalty of suspension of registration; more so since they had always followed the highest standards of conduct and compliance and took special care to ensure that all applicable legislation and regulations were invariably adhered to and special efforts were constantly made to ensure total transparency and adherence to ethical values and standards in all their dealings with clients/investors, as borne out by their impeccable track record in years of business. It was submitted that the recommended penalty of suspension of their certificate of registration for three (3) months was extremely and unfairly

harsh, more so since their actions were based on a bona fide plausible/possible interpretation of the applicable law.

4.4.2 I have noted that there has been a lapse on the part of JMM in their failure to obtain client registration forms and agreements and the same has been admitted to by JMM. However, I have also noted that the instances of absence of client registration forms/agreement are not significant when compared to the number of clients being serviced by JMM. In some of the instances the clients have not been active for the past few years. In others, JMM has entered into agreement albeit with some amount of delay. Under these circumstances, I would prefer to view this lapse as a technical lapse or irregularity.

4.4.3 I agree with the Enquiry Officer's finding that the charge regarding the member having failed to maintain separate client account in respect of some clients cannot be sustained. I also agree with the Enquiry Officer's findings that the member has substantially complied with the requirement of delivering securities to their clients on time.

4.5 The principal object of the SEBI Act and the regulations framed there under is to advance the twin objects of investor protection and promotion and development of the securities market. From the findings above, it is clear that no prejudice was caused to any investor as a result of the irregularities that have been alleged to have been committed by JMM. Under these circumstances the imposition of the recommended penalty of suspension of registration for the specified period of three months will not advance the objects of the parent statute or any of the Regulations framed there under.

5. **ORDER**

5.1 Accordingly, in view of the facts and circumstances of the case, I have thought it fit to reduce the penalty as proposed by the enquiry officer and accordingly I find that a warning would be adequate.

5.2 In view of the above, in exercise of the powers conferred on me by virtue of sub section (3) of section 4 of the Securities and Exchange Board of India Act, 1992, read with sub regulation (4) of Regulation 13 under the Securities and Exchange Board of India (Procedure for Holding Enquiry by the Enquiry Officer and Imposing Penalty) Regulations, 2002, I hereby warn M/s J M Morgan Stanley Retail Services Pvt. Ltd., Member of BSE, having Registration. No. INB011054831, to be more diligent in future regarding their activities in the capital market.

A.K.BATRA

PLACE : MUMBAI

WHOLE TIME MEMBER

DATE : June 02, 2004

SECURITIES AND EXCHANGE BOARD OF INDIA