BEFORE THE ADJUDICATING OFFICER

SECURITIES AND EXCHANGE BOARD OF INDIA

[ADJUDICATION ORDER NO. Order/MC/RM/2022-23/22434]

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. **NSE Clearing Corporation Limited (PAN No. : AAACN2641L)** having address at Exchange Plaza, C-1, Block G, Bandra Kurla Complex, Bandra (E), Mumbai – 400 051

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 NSE Clearing Corporation Limited (hereinafter referred as "**Noticee/NCL**"), for alleged violation of provisions of the para 7 of SEBI 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 March 24, 2021 to inquire into and adjudge under section 15HB of the SEBI Act, the aforesaid alleged violations against the Noticee. 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/9861/2021 dated May 06, 2021 (hereinafter be referred to as, the "**SCN**") was served upon the Noticee 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 Noticee in the SCN are summarized as below:

5. SEBI issued a circular dated December 17, 2018, under section 11(1) of the SEBI Act, 1992 and section 19 of the Depositories Act, 1996, on Early Warning Mechanism to prevent diversion of client securities wherein as per para 2 of circular, 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) was 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 MIIs as recorded in the minutes of the meeting held on January 24, 2019. SEBI 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.

6. As per clause 5.2 of the said SOP, mismatches between gross (client wise) securities pay-in and pay-out files of a stock brokers generated by the Clearing Corporations (CCs) shall be compared with actual transfer of securities to/from the client's depository accounts by the Depository. The cases of any mismatch found out by the Depository shall be informed to the CCs. As client can hold demat accounts across depositories, depositories will inform the quantity of securities delivered or received by a PAN for a CM-ISIN combination for a settlement to CCs. CCs will compile information across depositories and finalize the alerts to Stock Exchanges.

7. As per para 7 of the said circular, alerts triggered on the Stock Exchange/Clearing Corporation/Depository through early warning mechanism shall be immediately shared with other Stock Exchange/Depositories with respect to the Stock Broker/depository participant.

8. In order to check compliance with para 7 of circular, Noticee was asked to submit the details of alerts generated for the PAN (No. AABCK5190K) of Karvy Stock Broking Limited that were finalized and shared by it with National Stock Exchange of India Limited (NSE) and Bombay Stock Exchange (BSE) during February 2019 to November 2019

9. In this regard, Noticee vide email dated February 23, 2021 submitted that such mis-match related alerts have been sent to NSE at periodic intervals for the period February 2019-November 2019 and to BSE from August 2020.

10. National Securities Depository Limited (NSDL) (the demat account of KSBL which is under examination is with NSDL) vide email dated February 24, 2021 confirmed that as per SOP, it had sent various alerts that are pertaining to KSBL to Noticee during February 2019 to November 2019.

11. It was observed that as per SEBI Circular dated December 17, 2018 read with SOP framed under the said circular, Noticee was required to process the mis-match data received from depositories and finalize the alerts and forward the same to exchange for further necessary action to prevent diversion of client securities, However, despite receiving relevant information from NSDL, Noticee failed to provide any alerts to BSE.

12. **Therefore, it was alleged that despite receiving relevant information from NSDL, Noticee failed to provide any alerts to BSE. The said failure on the part of the Noticee was in violation of provisions of the para 7 of SEBI Circular dated December 17, 2018.**

13. The aforesaid alleged violation, if established, makes the Noticee liable for monetary penalty under Section 15HB of the SEBI Act.

14. In response to SCN dated May 06, 2021 Noticee submitted its reply dated May 24, 2021 and requested for an opportunity for personal hearing. Accordingly an opportunity of personal hearing was granted in January 14, 2022, which was subsequently rescheduled to February 04, 2022 at the request of the Noticee. The Personal hearing on February 04, 2022 was attended by Mr. Janak Dwarkadas (Senior Counsel), Mr. Amit Mahesh Pujara (Head Compliance, NSE Clearing Limited), Mr. Ankit Lohia (Counsel), Mr. Ravindra Mohan Bathula (General Counsel, NSE Clearing Limited) as Authorised representatives (AR) of the Noticee. The ARs of the Noticee reiterated the submissions made by the Noticee in its reply dated May 24, 2021. Further, Noticee made post hearing submissions vide letter dated February 11, 2022.

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

16. Noticee submitted that in respect of the allegations, the relevant paras of the SEBI circular dated 17 December 2018 may be referred, which are as follows:

    " ...5. Stock Exchanges/Clearing Corporations/Depositories, shall devise a mechanism to detect diversion of client's securities and to share information among themselves in respect of

    5.1 Diversion of pay-out of securities to non-client accounts

    5.2 Mis-matches between gross (client wise) securities pay-in and pay-out files of a stock brokers generated by the Clearing Corporation which shall be compared with actual transfer of securities to/from the client's depository accounts by the Depository. The cases of any mismatch found out by the Depository shall be informed to the concerned Stock Exchange/Clearing Corporation.

5.3 Stock exchange shall seek clarification from the concerned stock broker on the mismatches reported by Depository and identify transfer to a non-client/third party, without any trade obligation.
5.4 Such information on wrong / fraudulent / unauthorized transfer shall be shared by the Stock Exchange with other Stock Exchange/s.... "

"... 7. Alerts triggered at one Stock Exchange/Cleaning Corporation / Depository through early warning mechanism shall be immediately shared with other Stock Exchanges / Depositories with respect to the stock Broker / Depository participant ... "

17. Noticee submitted that in para 5 of the SEBI Circular, SEBI has directed that the stock exchanges/clearing corporations/depositories, shall devise a mechanism to detect diversion of clients' securities and to share information among themselves in that regard.

18. The mechanism adopted for sharing of information under para 5 of the SEBI Circular is elaborate and self-contained. The role of clearing corporations, stock exchanges and depositories under this para has been clearly laid out in the SOP which has been approved by SEBI therefore, the provisions of this para 5 of the SEBI Circular read in conjunction with the SOP clearly defines the role of a clearing corporation and the manner in which information is to be shared by the clearing corporation with respect to discharge of its responsibility under SOP.

19. The role of Clearing Corporation under Para 5.2 of SEBI Circular is that the clearing corporation generates the gross securities pay-in and pay-out files on client wise basis and passes on such files to the depositories for verification of the securities movement as per the records of the depositories. The depositories after verification send back the files giving the information of the actual transfer as per the depository records along with the identifier of mismatch. Therefore, at this stage, Noticee submitted that the clearing corporation receives the information about the mismatch from the respective depositories. The clearing corporation consolidates

mismatch information received from both depositories i.e. NSDL and CDSL and passes on the mismatch information to the concerned Stock Exchange.

20. In regard to the role of Stock Exchange under Para 5.3 & 5.4 of SEBI Circular, it submitted that NCL clears and settles trades executed on NSE and therefore passes on the information only to NSE which is the concerned stock exchange and not to other stock exchanges since NCL was only clearing for NSE alone before the MIIs consultation on framework for sharing of information under the SEBI Circular after the interoperability arrangement going live on staggered basis. On receipt of the consolidated mismatch information from the clearing corporation, the stock exchange seeks clarification from the concerned stock broker on the mismatches reported by depositories and then identifies whether transfer to a non-client/third party has taken place without any trade obligation in terms of para 5.3 of the SEBI Circular. Post identification of wrong/fraudulent/unauthorized transfer, the concerned stock exchange is required to share this information with other stock exchanges as per para 5.4 of the SEBI Circular.

21. In regard to the role of MIIs defined under SOP framed pursuant to SEBI Circular, as per the scheme of procedure under para 5 of the SEBI Circular and explained in paras above, the sharing of information is required to be done by the concerned stock exchanges with other exchanges and it is not the responsibility of the clearing corporation to share information with other exchanges. This is especially so since the action of sharing of information under para 5.4 requires the action of ascertainment of wrong/ fraudulent/ unauthorized transfer under para 5.3 by the concerned stock exchange. This procedure is further reflected and laid down under the SOP agreed between the MIIs and approved by SEBI which is set out below:

1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*	*11*
Reference number	*Particulars*	*Trigger*	*Action Item*	*Periodicity*	*Member's action*	*Exchange Action*	*Intimation to other exchanges/ Clearing Corporations/*	*New Client registration in UCC to be disabled*	*Terminal disablement*	*Procedure to be followed by Depositories for action*

							Depositories under uniform action mechanism			

22. It is apparent from the process adopted under SOP in respect of para 5.2 of the SEBI Circular that the intimation by the concerned exchange to other exchanges under column 8 will follow the exchange action under column 7 of ascertaining wrong/fraudulent/unauthorized transfer. It is further evident from the above that it is not the responsibility of a clearing corporation to share any mis-match information with the other exchanges ... "

23. Noticee submitted that Para 7 of SEBI Circular is independent of Para 5 of SEBI Circular. The Para 7 of the SEBI Circular pertains to alerts triggered under the SEBI Circular which are required to be shared with other stock exchanges / depositories. The SCN has been issued on the strength of the provisions of this para. Para 7 is reproduced below for ready reference:

    "Alerts triggered at one Stock Exchange I Clearing Corporation I Depository through early warning mechanism shall be immediately shared with other Stock Exchanges I Depositories with respect to the stock broker I depository participant."

24. The provisions of para 7 of the SEBI Circular are independent of provisions of para 5 of the SEBI Circular since the mechanism for sharing of the information for alerts arising out of diversion of client securities under para 5 of the SEBI Circular has already been dealt with under para 5.4. Therefore, the provisions of para 7 of the SEBI Circular cannot be construed as overriding para 5 of the SEBI Circular, which is self-contained as such interpretation would render the provisions of para 5.4 otiose and redundant. Therefore, the harmonious interpretation of para 7 and para 5 of SEBI Circular should be that the said provisions would operate in different fields as para 5 sets out the sharing mechanism in respect of alerts relating to the diversion of client securities specifically and para 7 of SEBI Circular sets out the

sharing mechanism in respect of alerts other than those set out in para 5 of SEBI Circular.

25. It may be noted that the clearing corporation generates files on client wise basis and the responsibility to take up the mismatch with the concerned stock broker is with the concerned exchange under para 5.3 of the SEBI Circular. Therefore, the clearing corporation cannot be held responsible/liable under para 7 of the SEBI Circular to inform other exchanges with respect to the concerned stock broker/depository participant since the responsibility to share information with other stock exchanges is laid out under Para 5.4.

26. Noticee submitted that in facts of the present case the information pertains to Karvy Stock Broking Ltd. (KSBL). SEBI vide email dated February 22, 2021 requested Noticee to furnish the details of alerts shared by Noticee to NSE and BSE pertaining to mismatch of securities for the PAN AABCK5190K and period Feb 2019 - Nov 2019. In this regard, it may be noted that the PAN pertains to KSBL which is registered trading member of NSE and since Noticee was providing clearing services to NSE for trades executed by its trading members, the mismatch information pertaining to KSBL was submitted to NSE by Noticee as NSE was the concerned stock exchange with which it had an arrangement for providing clearing and settlement services.

27. Noticee submitted that it clears and settles trades executed on NSE and therefore passed on the information only to NSE which is the concerned stock exchange and not to other stock exchanges. It may be noted that the interoperability arrangement was implemented in a staggered manner with effect from June 2019 onwards. The implementation of sharing of information under the SEBI Circular was discussed among the interoperability participants. The process of sharing of information with BSE was finalized after establishing file nomenclature/file formats/communication channels such as placing of data through FTP etc. for exchange of information. Accordingly, the mismatch information under the SEBI Circular was shared with BSE with effect from August 10, 2020 onwards.

28. A bare reading of the Circular dated 17th December 2018 issued by SEBI provides for the steps in the sharing of data in paras 5.2, 5.3 and 5.4. Under para 5.2 the data has to be provided by the Depository to the "concerned" Stock Exchange / Clearing Corporation. Under para 5.3 the data provided to the Stock Exchange is verified by the Stock Exchange. It is only after verification of the data by the Stock Exchange that, under para 5.4, the data is shared by the Stock Exchange with the other Stock Exchanges.

29. Intent of the Circular is clear from the language used in aforesaid paragraphs in context with paragraph 5.2. It is pertinent to note that the Circular has used the words "Stock Exchanges / Clearing Corporations / Depositories" in the first 7 paragraphs, however, in para 5.2 the words used are "the concerned Stock Exchange / Clearing Corporation".

30. Therefore, a bare reading of the Circular leaves no room for doubt that sharing of information is required to be done by the concerned stock exchange with other exchanges and it is not the responsibility of the clearing corporation to share information with other exchanges. The clearing corporation receives the information about the mismatch from the respective depositories. The clearing corporation consolidates mismatch information received from both depositories i.e. NSDL and CDSL and passes on the mismatch information to the concerned Stock Exchange.

31. Further it is evident that paragraph 5.2 of the Circular is required to be followed in letter and spirit. It thus emerges that the mis-matches with regard to gross (client wise) securities pay-in and pay-out files of a stock broker generated by the Clearing Corporation is compared with the actual transfer of securities to/from the clients depository accounts by the depositories and then the cases of mismatch found out by the depositories are informed to Noticee. Therefore, as set out hereinabove, the alerts generated by the depositories are passed on by the Noticee to the concerned stock exchange viz. NSE.

32. The Circular dated 27th November 2018 was issued by SEBI prescribing the guidelines for implementation & establishment of interoperability of peer-to-peer link between Clearing Corporations. The same was implemented on a staggered basis in consultation with SEBI.

33. It is pertinent to note the following dates and events:

Sr. No.	Date	Event
1	27th November 2018	Circular issued by SEBI for implementation of Interoperability among Clearing Corporations. Various steps towards implementation of interoperability adopted over a period of time.
2	17th December 2018	Circular issued by SEBI on Early Warning Mechanism to prevent diversion of client securities.
3	2^{nd} January 2019	2019 Standard Operating Procedure ("SOP") finalised during a meeting held between the Clearing Corporations, Stock Exchanges, Depositories and chaired by the Executive Director of SEBI. The SOP provided that under clause 5.2 of the Circular dated 17th December 2018 the data was to be shared by the Clearing Corporation with the Depository and the cases of any mismatch found out by the Depository was to be informed to the "concerned" Stock Exchange / Clearing Corporation. The wording of the SOP for clause 5.2 in column 2 (Trigger) that "this shall be subject to review after the alerts are generated by clearing corporation and shared with the Stock Exchanges" has to be considered in terms of the sequence set out in para 5.2 to 5.4.
4	Feb 2019 to November 2019	Period for which the data is sought in respect of Karvy Stock Broking Limited which was considered for the Show Cause Notice dated 6th May 2021.
5	June 2019	Interoperability agreement was executed between the Stock Exchanges and Clearing Corporations.

6	June to August 2019	Interoperability was being implemented in a staggered basis based on ongoing discussions between Stock Exchanges and Clearing Corporations in consultation with SEBI.
7	September 2019 onwards	Discussions commenced between the Stock Exchanges and Clearing Corporations regarding the mechanism to be followed for data sharing considering the nature of communication channel (information sharing corridor) available between the parties and the nature of changes to be carried out.
8	28th May 2020	Communication addressed by NSE to Indian Clearing Corporation Limited ("ICCL") the Clearing Corporation of BSE, which refer to a meeting of 21 May 2020 held between Clearing Corporations, Depositories and SEBI. Discussions were to put in place a mechanism for sharing the mismatches of NSE Members clearing through ICCL.
9	10th July, 2020	BSE addressed a communication to the Noticee, for putting in place a mechanism for sharing the mismatches of BSE Members clearing through NCL.
10	10th August 2020	The process of sharing of information with BSE was finalized after establishing file nomenclature/file formats/communication channels such as placing of data through FTP etc. for exchange of information. Accordingly, the mismatch information under the SEBI Circular was shared with BSE with effect from lOth August 2020 onwards.
11	6th May 2021	Show Cause Notice issued by SEBI to NCL to Show Cause why alert generated in respect of PAN no. AABCK5190K were not shared with BSE and resulting in violation of Clause 7 of the SEBI Circular of 17th December 2018.

34. Noticee submitted that a literal reading of para 7 of the circular dated 17th December 2018 defeats the intent and purpose of the circular. SCN in question proceeds on an erroneous premises that para 7 of the Circular is to be read

independently and dehors paras 5.2 to 5.4 of the Circular. In this regard it submitted that:

a) A literal reading of para 7 of the Circular dated 17th December 2018 defeats the intent and purpose of the Circular.
b) Para 7 of the Circular if read on a standalone basis seeks to defeat and supersede the chronology and sequence of events set out in paras 5.2, 5.3 and 5.4 of the Circular.
c) Paras 5.2 to 5.4 of the Circular must be read harmoniously with para 7 to avoid any data/alert being issued without verification, confirmation, and conclusion of the sequence set out therein or else it would render paras 5.2 to 5.4 redundant.
d) Intent of the Circular is to share concluded information after the Stock Exchanges have made necessary enquiries with the concerned Stockbroker.
e) If para 7 of the Circular is read and followed in isolation, then, it would result in duplication of data.

35. Under the circular dated 27th November 2018, SEBI directed implementation of interoperability between Clearing Corporations. Pursuant thereto interoperability has been implemented. Interoperability went live in a staggered manner. Process of Information sharing under the Circular dated 17 December 2018 inter alia required establishment of appropriate data communication channel/corridor (information sharing corridor) in terms of establishing file nomenclature/file formats/communication channels such as placing of data through FTP etc. for the purpose of sharing of data between Clearing Corporations and interoperability exchanges. The process of establishing information sharing mechanisms post going live in interoperability was undertaken with mutual discussions between the MIIs over a period of time and process for information sharing under the SEBI Circular was finalised with BSE as mentioned above.

36. SCN of 6th May 2021 imposes compliance of an obligation upon the noticee which never existed for the period in question (February 2019 To November 2019). The

SCN in question is based on the Circular of December 2018 for the period February 2019 to November 2019. Interoperability was agreed upon between the parties i.e., Market Infrastructure Institutions ("MIIs") vide an Agreement dated 15th June 2019 and was implemented in a staggered manner. In September 2019, onwards meetings were held between the participants/institutions to discuss and finalize modus operandi of sharing of information. Even as on 21st May 2020, as referred to in the emails of NSE and BSE, intention of the MIIs was to set up information sharing mechanism post going live on interoperability from June 17 to July 15, 2019 for capital market segment and on July 29, 2019, and August 19, 2019 for equity derivative and currency derivative segments.

37. Accordingly, as factually informed during the course of hearing on 4th February 2022, during the period in question, NSE was the concerned Stock Exchange and NCL provided the consolidated mismatch data received from depositories to NSE. Post interoperability, the implementation of sharing of information under the SEBI Circular was discussed among the interoperability participants. The process of sharing of information with BSE was finalized after establishing file nomenclature/file formats/communication channels such as placing of data through FTP etc. in the year 2020 for exchange of information. Accordingly, the mismatch information under the SEBI Circular was shared with BSE with effect from August 10, 2020, onwards. Therefore, the allegation that "despite receiving relevant information from NSDL, NCL failed to provide any alerts to BSE", as set out in the Show Cause Notice, cannot and does not survive.

38. Even otherwise, while issuing the Show Cause Notice, SEBI has not considered that sharing of information and data requires a common data sharing mechanism more like a common information corridor, which did not exist till the process of sharing of information with BSE was finalized for sharing information with BSE in terms of the Standard Operating Procedure (SOP). Therefore, the Circular dated 17th December 2018 has to be considered in tandem and in the backdrop of the circular dated 27th November 2018 by which post implementation of

interoperability, the process of information sharing between the clearing corporation and interoperability exchange was established over a period of time.

39. The language of the circular dated 17th December 2018 is clear and unambiguous, a reading of the Circular of 17th December 2018 makes it clear beyond doubt that responsibility of each of the MIIs is clearly spelt out therein. Parties involved, their respective role, chronology of events and sequence of the obligations to be discharged by each MIIs is spelt out in paras 5.2 to 5.4 of the Circular which require to be adhered to.

40. The process flow for trades and obligations as shared during the hearing held on 4th February 2022 is reproduced hereunder:

Process flow for trades and obligations:

Trading System at Exchange	i. Order (sell or buy) input by broker on the exchange giving the Unique Client Code for the client for which the order is being put by the broker. ii. The order if it matches with a counter order (i.e., buy finds a sell order or sell order finds a matching buy order) results in a trade at the price entered in the order and for the quantity iii. The trades flow from the trading system of the Exchange (e.g., NSE) to the Clearing Corporation (NCL)
Clearing Corporation processes	i. After the market closes the clearing corporation consolidates all the buy and sell trades of the client ii. Based on the trades, the clearing corporation determines the client level buy/ sell obligation for each security iii. The clearing corporation provides the client level buy/sell obligation to the depositories - CDSL and NSDL iv. The client level buy/sell obligation is provided to the depositories on the T+1 day
Process at depositories	i. The depository has the client's beneficiary account and also the brokers account details

	ii. The depositories match the client obligation sent to them by the clearing corporation with the actual movement of securities to and from the clients account with the client obligation data provided to them by CC iii. The depositories send back to the CC the information on the mismatches in the securities movement from the obligation provided by the CC
Process at CCs	i. The CC after getting the mismatches from the two depositories consolidates the data provided by the depositories ii. The CC provides this consolidated data to the Exchange

41. Noticee submitted that if the circular of 17th December 2018 of SEBI is not adhered to and followed in letter and spirit, it would result in dissemination of unverified information without any confirmation. Strict adherence of paras 5.2 to 5.4 is required to be observed to avoid any unverified data being disseminated to the market institutions. Intent of the Circular has always been to share concluded information after the Exchange has made necessary enquiries with the Stockbroker as per the mechanism set out in paras 5.2 to 5.4 of the Circular. If only para 7 of the Circular is followed, read in isolation, it would result in duplication of data.

42. In any event and without prejudice as set out in the Reply of NCL, the role of Noticee is that it receives the information about the mismatch from the respective depositories. The Noticee consolidated mismatch information received from both depositories i.e., NSDL and CDSL and passed on the mismatch information to the concerned Stock Exchange viz. NSE. Post implementation of interoperability and establishing the information sharing communication channel with BSE, from August 2020 onwards, the Noticee has been sharing data with BSE also which is in sync with the Circular dated 17th December 2018.

43. 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

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

Issue No. I Whether Noticee violated provisions of the para 7 of SEBI Circular dated December 17, 2018 (EWM 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 Whether Noticee violated provisions of the para 7 of SEBI Circular dated December 17, 2018.

45. As per Para 5 of the EWM Circular, MIIs were to devise a mechanism (Early Warning Mechanism /EWM) to detect diversion of clients' securities and to share information among themselves. As per para 6 of the aforesaid circular, the MIIs may generate any other alerts as deemed fit. In view of the above, the MIIs formulated a Standard Operating Procedure (SOP) in their meeting dated January 24, 2019. As per para 5.2 of the said SOP, mismatches between gross (client wise) securities pay-in and pay-out files of a stock brokers generated by the Clearing Corporations (CCs) are to be compared with actual transfer of securities to/from the client's depository accounts by the Depository. The cases of any mismatch found out by the Depository are to be informed to the Clearing Corporations by depositories. The Clearing Corporations have to compile this information across depositories and finalize the alerts and share with Stock Exchanges. Further, as

per para 7 of the EWM circular, the alerts triggered at one Stock Exchange/Clearing Corporation/ Depository through early warning mechanism shall be immediately shared with other Stock Exchanges / Depositories with respect to the stock broker / depository participant.

46. The allegation against Noticee is based on the requirement placed on Clearing Corporations to compile the mis-match alerts received from depositories, finalize the alerts and forward the triggered alerts to stock exchanges for further necessary action in terms of EWM. It is alleged that Noticee, despite receiving relevant mismatch alerts from NSDL (specifically in respect of PAN No. AABCK5190K of KSBL) from February–November 2019, failed to provide any alerts to BSE as required in terms of EWM Circular and SOP.

47. Noticee in its reply has stated that it passed on the information only to NSE which is the concerned stock exchange and not to other stock exchanges since NCL clears and settles trades executed on NSE alone before the interoperability arrangement going live on staggered basis. The Noticee has contended that the provisions of para 7 of the SEBI Circular are independent of provisions of para 5 of the SEBI Circular, and the harmonious interpretation of para 7 and para 5 of SEBI Circular should be that the said provisions would operate in different fields as para 5 sets out the sharing mechanism in respect of alerts relating to the diversion of client securities specifically and para 7 of SEBI Circular sets out the sharing mechanism in respect of alerts other than those set out in para 5 of SEBI Circular. Noticee has also contended that a literal reading of para 7 of the circular dated 17th December 2018 defeats the intent and purpose of the circular. SCN in question proceeds on an erroneous premises that para 7 of the Circular is to be read independently and dehors paras 5.2 to 5.4 of the EWM Circular.

48. I note that pursuant to the para 5 of the EWM Circular, MIIs formulated an SOP for detection of clients' securities mismatch. The point 5.2 of the SOP under the column 'Procedures to be followed by depositories for action' prescribes the following:

“CDSL:

Each depository will trigger an alert to CC if there is mismatch between obligation reported by CC and actual transfer (based on PAN of the client). As a client can have multiple accounts across depositories, each depository will be sharing the quantity transferred with CCs to enable CCs to mark alert to SEs

NSDL:

Depositories will generate the alert wrt mismatch between obligation received from CCs and actual transfer (based on PAN of the client) from clients account based on the parameters discussed and agreed during the joint meeting between CCs and Depositories held on November 15, 2018. As a client can hold demat accounts across depositories, depositories will inform the quantity of securities delivered or received by a PAN for a CM-ISIN combination for a settlement to CCs. CCs will compile information across depositories and finalise the alerts.”

49. It is relevant to note here that the SOP was prepared jointly by the exchanges, clearing corporations and depositories and clear understanding of the alerts to be generated by clearing corporations is implicit in the SOP. Upon perusal of the aforesaid prescribed actions for CDSL and NSDL, it is evident that the CCs were to compile data of securities delivered or received by clients having multiple accounts across depositories in order to finalise alerts of mismatch of securities, for sharing with stock exchanges.

50. It is evident from the SCN and reply of Noticee that it was compiling the alerts so required and sharing them with NSE from February 2019 onwards.

51. Noticee has argued that a harmonious interpretation of para 7 and para 5 of the EWM Circular should be that the said provisions would operate in different fields as para 5 sets out the sharing mechanism in respect of alerts relating to the diversion of client securities specifically and para 7 of SEBI Circular sets out the sharing mechanism in respect of alerts other than those set out in para 5 of SEBI

Circular. To examine this interpretation, para 5 of the EWM circular is reproduced below:

5. Stock Exchanges/ Clearing Corporations/ Depositories, shall devise a mechanism to detect diversion of clients' securities and to share information among themselves in respect of:

5.1 Diversion of pay-out of securities to non-client accounts

5.2 Mis-matches between gross (client-wise) securities pay-in and pay-out files of a stock brokers generated by the Clearing Corporation which shall be compared with actual transfer of securities to/ from the client's depository accounts by the Depository. The cases of any mismatch found out by the Depository shall be informed to the <u>*concerned*</u> *Stock Exchange / Clearing Corporation.*

5.3 Stock Exchange shall seek clarification from the concerned stock broker on the mismatches reported by Depository and identify transfer to a non-client / third party, without any trade obligation.

5.4 Such information on wrong / fraudulent / unauthorized transfer shall be shared by the Stock Exchange with other Stock Exchange/s

52. Para 5.2 of the circular, reproduced above, refers to how the alerts on mismatch of securities are to be generated. The pay-in and pay-out of securities is generated by the Clearing Corporations, which was to be shared with depositories for comparing with actual transfer of securities. In case of any mis-match, the data was to be reported back to the concerned stock exchange/ clearing corporations. Thus, the CC was required to be informed of mismatches in respect of trades cleared through that CC. The use of the word 'concerned stock exchange / Clearing Corporation' therefore, refers to the fact that the CC generating the pay-in and pay-out should be informed of mis-matches with respect to its pay-ins and pay-outs.

53. At the time of framing the SOP, the MIIs have recognized that some clients have accounts across both depositories and therefore, the alerts showing mismatch of securities should be compiled by the CC after receiving mis-match data from both depositories. Therefore, para 5.2 of the circular is required to be read with clause 5.2 of the SOP for generation of alerts based on data gathered from both depositories.

54. Para 5.3 of the EWM circular refers to further processing of the alerts by stock exchange, and para 5.4 requires information on wrong / fraudulent / unauthorized transfer so detected, to be shared with other stock exchanges. Para 6 gives discretion to MIIs to generate any other alerts as deemed fit.

55. It is relevant to note the purpose of the EWM Circular which was to set up an early warning mechanism to share alerts with all the MIIs so that any diversion/misuse of client's securities are detected at the early stage, and appropriate preventive measures could be taken in a timely manner by MIIs collectively to safeguard clients securities. Taking a purposive interpretation of the circular, it was of utmost importance to initiate the alerts as early as possible and share the same with all other MIIs i.e. with all the Stock Exchanges with respect to stock brokers and all of the depositories with respect to the depository participants. To interpret para 7 restrictively , on the same lines as para 5.2 as suggested by the Noticee, would go against the purpose of the circular which was to have a mechanism of sharing alerts for generating early detection of the misuse or diversion of clients' securities. I also note that at the time the EWM circular was issued, diversion of securities was actually taking place, and early detection of wrongdoing was imperative. Para 7 of the EWM Circular reads as:

> *"Alerts triggered at one Stock Exchange / Clearing Corporation/ Depository through early warning mechanism shall be immediately shared with other Stock Exchanges / Depositories with respect to the stock broker / depository participant*."

56. A purposive interpretation thus requires that para 7 be read in the context of all alerts generated including those referred in para 5 and 6, and requires that any one MII generating an alerts shares it with other stock exchanges in respect of brokers and other depositories in respect of depository participants.

57. Further, as discussed above the clause 5.2 of SOP also mandates that the compiled, finalized mismatch alerts to be shared with stock exchanges by clearing corporations, and not only to concerned exchange. Hence, clause 5.2 of SOP and para 7 of the EWM Circular if read together the purposive interpretation clearly mandate that the clearing corporations were required to compile and finalise the alerts from the Depositories and then share the mismatch alerts with the stock exchanges i.e. both concerned stock exchange and other stock exchange. Therefore, the contention of the Noticee that para 7 refers to sharing of alerts only with the concerned stock exchange is not tenable.

58. Noticee has also contended that, as per the scheme of procedure under para 5 of the EWM circular, sharing of mismatch alerts post ascertainment of wrong/ fraudulent/ unauthorized transfer is required to be done by the concerned stock exchanges with other exchanges and it is not the responsibility of the clearing corporation to share information with other exchanges. In this regard, I note that, ‘sharing of mismatch alerts’ by clearing corporations and ‘ascertainment of wrong/ fraudulent/ unauthorized transfer’ (unauthorized transfers) are separate steps in the process of EWM, and ‘sharing of mismatch alerts’ is not contingent upon ‘ascertainment of unauthorized transfers’. If Noticee had any doubt or contention regarding the flow of information, Noticee being part of the group of MIIs who formulated to the SOP had the option to discuss the same in subsequent meetings of the MIIs and suggest changes in SOP. Till the time such changes were incorporated in the SOP, Noticee was bound to follow the SOP and share alerts with both the stock exchanges.

59. Noticee has also argued that sharing of information on alerts with other stock exchange was linked to interoperability of CCs by stating that Noticee cleared and

settled trades executed on NSE only till interoperability arrangement was implemented in a staggered manner with effect from June 2019 onwards. Noticee has stated that the implementation of sharing of information under the SEBI Circular was discussed among the interoperability participants and was finalized after establishing file nomenclature/file formats/communication channels such as placing of data through FTP etc. for exchange of information. Accordingly, the mismatch information under the SEBI Circular was shared with BSE with effect from August 10, 2020 onwards. I note that interoperability was a separate exercise with its own timelines for implementation. Even without interoperability, clients could trade on both stock exchanges, and mismatch alerts were at client level. To facilitate client trades at both BSE and NSE, most brokers had memberships at both stock exchanges. I note that the purpose of EWM circular was to give early warning signals of potential wrong doings, and therefore, the alerts were required to be shared with other stock exchanges / depositories under Para 7, to enable them to be aware of such signals and take further action as per the SOP. The interpretation of Para 7 cannot be limited by implying that sharing of alerts with other stock exchange was subject to or dependent upon interoperability amongst CCs.

60. Further, the difficulties faced by the Noticee in implementing and setting out mode of implementation of EWM circular and SOP by MIIs (including Noticee), and practical possibility/ feasibility of meeting the timeline for the same, does not alleviate the responsibility of complying with the circular. The Noticee was also free to approach SEBI to raise these contentions with SEBI and seek extensions or modification in directions. However, there is nothing on record to indicate that Noticee raised the issue with SEBI. Further, the Noticee was already having mismatch alerts available with it, which it was sharing with NSE, and sharing with BSE for the purpose of compliance with circular cannot be condoned merely on the ground of operational issues.

61. In view of the foregoing, I find that Noticee was mandated to share alerts with both BSE and NSE in terms of para 7 of the EWM circular, and by failing to share alerts

with BSE, it violated provisions of para 7 of SEBI Circular dated December 17, 2018 read with clause 5.2 of the SOP.

62. Here it is important to determine whether the non-compliance with para 7 of the EWM circular read with clause 5.2 of the SOP was a technical breach or a substantial non-compliance. I note that with regard to the diversion of securities by KSBL, the Noticee was sharing alerts with NSE. In this regard, I note that find it relevant to quote the following para 240 from the order passed against NSE in the matter of KSBL

"240. NSE in its email of March 22, 2019 wrote to SEBI stating, inter alia that in 70% of cases of running account settlement, they were receiving alerts of mismatches from depositories and they were finding it difficult to act on such a large number of alerts. Pursuant to a review meeting held in SEBI on April 09, 2019 on reconciliation of holding statements with depository data for all MIIs, SEBI undertook reconciliation of weekly brokers reports with depository data in which mismatches were observed for securities reported by KSBL and actual balance in demat accounts of KSBL as on April 19, 2019."

63. From the aforesaid para, I note that on account of alerts on mismatch of securities generated by depositories, by April 19, 2019, mismatches had been observed for securities reported by KSBL and actual balance in accounts of KSBL. Thus, after the relevant alerts were implemented post the EWM circular, by April 2019, the KSBL mismatches had been detected at NSE. I note that the material on record does not bring out that failure to implement sharing of the alerts with BSE by Noticee delayed detection of the wrong doing by KSBL. I also note that the Noticee had partially complied with the EWM circular by compiling mismatch of securities received from depositories and sharing alerts with NSE.

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?

64. As it is established that Noticee violated para 7 of SEBI Circular dated December 17, 2018 by not sharing alerts on mismatch of securities with BSE, 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.*

65. 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.

66. The violations by the Noticee, as established, are of para 7 of the SEBI Early Warning Mechanism Circular dated December 17, 2018 read with clause 5.2 of the SOP framed under the circular, which attract penalty under Section 15 HB of SEBI Act which provides for minimum penalty of Rs. one lakh rupees and maximum penalty of Rs.1 crore. As noted on preceding paras, the violation by the Noticee resulted from partial non-compliance with the EWM Circular and material on record does not bring out that inability to detect KSBL wrongdoings earlier than they were detected, is attributable to Noticee's partial compliance with para 7 of the EWM circular. At the same, I note that Noticee is an MII carrying out important risk management related functions, and even a partial non-compliance by the Noticee of early warning mechanism can potentially have market wide impact. Hence, the violation cannot be treated lightly. In view of the nature of the violation committed and the aforesaid mitigating factors, I find that a penalty of Rs.25 lakhs shall be commensurate with the violation committed.

ORDER

67. 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. 25,00,000/- (Rupees Twenty Five Lakhs only) under Section 15HB of SEBI Act,1992 on Indian Clearing Corporation Limited for violation of para 7 of the SEBI Early Warning Mechanism Circular dated December 17, 2018.

68. 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

69. The Noticees shall forward said Demand Draft or the details / confirmation of penalty so paid to the Enforcement Department – Division of Regulatory Action –

II 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

70. 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: 2022.12.28 16:54:54 +05'30'

DATE: December 28, 2022 **MANINDER CHEEMA**

PLACE: MUMBAI **ADJUDICATING OFFICER**