BEFORE THE ADJUDICATING OFFICER

SECURITIES AND EXCHANGE BOARD OF INDIA

[ADJUDICATION ORDER NO. Order/MC/RM/2022-23/15975]

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. **National Stock Exchange of India Ltd., (PAN No.: AAACN1797L)** 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 National Stock Exchange of India Ltd. (hereinafter referred as "**Noticee/NSE**"), for alleged violation 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 r/w para 2.5 of the Circular SEBI/HO/MIRSD/MIRSD2/ CIR/P/2016/95 dated September 26, 2016 and para 2 of the Circular SMD/SED/CIR/93/23321 dated November 18, 1993.
   b) 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.
   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 SEBI Act, the aforesaid alleged violations against the Noticee. Subsequently, vide order dated June 18, 2021, the undersigned was appointed as Adjudicating Officer 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/00469/2021 dated January 07, 2021 (hereinafter be referred to as, the "**SCN**") and Supplementary Show Cause Notice No. EAD-2/AP/VS/10004/2021 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 and Bombay Stock Exchange Limited (hereinafter referred to as "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 sought following details from NSE:

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 NSE as under:
a) Details of further action taken on the findings relating to KSBL during September 2017 in the absence of requisite details from Depositories including if the matter was followed up with SEBI.
b) Details of system/procedure/facility provided by NSE on reporting of Bank and Demat accounts maintained by Stock Broker, uploading clients' fund balance and securities balance by the Stock Brokers on Stock Exchange system, Monitoring of Clients' Funds lying with the Stock Broker, reporting of the daily holding statement by stock brokers and analysis thereof etc. by NSE.

8. Based on the NSE response, SEBI examined the matter and made certain preliminary findings. The said findings were communicated to NSE, vide SEBI's letter dated July 21, 2020 and it was advised to submit its response. NSE submitted its response vide email dated August 07, 2020. The preliminary findings, the response of NSE and SEBI's observations are summarized as under:

9. **Preliminary Finding No. 1:** NSE did not approach SEBI when Depositories were reluctant to provide information (pledge details w.r.t demat accounts of KSBL) and NSE accepted KSBL's contention on face value. NSE raised issues on non-sharing of data by depositories only in May 30, 2019 in meeting with SEBI after which Depositories were directed to provide information. It is felt that if SEBI was alerted

previously by NSE and Depositories, the default may have perhaps come to light much earlier enabling SEBI to take appropriate measures.

10. In regard to the preliminary finding no.1, response of the NSE was as follows:

a) Issue of exchanges not having access to data from depositories has been repeatedly discussed over the last few years at various forums/meetings of MIRSD, SEBI and SEBI was well aware of the situation.

b) Through 2018 and 2019, on an initiative introduced by the WTM at SEBI, there were multiple communications between SEBI and MIIs relating to automation of inspection, running of pilot program for reconciliation of stock broker reported securities balances with actual balances held by the depository, standardization of books, data sharing between exchanges and depositories. In these meetings it was discussed and made clear that Exchanges did not have access to the Depository Records.

c) The meeting under reference of May 2019 was titled by SEBI as “2nd review meeting - Reconciliation of holding statements with depository data”. In the meeting invite, there is reference to meeting held in April 2019.

d) It was during the joint meeting of all MIIs held at SEBI on May 30, 2019 that specific directions were given by SEBI to the depositories to provide access to exchanges for the purpose of checking compliance with various regulatory requirements pertaining to handling of clients’ securities.

e) SEBI in its joint meeting held on July 12, 2018 and September 28, 2018 for offsite supervision and the standardisation of the books of accounts/records agreed to reconcile holding data since it was clearly known that Exchanges did not have any means to access the DP records and undertake the reconciliation by themselves.

f) Further, while agreeing to undertake the securities reconciliation on behalf of the Exchanges, SEBI also decided to draft a data sharing agreement between the Exchanges and Depositories.

g) Further, from the scope of examination shared by SEBI for all the joint inspections it can be noted that SEBI had decided to verify the area relating to pledges by itself. We assumed that SEBI acknowledged that depositories data was not available with exchanges and that SEBI had the wherewithal to run this critical activity.

h) NSE examines the compliances relating to pledging of client securities in all its inspections and attempts to identify as to whether there has been any misappropriation of client's securities/funds by the Member. As NSE did not have access to the DP records, it primarily relies on the declaration made and the records submitted to NSE by the Member during the inspections.

i) None of the records submitted by KSBL, including statement of holdings from depository, contained any information that indicated to NSE that client securities had been pledged by KSBL from DP account 11458979, to raise funds.

j) Further during the inspection of KSBL conducted in FY 2017-18, for the period October 01, 2016 to September 30, 2017, NSE verified the books and records of KSBL used for carrying out the transactions on NSE. During the said inspection, it was noted that the DP A/c no 19502787 was tagged as KARVY STOCK BROKING LIMITED-CLIENT ACCOUNT-NSE CM and used for pledging of client securities. Accordingly, NSE's Inspection team carried out the pledge verification and observed that there was no violation on the same.

k) According to Para 4(a) of SEBI Master Circular SEBI/MIRSD/Master Cir-04/2010 dated March 17, 2010, the inspection of members by stock exchanges shall cover compliance with the relevant provisions of the Act, Rules and

Regulations made there under, Rules and Regulation of the Stock Exchange and the circulars issued by SEBI and Stock Exchanges from time to time.

l) Para 2.5 of the Circular SEBI/HO/MIRSD/MIRSD2/ CIR/P/2016/95 dated September 26, 2016 mandates the stock brokers to do the following:
   i. Securities of only those clients can be pledged who have a debit balance in their ledger.
   ii. The securities to be pledged shall be pledged from BO account tagged as "Name of the Stock Broker – Client Account."

m) Para 2 of the Circular SMD/SED/CIR/93/23321 dated November 18, 1993 states that "it shall be compulsory for all member brokers to keep separate accounts for client's securities and to keep such books of accounts, as may be necessary, to distinguish such securities from his/their own securities".

11. From the above SEBI observed as under:

a) That NSE did not approach SEBI immediately when Depositories were reluctant to provide information (pledge details w.r.t demat accounts of KSBL) on January 10, 2017, October 05, 2017 and October 30, 2017. It was observed from the response of NSE that the discussions over access to the DP records of Depositories by Stock Exchange, if any, happened during 2018 & 2019 and NSE didn't approach SEBI immediately when Depositories were reluctant to provide information.

b) Immediate proactive action w.r.t KSBL was warranted by NSE during the relevant time of inspections by NSE of KSBL i.e. FY 2016-17 & 2017-18 as there were serious findings by NSE relating to KSBL funding substantial amounts (Corporate Guarantee amounting to ₹1,917 Crores) to the group company not involved in any securities business and other transactions resulting into negative networth of ₹79.75 Crores of KSBL. It was also observed by NSE that the value of corporate guarantee issued as above was higher than its total balance sheet value of ₹1338.21 crores as on 31-03-2016. Based on above findings NSE levied a monetary penalty of ₹25 lacs in March 2018 along with direction, inter alia, to close outstanding corporate guarantees issued by KSBL.

c) It was also observed that the KSBL was meeting various risk parameters as given below for which inspection was conducted by NSE during the FY 2016-17 and 2017-18 and serious observation as noted above was made by NSE:-
   i. Top 25 TMs to whom highest penalties were levied
   ii. Top 25 TMs against whom highest number of IG and Arbitration cases filed
   iii. Top 25 Members with highest number of CTCL terminals
   iv. Alerts from RBS assessment
   v. TMs against whom Arbitration award of more than ₹50,00,000/- is passed

d) Therefore, from the above observations against KSBL, it was alleged that NSE followed a casual approach towards verification of client securities in case of KSBL in its inspection during the FY 2016-17 and 2017-18 by not approaching SEBI immediately when Depositories were reluctant to provide information with respect to pledge details of demat accounts of KSBL. It was observed that if SEBI had been alerted immediately on the need for the Depositories data, the default would have come to light much earlier enabling SEBI to take appropriate measures.

12. **Thus, in view of the above, it was alleged that NSE limited its scope for verification of client securities in case of KSBL and thereby not did not comply with provisions and intent of the para 4(a) of the SEBI Master Circular SEBI/MIRSD/Master Cir-04/2010 dated March 17, 2010 r/w para 2.5 of the Circular SEBI/HO/MIRSD/MIRSD2/ CIR/P/2016/95 dated September 26, 2016 and para 2 of the Circular SMD/SED/CIR/93/23321 dated November 18, 1993.**

13. **Preliminary Finding No. 2:** NSE had not acted in a responsible manner as it did not examine the said demat account no. 11458979 (the impugned demat account referred to in SEBI order dated November 22, 2019 through which shares of clients

of KSBL were wrongly pledged with banks/financial institutions and funds raised by pledging of client securities were credited to the KSBL's own bank accounts) when reported by NSDL on November 14, 2017 for any possible misuse of clients' securities during its ongoing inspection of NSE for the period 01-Oct-2016 to 30-Sep-2017.

14. Pursuant to 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. NSE had not explained properly to SEBI on reconciliation of demat accounts and use of such unreported demat accounts (by trading members) including demat account no 11458979 held by KSBL in the oversight of members.

15. In regard to the preliminary finding no.2, response of the NSE was as follows:
    a) Upon being requested by NSE, the Depositories (NSDL & CDSL) have shared with NSE a list of Demat accounts for NSE Members.

    b) NSDL did not specifically report said demat account no 11458979 as a mismatch account. The said account was one of 5000 accounts that were not reported relating to approximately 1100 members. The same report had details of another 71 DP accounts of KSBL that had remained unreported. NSE immediately wrote to KSBL (and other stock brokers) regarding the mismatches. NSE was informed by KSBL that it pertained to other Exchange's Margin Account and was reported to respective Exchange.

    c) NSE did not disregard the information provided by NSDL and took adequate steps to seek reporting of hitherto unreported DP accounts of the stock brokers. Exchange has diligently undertaken reconciliation of the demat accounts maintained by the Trading members in accordance to the SEBI circular dated September 26, 2016. Based on the consistent follow up with the trading members to report such demat accounts to the Exchange, currently there are 179 accounts which are yet to be reported to the Exchange.

d) In the absence of any red flags or indication of pledge or indeed the amount of client securities held in the account, NSE did not have any reason to suspect that client securities had been pledged from the account.

e) As was the practice prior to the year 2019, all exchanges including NSE conducted inspections of books and records of Members pertaining to the respective exchange as the Members were required to maintain exchange wise books & records. Exchange-wise inspections were conducted in order to avoid the duplication of examination & enforcement actions by the exchanges and to reduce the supervisory burden on the Members. Since the said DP accounts was a BSE tagged account, it is understood that the same would have been examined by BSE.

f) Further during the inspection of KSBL conducted in FY 2017-18, for the period October 01, 2016 to September 30, 2017, NSE verified the books and records of KSBL used for carrying out transactions on NSE. During the said inspection, it was noted that the DP A/c no :19502787 was tagged as KARVY STOCK BROKING LIMITED-CLIENT ACCOUNT NSE CM and used for pledging of client securities out of the 8 Demat accounts examined. Accordingly, NSE's Inspection team carried out the pledge verification and observed that there was no violation on the same.

g) NSE, in all its inspections, critically examines the Member's adherence to guidelines laid down for pledging of client securities and the utilization of the funds raised. During the inspections, Member submits to the Exchange the client wise bifurcation of the securities pledged with Banks/NBFC and the quantum of the funds raised. Exchange ascertains the obligation of each and every client along with their clear ledger balance whose securities are pledged and compares it with the value of the proportionate funds that would have been raised by pledging their respective securities. If the value of the proportional funds raised is in excess of the obligation of the clients, it is evident that the excess funds may have been used for other than the approved purpose. It is also verified that the funds so raised are credited in the client bank account of the Member and is not diverted anywhere else.

16. From the above SEBI observed as under:

a) NSE has been verifying pledge of client securities as per the initial records of pledge made available by the member viz KSBL. Such approach is not helpful in ensuring the availability of client securities as member can always hide the demat accounts in which the illegal pledge was done. Had the exchange verified the details of client collateral with the member and then availability of such encumbrance free collaterals in demat accounts of members (irrespective of exchange), it could have helped exchange to find any wrongdoing by the trading member.

b) Thus, NSE has allegedly followed casual approach towards verification of client securities in case of KSBL in its inspection during the FY 2016-17 and 2017-18 and limited its scope for verification of client securities in case of KSBL.

17. **Therefore, NSE is alleged to have violated provisions and intent of the para 4(a) of the SEBI Master Circular SEBI/MIRSD/Master Cir-04/2010 dated March 17, 2010 r/w para 2.5 of the SEBI circular SEBI/HO/MIRSD/MIRSD2/CIR/P/2016/95 dated September 26, 2016 and para 2 of the Circular SMD/SED/CIR/93/23321 dated November 18, 1993.**

18. **<u>Preliminary Finding No. 3:</u>** NSE failed to notice that all such demat accounts were not tagged as per the prescribed nomenclature for the prescribed purpose as laid down in para 2.3 to the annexure of SEBI circular dated September 26, 2016.

19. In regard to the preliminary finding no.3, response of the NSE is as follows:

a) Pursuant to the SEBI circular dated Sep 26, 2016, Members were required to tag their Demat accounts with the Depositories and report the same to the Exchanges.

b) While the primary responsibility of tagging of DP account with the Depositories is with the Members, Exchanges are required to ensure that the accounts are correctly reported and are in line with the tagging done.

c) In the absence of any information about the details/nature of the account and non-provision of the details by the Depositories on being asked, the correctness of the nomenclature of the DP account could not have been commented upon by the Exchange in the inspection during FY 2016-17 & 2017-18. It is expected that adequate systems should have been put in place by the Depositories to ensure that demat accounts are tagged only as per the prescribed nomenclature.

d) NSE diligently followed up with members on receiving the mismatch report and further the tagging nomenclature for the said account appeared to meet the criteria set out in the said SEBI circular.

20. From the above SEBI observed as under:

a) It was noted that NSE received the details of demat accounts of trading members (as part of Enhanced Supervision of Stock Brokers/Depository Participants SEBI circular dated September 26, 2016) during the FY 2017-18 from Depositories. While the DP accounts details as received by NSE from depositories indicated separately account type/category as 'beneficiary client', 'pool account' etc., but the nomenclature of those DP accounts were not done by NSE in accordance with the SEBI Circular SEBI/HO/MIRSD/MIRSD2/CIR/P/2016/95 dated September 26, 2016, para 2.3 of which prescribes that the Stock Exchanges and/or Depositories, as the case may be, shall ensure that the details of all banks and demat accounts opened by the stock brokers are communicated to Stock Exchanges by the stock brokers in the format specified.

Further, the new banks and demat accounts opened by the stock brokers shall be named as per the para 1.1 and 1.2 of the annexure to SEBI Circular SEBI/HO/MIRSD/MIRSD2/ CIR/P/2016/95 dated September 26, 2016, which read as follows:

"1.1 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."

"1.2 The nomenclature for bank accounts and demat accounts to be followed is given as under:

--1.2.3 Demat account(s) which hold clients' securities shall be named as "Name of Stock Broker- Client Account".

21. **Therefore, it was alleged that NSE failed to examine the tagging of demat accounts as per the prescribed nomenclature, in terms 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.**

22. **<u>Preliminary Finding No. 4:</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.

23. 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.

24. 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 NSE. NSE vide its email made its submission to SEBI, which is summarised as follows:
    a) NSDL has shared instances pertaining to off-market transfer and multiple proprietary accounts of the period March to October 2019 with respect to demat account no. 11458979 of KSBL, with NSE.
    b) The off-market transfers from the said account have been made to the collateral account of Karvy and registered clients of Karvy.
    c) The information shared by NSDL with respect to the off-market transfers contained the source demat account and target demat account details along with the ISIN wise quantity transferred by way of off-market transfer mode and did not contain the ISIN wise balance lying in the said demat account. In its absence NSE was not able to identify any irregularity in the said account.
    d) Accordingly, NSE did not observe any irregularities by way of transfer of client securities (from client accounts) to the own accounts of the member or transfer to any third party (non-client entities).
    e) With reference to multiple proprietary demat accounts maintained by Karvy, NSDL had shared the details of the demat accounts of Karvy including the demat account no, 11458979. The account was previously reconciled and taken up with Karvy in September, 2017. It was informed by Karvy, vide its email dated September 08, 2017 during said reconciliation that it was for the margin account

of the other exchange and did not pertain to NSE transactions and the same was therefore reported to such other Exchange by Karvy.

f) From April 2019, Exchange has already initiated the client securities reconciliation exercise through which the misuse of client securities by Karvy were unearthed by NSE resulting the initiation of limited purpose inspection and temporary suspension of the member on December 02, 2019.

25. In view of the above NSE response, SEBI observed as follows:

a) NSE submitted that alerts provided by NSDL pertaining to off-market transfers did not contain ISIN wise securities balance lying in the said account and only contained ISIN wise quantity transferred by off-market mode. Hence, it did not observe any irregularity by way of such off-market transfers. As per the SOP, Surveillance Action should have been initiated by NSE. Since these are large value off-market transfers were other than for settlement purposes, NSE should have examined further and sought the securities balance details from the Depositories and taken appropriate action

b) NSE submitted that upon examination of the alerts received form NSDL for multiple proprietary demat account maintained by KSBL and opening any new demat account in the name of stock broker for client purpose, NSE recalled that the said account no. 11458979 was previously reconciled in September 2017 and was found to be KSBL's Margin account for the other Exchange (as per the submission made by KSBL) and hence did not examine further. Since the account no. 11458979 (Category-Beneficiary client, Type-Body Corporate, Subtype-Domestic) was not tagged as a Margin account. It becomes all the more reason for the NSE to examine the nomenclature of the account. By merely relying on the submission of KSBL, NSE did not take action on the alerts issued by NSDL.

26. 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 NSE, NSE failed to take appropriate action

against KSBL for the account no. 11458979. **The said failure on the part of the Notice was alleged to be 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.**

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

28. In response to SCN dated January 07, 2021 Noticee requested additional time for filing of reply to SCN and sought inspection of all the records, documents, papers and information relevant to the proceedings like :
   a) Copy of the SEBI Investigation report,
   b) Information submitted to SEBI pursuant to Joint Inspection by NSE and BSE
   c) Reports generated pursuant to forensic audits
   d) Communications between NSE and depositories
   e) Communication among MIIs
   f) NSE Inspection Reports made by NSE during FY 2016-17 and FY 2017-18
   g) Material basis which allegation of adoption of casual approach by NSE is made
   h) Other material available which is relied upon

29. Noticee was given inspection of the annexures to the SCN dated January 07, 2021 on February 09, 2021. Noticee filed reply to SCN vide letter dated February 23, 2021 and filed reply to SSCN vide letter June 01, 2021.

30. In regard to request of Noticee seeking aforesaid information/documents, vide letter dated December 14, 2021, Noticee was provided with (i) relevant extracts of SEBI Investigation report, (ii) information submitted to SEBI pursuant to Joint Inspection by NSE and BSE, (iii) communication between NSE and Depositories and (iv) Communication among MIIs. In regard to the report of forensic auditor, it was observed that since forensic auditor was appointed by NSE and the referred forensic audit report was forwarded by NSE to SEBI, the same was already available with the Noticee. Similarly the NSE inspections during FY 2016-17 and

FY 2017-18 were conducted by NSE, hence the inspection reports were available with the Noticee.

31. Opportunity of Hearing before undersigned was provided to the Noticee through video conferencing on January 13, 2022. Upon request of Noticee for rescheduling of the personal hearing, the hearing was rescheduled to February 03, 2022 and then subsequently to February 09, 2022. The Personal hearing on February 09, 2022 was attended by Authorised Representative of the Noticee, viz.: Mr. Darius Khambhata, Senior Advocate, Mr. Somasekhar Sunderasan, Advocate, Ms. Shruti Rajan, Advocate (Trilegal), Mr. Anubhav Ghosh, Advocate (Trilegal), Mr. Vivek Shah Advocate (Trilegal), Ms. Vidhi Shah, Advocate (Trilegal), and Mr. M Vasudev Rao (NSE). The Authorised representative of the Noticee reiterated the submissions made by the Noticee in their replies and submitted a compendium of documents referred during the hearing. Further, Noticee made short note of submissions dated 23 February, 2022 along with the list of dates.

32. The submissions made by the Noticee are summarized as below:

33. Noticee submitted that these adjudication proceedings have been initiated against NSE for considering whether penalty must be imposed on the NSE, in connection with the fraud and unauthorised transactions discovered in the operations of KSBL. It is pertinent to note that the findings of fraud were in fact an outcome of investigations and audit conducted by the NSE in 2019, along with other market infrastructure institutions (" MIIs"). It is relevant to note that all MIIs stand accused of failure to oversee for no reason other than the fact that the fraud at KSBL was uncovered as well as the fact that SEBI was kept informed at all times regarding the steps being taken by NSE. As a result thereof, the due-diligence which are applicable to SEBI should also be applied to NSE and the proceedings should not be basis hindsight.

34. It is further relevant to note that by ex-parte orders dated November 22 and November 29, 2019, based on investigations by the NSE, SEBI ruled that KSBL

was guilty of fraudulent and unauthorised transactions in securities and funds of its clients. Thereafter, NSE, BSE and MSEIL have also passed orders, cancelling KSBL's membership of stock exchanges.

35. It is submitted that the Notice fails to clearly and specifically identity the charges against the Noticee. In terms of the Notice, it has been observed that the Noticee adopted a "casual approach" towards verification of client securities in case of KSBL, and thereby violated the Relevant Circulars. However, there is no legally identifiable definition or metric that can measure such 'casual approach' for the purposes of imposing liability.

36. Neither does the Notice allege nor is it the case of SEBI that the Noticee manifested negligence, recklessness or a breach of its legal duty of care. Instead, it has been left to the Noticee to interpret the nature of non-compliance or rather, the kind of actions that could have been undertaken to facilitate an early identification of KSBL's default.

37. The allegations in the Notice emanate from a purported omission on the part of the Noticee. However, to prove omission, there must be an explicit legal duty of care, that must have been breached by the Noticee. However, the allegations in the Notice do not identify the exact legal obligation that the Noticee has breached or failed to abide by. Alternatively put, the case against the Noticee is largely that the Noticee did not do 'enough' to facilitate an early identification of KSBL's default. However, the threshold or standard of 'enough', as perceived in the Notice, does not manifest itself in law.

38. It is submitted that the alleged charges are in fact, vague and ambiguous and deserve to be set aside. Specifically, the Notice relies on a very broad paragraph in the Master Circular to demonstrate that stock exchanges are obliged to conduct inspections of their active trading members in different segments to verify their compliance with applicable legal framework. The Notice then relies upon paragraph 2.5 of the Enhanced Supervision Circular which does not cast any

obligation on a stock exchange, but rather, only sets out the obligations of a stock broker. Merely because KSBL breached its own obligations, liability cannot be attributed to the Noticee for its inability to ensure that its members comply with applicable law.

39. It is submitted that it is a settled position of law that a show cause notice must be clear and specific in its terms and cannot be vague, so as to enable the Noticee to understand the charges and effectively respond to them. In a recent judgment (*UMC Technologies Private Limited v. Food Corporation of India, Civil Appeal No. 3687 of 2020 (Arising out of S.L.P. (C) No. 14228 of 2019)*, the Apex Court, while adjudicating on validity of a show cause notice proposing to blacklist the appellant, stated the following:

"13. At the outset, it must be noted that it is the first principle of civilised jurisprudence that a person against whom any action is sought to be taken or whose right or interests are being affected should be given a reasonable opportunity to defend himself The basic principle of natural justice is that before adjudication starts, the authority concerned should give to the affected party a notice of the case against him so that he can defend himself Such notice should be adequate and the grounds necessitating action and the penalty/action proposed should be mentioned specifically and unambiguously. An order travelling beyond the bounds of notice is impermissible and without jurisdiction to that extent. This Court in Nasir Ahmad v. Assistant Custodian General, Evacuee Property, Lucknow and Anr. MANU/SC/0377/1980: (1980) 3 SCC I, has held that it is essential for the notice to specify the particular grounds on the basis of which an action is proposed to be taken so as to enable the noticee to answer the case against him. If these conditions are not satisfied. the person cannot be said to have been granted any reasonable opportunity of being heard".

40. In Gorkha Security Services v. Govt. of NCT of Delhi, the Supreme Court of India has emphasized on the need for the details of all alleged breaches and defaults to be encompassed in a show cause notice.

"19 ...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. Another requirement, according to us, is the nature of action which is proposed to be taken for such a breach ... " (emphasis supplied)

41. Further, the Hon'ble SAT, has in a few instances, disposed of SEBI proceedings against noticees on the basis of the Notice being vague and ambiguous and the same resulting in violation of noticees' right of being heard. For instance, in Swaranganga Trading Pvt. Ltd v. AO, SEBI , the tribunal correctly observed that:
"Having heard the authorised representative of the appellant and the learned counsel for the respondent, we are satisfied that the show cause notice that was issued to the appellant was as vague as it could be and did not spell out the charge which the appellant was required to meet. Paragraph 2 of the show cause notice which has already been reproduced hereinabove only states that the appellant had colluded with certain brokers for transacting in the shares of the company and that it created false and misleading appearance of trading in the scrip. No further details have been provided to the appellant. Who are the brokers with whom the appellant colluded and in what manner did the appellant create a misleading appearance in the trading of the scrip of the company is not spelt out in the show cause notice. On a plain reading of paragraph 2 of the show cause notice it is not possible for the delinquent to offer his explanation as the allegations made therein are vague. .... "

" ....A show cause notice is meant to contain the precise charge that is levelled against the delinquent in a concise manner so that he could reply to the same. This is the basic requirement of the principles of natural justice. As pointed out earlier, paragraph 2 of the show cause notice leveling the charge of violating Regulation 4 of the regulations is vague and we are satisfied that it violated the principles of natural justice. The show cause notice does not spell out the precise case against the appellant which it was required to meet. In this context we may refer to the

observations made by the Apex Court in Canara Bank v. Debasis Das, (2003) 4 SCC 557 wherein the learned Judges made the following observations which are relevant for our purpose-

42. *"The adherence to principles of natural justice as recognized by all civilized States is of supreme importance when a quasi-judicial body embarks on determining disputes between the parties or any administrative action involving civil consequences is in issue. These principles are well settled The first and foremost principle is what is commonly known as audi alteram partem rule. It says that no one should be condemned unheard Notice is the first limb of this principle. It must be precise and unambiguous. It should apprise the party determinatively of the case he has to meet. Time given for the purpose should be adequate so as to enable him to make his representation. In the absence of a notice of the kind and such reasonable opportunity. the order passed becomes wholly vitiated. Thus, it is but essential that a party should be put on notice of the case before any adverse order is passed against him. This is one of the most important principles of natural justice. It is after all an approved rule of fair play. The concept has gained significance and shades with time."* (emphasis supplied)

43. Additionally, it is submitted that on February 11, 2021 and February 23, 2021, further inquiries were received by the Noticee from SEBI in relation to the subject matter of the Notice, which is clearly indicative of a parallel and ongoing investigation, despite issuance of a show cause notice. The receipt of such inquiries after the issuance of Notice in itself point to the premature nature of the Notice and the incomplete investigation based on which the Notice has been issued, which has compelled SEBI to seek additional information at this stage.

44. In view of the above, it is submitted that the charges levelled against the Noticee are not clear and therefore, deprive the Noticee from effectively raising a defense against such allegations. Therefore, it is evident that the Notice is vague and the allegations contained therein are ambiguous, and is violative of the rudimentary

principles of natural justice. Thus, the Notice must be quashed and set aside on this ground alone.

45. It is submitted that the SCN and Supplementary SCN purports to be based on violation of SEBI circulars issued by SEBI. Even a plain reading of the circulars relied upon by SEBI to make the allegations would show that they are substantially circulars casting the primary obligations on stock brokers. Likewise, circulars issued to stock exchanges and depositories are generic circulars without a demarcated role and standard for their provisions to be used in penalty proceedings. A reading of these submissions would make it clear that no case for imposition of a penalty on the NSE is made out - merely because of a fraud detected in the functioning of a stock broker, which too was an outcome of investigations by the NSE, it cannot be alleged that the NSE's oversight had failed. The relevant extracts of the SEBI Circulars purported to have been violated by NSE are referred to herein below:

46. The 1993 Circular ex facie imposes obligations, not on stock exchanges but on stock brokers. Clause 2 of the 1993 Circular reads as under:

> *"2. It shall be compulsory for all Member brokers to keep separate accounts for client's securities and to keep such books of accounts, as may be necessary, to distinguish such securities from his/their own securities. Such accounts for client's securities shall, inter-alia provide for the following:-*
>
> *a. Securities received for sale or kept pending delivery* in *the market;*
>
> *b. Securities folly paid for, pending delivery to clients;*
>
> *c. Securities received for transfer or sent for transfer by the Member,* in *the name of client or his nominee(s);*
>
> *d. Securities that are fully paid for and are held in custody by the Member as security/margin etc. Proper authorization from client for the same shall be obtained by Member;*

e. Fully paid for client ' s securities registered in the name of Member, if any, towards margin requirements etc.;

f. Securities given on Vyaj-badla. Member shall obtain authorization from clients for the same. "

47. The 2016 Circular, is the only circular stipulating guidelines for functioning of an enhanced supervision of stock brokers i.e. a framework, the implementation of which also did not happen immediately. The deadlines for implementation were postponed and these are "directory" provisions as opposed to being "mandatory" provisions in the eyes of law. Even the 2016 Circular primarily casts obligations on stock brokers and not on stock exchanges, which will become clear from the following provisions:-

Clause 1.1

*"**Naming/Tagging of Bank and Demat Accounts by Stock Broker***

1.1. 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.

1.2. The nomenclature for bank accounts and demat accounts to be followed is given as under:

1.2.1. Bank account(s) which hold clients funds shall be named as "Name of Stock Broker- Client Account".

1.2.2. Deleted

1.2.3. Demat account(s) which hold clients' securities shall be named as "Name of Stock Broker- Client Account".

1.2.4. Deleted

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"

1.2.6. Demat account(s) held for the purpose of settlement would be named as "Name of Stock Broker - Pool account".

1.2. 7. Bank account(s) held for the purpose of settlement would be named as "Name of Stock Broker -Settlement Account"

Clause 2.5

" 2.5. As per existing norms, a stock broker is entitled to have a lien on client's securities to the extent of the client's indebtedness to the stock broker and the stock broker may pledge those securities. Pledge of such securities is permitted, only if, the same is done through Depository system in compliance with Regulation 58 of the SEBI (Depositories and Participants) Regulations,1996. To strengthen the existing mechanism, the stock brokers shall ensure the following:

2.5.1. Securities of only those clients can be pledged who have a debit balance in their ledger.

2.5.2. Funds raised against such pledged securities for a client shall not exceed the debit balance in the ledger of that particular client.

2.5.3. Funds raised against such pledged securities shall be credited only to the bank account named as "Name of the Stock Broker- Client Account".

2.5.4. The securities to be pledged shall be pledged from BO account tagged as "Name of the Stock Broker- Client Account".

2.5.5. Stock Brokers shall send a statement reflecting the pledge and funding to the clients as and when their securities are pledged/unpledged in the prescribed format."

48. Clause 2.3 of the 2016 Circular generically refers to certain deadlines for change of nomenclature of demat accounts which is to be "ensured" by "stock exchanges and/or depositories" The provision is part of the guidelines stipulated for enhanced supervision. The provision does not stipulate a specific action and a specific responsibility for each MII, in connection with nomenclature of a demat account, which is consistent with it being an indicative guideline. Neither a stock exchange nor even a depository can force the change of the name and nomenclature of a demat account on its own. It can only oversee the changes being made by its members.

49. If a member actively defrauds the stock exchange by giving false information or incomplete information, compliance with the indicative deadlines cannot be

achieved. The usage of the phrase "ensure" is not a legal standard of a guarantee to ensure assignment of nomenclatures to demat accounts. Even a plain reading of this Circular clearly demonstrates that the ability of an exchange to comply with these requirements is contingent on it having access to complete and correct information. Clause 2.3 is extracted below:

"2.3. Stock Exchanges and/or Depositories, as the case may be, shall ensure the following:

2.3.1. All existing demat accounts maintained by stock brokers are assigned the appropriate nomenclature as mentioned above, within three months from the date of this circular.

2.3.2. All existing bank accounts maintained by stock brokers which do not have the above mentioned nomenclature, shall be assigned appropriate nomenclature, within six months from the date of this circular.

2.3.3. Details of all existing bank and demat accounts shall be communicated to Stock Exchanges by the stock brokers in the format specified above within one month from the date of this circular.

2.3.4. All new bank and demat accounts opened by the stock brokers shall be named as per the above given nomenclature and the details shall be communicated to the Stock Exchanges within one week of the opening of the account.

2.3.5. In case of closure of any of the reported bank and demat accounts, the same shall be communicated to the Stock Exchanges within one week of its closure.

2.3.6. Depositories shall ensure that once the nomenclature for a particular demat account has been assigned by the stock broker, then the same shall not be modified.

2.3. 7. Any non-compliance/non-reporting in this regard by the stock broker shall attract penal action as per the provisions of Stock Exchanges.

2.3.8. Based on the list of stock brokers (including PANs) provided by the respective stock exchanges, Depositories shall also provide stock broker-wise details of all the demat accounts opened by a stock broker to the *concerned Stock Exchanges to facilitate reconciliation with the data submitted by the stock broker."*

50. The 2016 Circular was meant to take effect immediately. However, vide circular dated December 20, 2016, the effective date of the 2016 Circular was postponed to April 01, 2017 and certain provisions of the 2016 Circular were made effective in a staggered manner.

51. Likewise, the 2010 Master Circular casts general and overarching obligations on stock exchanges like NSE. Clauses 3 and 4(a) of the same read as under:

"3. The Stock Exchange or the Clearing Corporation, as the case may be, shall inspect all active members in various segments every year.
4. The inspection shall cover:
a. Compliance with the relevant provisions of the Act, Rules and Regulations made there under, Rules and Regulation of the Stock Exchange I Clearing Corporation and the circulars issued by SEBI and Stock Exchanges I Clearing Corporations from time to time. "

52. Accordingly, it is submitted that the charges in the SCNs are vague and only in general terms without pointing out any specific standard that was to be met by NSE for an allegation of violation with a penalty imposition on the NSE to follow.

53. In fact, the Supplementary SCN issued on May 6, 2021, after the response to the first SCN dated January 7, 2021, was already filed, clearly demonstrates SEBI's efforts to post facto improve its case and its failure to undertake a comprehensive review of the facts. The Supplementary SCN cannot be used as a device to defeat the explanations being put forth by NSE.

54. Noticee has submitted that it as a frontline regulator of the securities market, has proactively introduced various processes, systems and checks in the nature of oversight and monitoring measures. and the typical inspection process usually followed by Noticee for trading members includes following:

a) Analysis of client wise and proprietary net sales to ascertain whether the respective client securities are used for meeting pay-in obligations.
b) Reconciliation of client funds and security balances to determine their availability.
c) Analysis of members proprietary losses to assess whether clients funds have been used for meeting such obligation.
d) Detailed analysis of financial records or statements of the member including net worth, loans to group companies, and debtor/creditor analysis.
e) Detailed analysis of the demat transaction statement using analytical tools in order to ascertain whether any client securities have been transferred off market to other entities.
f) Matching of the weekly client wise securities balances with the monthly client wise security balances being reported by the members (based on certain thresholds) as per the Enhanced Supervision Circular.

55. As the regulatory regime evolved and imposed more prescriptive standards, the Noticee ensured that its members reported their bank and demat account details (April 2017 onwards), weekly monitoring of clients' funds (April 2017 onwards), monthly clients' funds and securities balances (July 2017 onwards), and daily holding statements (January 2019 onwards).

56. In the year 2017 and prior to the implementation of SEBI circular dated June 20, 2019, the Noticee's inspections with regard to pledging of securities were largely focused on verifying whether client securities have been pledged and funds have been raised in excess of their obligations. This is essentially because stock exchanges did not have access to the depository records, and hence, reliance was primarily placed on the members' submissions and records for the purpose of inspections.

57. Despite the unavailability of holistic data, the Noticee promptly approached depositories on several occasions in lieu of multiple broker inspections.

Particularly, in 2017, when the Noticee approached National Securities Depository Limited ("NSDL") and Central Depository Services Ltd ("CDSL") seeking information in relation to a number of brokers on the basis of its risk assessment, the depositories were reluctant to share the information sought by the Noticee on account of a SEBI letter dated February 21, 2006 as evinced vide their emails dated January 10, 2017, October 5, 2017 and October 30, 2017.

58. Noticee has consistently adopted best practices in the exercise of its quasi-regulatory functions, including its oversight and monitoring obligations. It may be noted that a number of these proactive measures have gone on to find place in circulars issued by the market regulator for the prevention of misuse or diversion of clients' securities by stock brokers, including SEBI's Early Warnings Circular dated December 17, 2018.

59. Noticee's inspection of KSBL: In the financial year 2016-17, during its periodic inspections conducted from January 2017 to March 2018, the Noticee found that KSBL was issuing corporate guarantees of significant value for its group companies not involved in the securities business in violation of Rules 8(l)(f) and 8(3)(f) of the Securities Contract Regulation Rules, 1957, and identified a shortfall in its net worth. On the basis of its findings, vide order dated March 22, 2018, the Noticee imposed a monetary penalty of INR 25 lacs on KSBL and directed it to close all outstanding corporate guarantees. Further, on December 19, 2018, the Noticee again levied a penalty of INR 3.16 lacs for violation relating to non-settlement of client accounts and irregularities in uploading client's email and mobile records. In this regard it may be noted that vide letter dated March 1, 2017 and emails dated March 7, 2017, August 21, 2017 and February 14, 2018, the Noticee intimated SEBI regarding the observations of its inspection and sought to obtain SEBI's guidance in the matter.

60. Although in the year 2017, the Noticee had sought information from the depositories regarding the pledging of client securities by KSBL, the depositories were reluctant to share this information since SEBI had, vide a letter dated

February 21, 2006, advised depositories to share with stock exchanges, data pertaining to off market transfers of beneficial owner account holders and not data that may relate to trading members.

61. In February 2018, when a joint inspection was conducted between market infrastructure institutions ("MIIs") and SEBI of KSBL, no adverse observations in relation to the Noticee's inspection process was raised by SEBI at that stage, neither were there any red flags identified by the Noticee in terms of the specific areas of diligence that were demarcated to it. Further, during the inspection of KSBL in FY 2017-18, the Noticee verified the books and records of KSBL used for carrying out transactions on NSE and did not observe any violations in its pledge verification.

62. During FY 2018-19, KSBL declared that it had pledged around INR 65 crores as on August 31, 2018 with Banks/NBFCs against which an over-draft facility to the tune of INR 32.28 crores were raised. During its inspection of transactions carried out by KSBL on NSE, the Noticee observed that KSBL had raised excess funds of approximately INR 90,385 for 9 clients. The findings of this inspection were promptly communicated to SEBI on July 15, 2019 for being incorporated in the joint inspection scheduled by SEBI in FY 2019-20.

63. Throughout 2018 and 2019, the Noticee specifically raised the issue of non-sharing of data by depositories and the systemic information asymmetry between depositories and stock exchanges with SEBI. On July 12, 2018, SEBI, NSE and BSE held a meeting on the joint inspection of brokers. The minutes of this meeting record that for the inspection of all brokers in a phased manner, "SEBI to send the Securities Holding Mismatches Data at the ISIN level to Exchanges to start their off-site supervision based on this methodology (Reconciliation of securities holding data/standardized RoS (at ISIN level) provided by the broker vis-a-vis depository data)." Further, the role of SEBI was to reconcile the data submitted by brokers to exchanges and depositories and communicate mismatches, if any, to the stock exchanges. In the same meeting, SEBI also agreed to put in place a data sharing

agreement between exchanges, depositories and SEBI for the purpose of broker supervision and surveillance.

64. On May 30, 2019, a joint meeting was held at SEBI for all MIIs, where stock exchanges explicitly requested for access to depository data for the purpose of broker inspection. Accordingly, vide email dated July 4, 2019, SEBI directed the depositories to allow stock exchanges to access the statements for the purpose of inspections of members of the exchanges. The minutes of the said meeting also specifically note that SEBI would perform a reconciliation of securities at the client level and share mismatch reports with NSE and BSE, who would in tum ascertain the reasons for mismatches and provide a presentation in this regard at the next review meeting.

65. Subsequently, as part of its offsite supervision, the Noticee undertook reconciliation of the weekly securities reportings in June and July 2019, which is when it observed certain discrepancies in the submissions made by KSBL.

66. For the purpose of the FY 2019-20 joint inspection, each MII was assigned a distinct scope and role. Accordingly, the Noticee was only required to examine matters relating to margin reporting, RBS, KYC/PMLA compliances, position limits and investor grievance mechanism. However, it may be noted that even during the joint inspection, no alerts with regard to pledging in account number 11458979 were shared by depositories, in spite of the fact that securities worth INR 1,685 crores were pledged by KSBL with banks /NBFCs, during Q4 of FY 2018-19 from the demat account number 11458979 (Karvy StockBroking Limited- BSE).

67. In the meanwhile, the Noticee initiated a limited purpose inspection of KSBL's books, operations, records, etc. on a sample basis at the registered office of KSBL on August 19, 2019. In view of its observations during the limited purpose inspection, the Noticee promptly took the lead and suo motu alerted SEBI on August 27, 2019.

68. Additionally, pursuant to its observations in the limited purpose inspection, on September 5, 2019, the Noticee requested the depositories for details of pledge securities in the DP accounts of KSBL. Vide email dated September 06, 2019, NSDL shared the relevant details with the Noticee, on a review of which the Noticee observed that KSBL had pledged around INR 2,800 crores worth of client securities with banks and NBFCs and had raised funds to the tune of INR 851 crores. Vide email dated September 16, 2019 and letter dated September 18, 2019, KSBL admitted that it had wrongfully pledged client securities and undertook to restore securities back to its respective clients. KSBL further informed the Noticee that it was in discussions with bankers and financiers to obtain credit facilities to release pledged securities by September 30, 2019, which deadline it failed to meet.

69. In order to examine the matter further, the Noticee alerted the market regulator and all MIIs-BSE, NSDL and CDSL and conducted a joint visit of KSBL from September 16 -21,2019. A second visit was also made by the said MIIs from October 19 - 21, 2019.

70. It may be noted that the Noticee noted that KSBL had not previously disclosed the demat account no. 11458979 named KARVY STOCK BROKING LTD (BSE), in its January 2019- August 2019 submissions to the Noticee, but rather, it had taken the stance that since the account pertained to another exchange's margin account, it was reported to the respective exchange.

71. Following the inspections, a series of meetings were held at SEBI between the Noticee and SEBI alone as well as between the MIIs and SEBI to review the matter, exchange information regarding the inspection, communications with KSBL and their observations, and to discuss the next steps to protect the interests of investors in the securities market.

72. Given the magnitude of operations of KSBL and pursuant to discussions with SEBI, a forensic auditor was appointed by the Noticee as the leading party along with

BSE and NSDL. The Noticee actively engaged in inspections and assisted in the forensic audit of KSBL. For instance, the Noticee worked extensively with E&Y to explain how the Noticee detected the misutilization of funds raised by KSBL by pledging clients' securities, collected approximately 50GB of data from the software systems of KSBL, collated all the bank statements of KSBL's 174 banks accounts and sent out requisitions to KSBL for information required for the purpose of forensic audit.

73. Additionally, the Noticee also hosted and organized meetings with KSBL to review their progress in terms of remediating the concerns of its clients and ensuring adequate fulfillment of its obligations, and specifically, to discuss their plan of action to unpledge client securities.

74. As an interim measure, with effect from November 11, 2019, the Noticee directed KSBL to refrain from onboarding new clients and prohibited it from taking any new positions in currency derivatives segment with effect from November 15, 2019. Further, on November 22, 2019, a preliminary report was forwarded by the Noticee to SEBI with regard to KSBL followed by a final report in January 2020.

75. Thereafter, SEBI passed an ex-parte ad interim order dated November 22,2019, an interim order dated November 29, 2019 and a confirmatory order dated November 24, 2020 ("SEBI KSBL Orders") on the basis of the reports received from the Noticee and the inspections carried out by it. A plain reading of these SEBI orders evidently highlights the significant and lead role played by the Noticee in the identification and administration of KSBL's default, and the humongous efforts that the Noticee has expended in this matter.

76. It may be noted that SEBI itself has extensively and heavily relied upon the reports prepared by the Noticee, the limited purpose inspection undertaken by it and the efforts of the Noticee in unearthing the illegalities involved in the operations of KSBL, as evinced from the SEBI KSBL Orders. Paragraph 3 of the order dated November 22, 2019 reads as, "*It has also been intimated by NSE that it has*

appointed a forensic auditor to examine in detail the case of misuse of client funds and securities by KSBL. In the said Report, NSE has requested SEBI to take appropriate and expeditious action in the matter." Evidently, the vigilance and alacrity of the Noticee manifests itself in the official language of SEBI set out in terms of the SEBI KSBL Orders.

77. On December 2, 2019, the Noticee temporarily suspended KSBL and issued it a show cause notice to explain why appropriate disciplinary action should not be taken against it. KSBL challenged the temporary suspension before the Member and Core Settlement Guarantee Fund of the Noticee, which set aside the appeal vide order dated December 6, 2019.

78. Thereafter, the Noticee also forwarded the forensic audit report submitted by E&Y to SEBI on January 15, 2020. On November 23, 2020, the Noticee declared KSBL to be a defaulter and expelled it from its platform.

79. Thereafter, vide emails dated January 8, 2020 and July 21, 2020, SEBI sought certain information from the Noticee in order to ascertain the due diligence carried out by stock exchanges in respect of KSBL pursuant to the Enhanced Supervision Circular. The Noticee submitted this information to SEBI vide emails dated January 15, 2020 and August 7, 2020.

80. In view of the aforesaid broad obligations which NSE had and which have been performed in spirit of law, it is submitted that these obligations are primarily like a quasi-regulator and not a guarantor. It's not that a Stock Exchange is to be held liable vicariously or as a guarantor, should a member or broker do something wrong. If a member violates the law, there is separate action taken against it and therefore the charge against NSE has to be viewed from the lens of requisite due-diligence.

81. NSE carried out a reasonable standard of due-diligence as a reasonable person would employ in a given situation and hence, the conduct of NSE will lead to a

conclusion that it cannot be said to have been guilty of violating the circulars as long as it is shown from the inspections carried out by NSE that reasonable due-diligence had been exercised and that the standard of reasonable person was attained. Hence, **it** is relevant to consider each allegation from this point of view as mentioned herein below;

82. NSE acted with reasonable diligence while inspecting KSBL: It is pertinent to view the aforesaid allegations no. 1 and 2 from the standpoint of due-diligence which has been observed by NSE as a part of all its inspections. It is submitted that based on SEBI guidelines, NSE conducts a routine inspection of its trading members every three years. However, based on certain established risk assessment criteria, if a member is categorized as high risk, then NSE undertakes an annual inspection of such members, based on applicable SEBI guidelines. It may be noted that there is no specific guidance by SEBI on the exact manner in which inspections must be conducted, and these are usually carried on by NSE in exercise of its quasi regulatory and oversight responsibilities.

83. In the course of these inspections, NSE examines a broker's compliance based on an internal inspection checklist, in terms of which sample data on aspects such as margins, settlements, pledging, etc. is reviewed. In so far as pledging is concerned, NSE would inspect demat statements of those accounts that were reported to NSE by a broker in order to verify whether client securities have been pledged from those accounts.

84. For the present proceedings, it is submitted that the inspection carried out in 2016 is of utmost importance. Accordingly, it is submitted that in line with the above practice, NSE would undertake regular inspections of KSBL. In one such inspection conducted in October 2016, for the period September 1, 2015, to August 31, 2016, NSE verified books and records of KSBL and based on the demat statements submitted by KSBL. It did not observe any pledging of client securities and no other records made available to NSE, including routine filings made by the broker at that point in time revealed any suspicious pledging activity. However, at this stage, for the first time, NSE observed that KSBL had provided corporate

guarantees amounting to Rs. 1917 crores towards credit facilities availed by its subsidiaries. Further, NSE also observed that KSBL had raised funds by issuing commercial paper to banks amounting to Rs. 370 crores and loans & advances given by it to associates amounted to Rs 110.21 crores, resulting in negative net worth of Rs. 79.75 crores.

85. Accordingly, to aid in a more comprehensive review, NSE pro-actively sought information from depositories on January 2, 2017, to analyse if there had been any pledging of client securities by KSBL from all their demat accounts during the past 12 months. It is pertinent to note that even though there was no regulatory requirement of obtaining the pledge data from depositories, NSE proactively initiated this request. However, this information was not provided by the Depositories to NSE in view of the SEBI letter dated February 21, 2006 (SEBI Letter) which reads as follows:

> *"As you may be aware, currently data regarding off market transactions above 100,000 shares and information on beneficial owners whose holding crosses 5% or beneficial owners who hold more than 5% and transferred 2% or more is being furnished to SEBI by the depositories on a monthly basis and the same is forwarded to BSE and NSE by SEBI The issue was reviewed in the weekly surveillance meeting held on February 6, 2006.*
>
> *As the data is required only in the course of investigations the stock exchanges have suggested that they would prefer seeking relevant information from the depositories on a case-to-case basis for their investigation cases or analysis. You are therefore requested to provide the requisite information to BSE and NSE as and when required by them and intimated to you directly by them. The information may be directly provided to the stock exchanges without routing the same through SEBI*
>
> *You are requested to take necessary action to ensure that a system is in place with immediate effect, for transmission of data from the depositories to the stock exchanges in the manner described above."*

86. Citing the above letter issued by SEBI, NSDL clarified that in terms of the SEBI Letter, SEBI "*had advised depositories to share with stock exchanges data pertaining to off- market transfers of beneficial owner account holders only and not related to Trading Member*". The stance of the depositories was that the Depositories were not free to share information outside the framework set out in the SEBI Letter. Hence, there is no question of NSE being accused of not drawing SEBI's attention to the interpretation of the SEBI Letter. Neither did SEBI direct the Depositories to provide information nor was there any clarification forthcoming. SEBI did not intervene to say that the stance of the Depositories was wrong, and SEBI did not direct the Depositories to provide the information, clarifying the SEBI Letter. Therefore, the allegation that NSE did not escalate the matter to SEBI is not tenable. In fact, it is a matter of record that SEBI was kept informed, and SEBI did not intervene.

87. In parallel with respect to the issue of KSBL's operations, NSE indeed wrote to SEBI on March 01, 2017, apprising them on the afore-mentioned concerns. In response thereto, on March 10, 2017, SEBI took the view that nothing is alarming at the moment and hence, indicated that NSE should fructify its analysis and keep SEBI informed.

88. NSE continued its inspection of KSBL and pro-actively updated SEBI regarding its correspondence with KSBL and its findings vide its emails dated August 21, 2017 and February 14, 2018. Hence, it is submitted that SEBI was kept informed at all times of what NSE was doing, what they were investigating and the fact that it was being placed before the disciplinary committee of NSE. After following the prescribed process under law, necessary action was taken against by NSE in March 2018 against KSBL, for extending corporate guarantees, including imposition of a penalty of INR 25 lakhs. NSE also directed that KSBL immediately close outstanding corporate guarantees and submit relevant proof thereof including a certificate from a chartered accountant confirming compliance with the above.

89. On September 22, 2017, NSE wrote to NSDL once again seeking details of securities pledged by some key trading members, including KSBL from their clients' accounts. It is noteworthy that SEBI was copied on this email to NSDL which well indicates that SEBI was aware of the unavailability of pledge related information with NSE. Therefore, to suggest in a penalty proceeding that NSE would be punished for not informing SEBI about such interpretation would be untenable.

90. In its response dated October 5, 2017, NSDL replied to NSE alone expressing its inability to share such information on account of the SEBI Letter.

91. SEBI was well aware of the fact that stock exchanges did not have access to data from depositories. In fact, the exchanges have repeatedly discussed this with SEBI in various joint meetings held between SEBI and the MIIs. During the joint meetings held on July 12, 2018 and September 28, 2018 for offsite supervision and standardization of books of accounts/records, SEBI itself agreed to reconcile holding data between exchanges and depositories and share mismatch reports since it was clearly known that stock exchanges did not have any means to access the records of depositories and undertake the reconciliation themselves.

92. It is abundantly clear from the above that NSE did not have vital information pertaining to pledge related data for the purpose of conducting supervision and examination of KSBL, and that SEBI was always aware of the same. When the depositories reverted with the refusal, it was evident that they did so in reliance of their reading of the SEBI Letter, which fact was brought to SEBI's attention, without any intervention by SEBI.

93. In particular, since the SCN has made a particular claim about a particular demat account, on that demat account, it is submitted that the Impugned Demat Account was a BSE Tagged Account.

94. It is submitted that following certain compliances introduced vide SEBI Circular dated September 26, 2016, trading members began reporting all their existing demat account numbers to stock exchanges. Stock exchanges also received a list of such demat accounts from depositories to enable verification of compliance by the stock brokers.

95. Hence, NSE started reconciling these data sets and found that over 5000 demat accounts pertaining to 1100 active trading members had not been reported at all. Out of these 5000 demat accounts, it was discovered that 72 account numbers maintained by KSBL had not been reported to NSE thus far, which included the Impugned Demat Account

96. It is relevant to note that NSE sought an explanation for the same in terms of an email dated September 4, 2017. In its reply dated September 8, 2017, KSBL informed NSE that many of these accounts were inoperative, used for the portfolio management operations etc. KSBL expressly also clarified that the Impugned Demat Account was a BSE margin account and had been reported to the relevant exchange. Further, on perusal of the client master details of the said account (as available with depositories), it was evident that the account was opened in the name of "KARVY STOCK BROKING LTD (BSE)" which corroborated KSBL's response. Therefore, there was no reason to further investigate this account, especially in the absence of any red flags or data in relation to the quantum of client securities pledged from the Impugned Demat Account. In short, NSE's institutional response was clear, incisive and reasonable. To initiate penal proceedings because of a subsequent discovery of a fraud by KSBL and that too due to investigations by the NSE, is demoralizing, untenable and inappropriate.

97. Throughout 2018 and 2019, based on an initiative introduced at SEBI, there were multiple communications between SEBI and MIIs relating to automation of inspection, running of pilot program for reconciliation of broker reported securities balances with actual balances held by the depository, standardization of books, data sharing between exchanges and depositories. In these meetings it was

discussed and made clear that stock exchanges did not have access to the depository records.

98. On July 12, 2018, SEBI, NSE and BSE held a meeting on joint inspections of brokers. The minutes of this meeting record SEBI's responsibilities regarding reconciliation with respect to inspection of all brokers as under, "SEBI to send the Securities Holding Mismatches Data at the ISIN level to Exchanges to start their off-site supervision based on this methodology (Reconciliation of securities holding data/standardized RoS (at ISIN level) provided by the broker vis-a-vis depository data)."

99. Accordingly, based on the above decision, SEBI undertook a reconciliation exercise at an aggregate broker level, which essentially matched the data uploaded by the broker to the exchanges (a practice that commenced from January 2019) with the data received from depositories. Consequently, the regulator reviewed this data for a number of brokers, including KSBL, and upon identification of security balance mismatches, shared the mismatch report with NSE in April 2019. Accordingly, it is submitted that until this point of time, despite the exercise of due-diligence, NSE had no reason to either investigate any further as it did or to raise any alarm with SEBI on mismatch.

100. As and when NSE received this report, NSE took up these mismatches with the concerned brokers including KSBL, which submitted that it had incorrectly recorded the securities in its back office and is in the process of reconciling the same. It was only after NSE persisted with KSBL that for the first time, KSBL shared data regarding Impugned Demat Account, i.e., demat account number IN300394- 11458979 (named as KARVY STOCK BROKING LTO -BSE). However, while doing so, KSBL deliberately misreported the holdings as free balance and not pledged securities.

101. Further, on May 30, 2019, a joint meeting was held between MIIs and SEBI, where stock exchanges explicitly requested for access to depository data for broker

inspection. Accordingly, vide email dated July 4, 2019, SEBI directed the depositories to allow stock exchanges such access. The minutes specifically note that SEBI would perform a reconciliation of securities at the client level and share mismatch reports with NSE and BSE, who would in tum ascertain the reasons for mismatches. Therefore, it can be reasonably inferred that the primarily responsibility remained with SEBI to do the reconciliation.

102. Even after the directions from SEBI during the meeting held in May 2019 and its subsequent reminder mail on July 04, 2019, CDSL provided the access to NSE only in the month of September 2019. NSDL, on the other hand, has, after multiple follow-ups, sent details of their online portal to the NSE inspection team, only in the month of June 2020.

103. Subsequently, in the month of June 2019, SEBI also undertook a client-level reconciliation of security balances as on May 16, 2019 and shared the details of 23109 instances of client-level mismatches amounting to Rs. 138 crores with NSE on June 25, 2019. Based on this, explanations were sought by NSE from the concerned Members including KSBL. However, KSBL, had failed to give explanation for all the instances shared, in-spite of multiple follow-ups.

104. Thereafter, on August 1, 2019, NSE also organized a meeting with the MD/CEO of KSBL to understand the reasons for the mismatches. In response, NSE was informed that the mismatches occurred on account of incorrect reporting of the weekly holding data which occurred due to a software issue and therefore, KSBL sought additional time to justify the mismatches.

105. In any case, given the significant concerns that were emerging in respect of KSBL's functioning, NSE suo-motu initiated a limited purpose inspection focused on the mismatch at the registered office of KSBL on August 19, 2019. NSE promptly took the lead and alerted SEBI on August 27, 2019 and September 3, 2019.

106. Basis the concerns arising from the limited purpose inspection as stated above, NSE made a request to NSDL to share pledge related information regarding demat accounts held by KSBL. Following, NSE's request, NSDL shared pledge related information with NSE on September 06,2019.

107. An analysis of this information along with the books and records of KSBL by NSE is what ultimately led to the discovery of the grave wrongdoings at KSBL's end i.e., KSBL had pledged client securities worth INR 2873.82 crores with banks/NBFCs as on September 11, 2019 and had raised funds to the tune of INR. 851.43 crores.

108. In summary, we submit that it is incorrect to state that NSE raised issues only in May 2019. It is evident from the records that NSE was consistently updating SEBI and interacting with them in relation to mismatches. It is submitted that the intensive efforts of NSE were instrumental in unearthing the fraud and active concealment perpetrated by KSBL.

109. Subsequently, NSE promptly alerted other MIIs and requested them to join the inspection to examine the matter further to enhance the speed and scope of the inspection, in view of the grave findings identified by NSE. Hence, a joint visit was conducted by all the MIIs- NSE, BSE, CDSL and NSDL along with SEBI on September 16, 2019 and October 19,2019.

110. The KSBL fraud was discovered due to the proactive approach of NSE and prompt co- ordination between NSE and SEBI. All actions taken by SEBI against KSBL are premised on the reports given by NSE to SEBI. This is evidenced by SEBI's own ad- interim ex-parte order dated November 22, 2019, as explained below. It would therefore, be untenable for SEBI as a regulator to hold that there was any lack of diligence on part of NSE since, in the instant matter, NSE inter alia acted as the bona fide 'informant' and was instrumental in unearthing the fraud and active concealment perpetrated by KSBL.

111. In February 2018 and March 2019, regular joint inspections of a number of brokers, including KSBL, were conducted by all MIIs including depositories. For the purpose of these inspections, a defined scope was shared by SEBI with the MIIs, verbally prior to the February 2018 inspection, as evident from the report submitted by NSE to SEBI on February 15, 2018. This division of responsibilities was later formalised by SEBI via its email on September 24, 2018, setting out general guiding principles for inspection of intermediaries.

112. In terms of this, NSE was only required to examine matters relating to margin reporting, RBS, KYC/PMLA compliances, position limits and investor grievance mechanism in accordance with the prescribed inspection scope as mentioned above.

113. Specifically, the responsibility to verify pledge related information was allocated to SEBI and/or depositories in terms of the defined scope of work. However, both SEBI and the depositories were unable to identify any alerts with regard to pledging in the Impugned Demat Account, in spite of the fact that securities were pledged from that account.

114. Since NSE did not have any information/alert from the depositories regarding the pledging in the DP accounts of KSBL, there were no reasonable grounds for NSE to suspect any irregularity in this regard based on the submission made by KSBL. Further, since the Impugned Demat Account was a BSE tagged account, it was understood by NSE that the same would have been examined by BSE.

115. It is our respectful submission that NSE acted in good faith and in full compliance of the practice existing at the time. NSE did not disregard the information provided by NSDL and took adequate steps to seek reporting of hitherto unreported DP accounts of the brokers.

116. If indeed depositories had noticed securities pledged from KSBL's DP accounts; we submit that it could have alerted the exchanges and provided information so that transactions could have been examined by the relevant exchange.

117. Also, it is submitted that the allegation around the Impugned Demat Account is wholly premised on hindsight bias and will therefore not stand in law.

118. In view of the above, it is submitted that by issuing the SCN and Supplementary SCN, is also not correct because there was huge involvement of SEBI in this matter and that that SEBI must take share of it's responsibility also. Without prejudice, it is submitted that SEBI was very well aware about the entire process being followed by NSE and also never interceded, even after it knew that information was available with depositories. Further, SEBI's own correspondence reflects that pledge related matters will be primarily looked into by SEBI as it is over- arching regulator. Accordingly, it is submitted that NSE has performed its duties with reasonable care and due-diligence and the records as relied hereinabove, will bely the allegations which are fairly vague and generalised.

119. In support of our submissions as regards adequate due-diligence having been followed by NSE, reference is placed to an order passed by the Hon'ble Supreme Court in the matter of Chander Kanta Bansal vs Rajinder Singh Anand, where the Hon'ble Supreme Court has placed reliance on the following definitions of 'due diligence':

"I 0... The words "due diligence" has not been defined in the Code. According to Oxford Dictionary (Edition 2006), the word "diligence" means careful and persistent application or effort. "Diligent" means careful and steady in application to one's work and duties, showing care and effort. As per Black's Law Dictionary (English Edition), "diligence" means a continual effort to accomplish something, care, caution; the attention and care required from a person in a given situation. "Due diligence" means the diligence reasonably expected from, and ordinarily exercised by, a person who seeks to satisfy a legal requirement or to discharge an obligation. According to Words and Phrases by Drain- Dyspnea (Permanent Edition 13A) "due diligence", in law, means doing everything reasonable, not everything possible. "Due diligence" means reasonable diligence; it means such diligence as a prudent man would exercise in the conduct of his own affairs. It is clear that unless the

party takes prompt steps, mere action cannot be accepted and file a petition after the commencement of trial ... "

120. In fact, it may be noted that SEBI itself, has applied the test of reasonable person as was observed by Hon'ble SAT in the matter between Sharedeal Financial Consultants Private Limited vs Chairman, SEBI:
"Due skill, care and diligence" has not been defined in the Act or in the regulations, obviously for the reason that it is not amenable to a precise definition. Due skill, care and diligence, to a larger extent is a matter of subjectivity. However, according to the enquiry officer " Due skill and care as used in clause A (2) of Schedule II of SEBI (Stock Brokers and Sub Brokers) Regulations, 1992, would mean, at least such care and skill as a man of ordinary prudence would exercise under similar circumstances. "He has applied the said test while assessing the conduct of the Appellant."

121. It is further submitted that, thereafter, a forensic audit was also commissioned by NSE, in consultation with SEBI and jointly with other MIIs to identify the wrongdoings of KSBL. For the purpose of this audit, NSE worked hand-in-hand with the forensic auditor, Ernst & Young, and explained to the auditor how NSE detected the misutilization of funds raised by KSBL by pledging clients' securities, collected approximately 50GB of data from the software systems of KSBL, collated all the bank statements of KSBL's 174 banks accounts and sent out requisitions to KSBL for information required for the purpose of forensic audit. The findings of the forensic audit culminated into a report which was forwarded by NSE to SEBI on January 15, 2020.

122. It is submitted that the Noticee fully complied with its obligation to exercise due diligence and oversight in terms of the Enhanced Supervision Circular and all other applicable legal framework.

123. Placing reliance on the observation of the Hon'ble Supreme Court in the above matter, the Hon'ble Securities Appellate Tribunal (SAT) in Almondz Global

Securities Limited v. SEBI ("Almondz Securities") while discussing the scope of 'due diligence' to be exercised by merchant bankers, made the following observation:

"52. This takes us once again to the very principle of due diligence. The diligentia that is expected of a Merchant Banker in a given case is such care as would be taken by a reasonable person. It would be the diligence or care a reasonable person would employ in a given situation. Degree of such care or diligence would undoubtedly, differ from case to case and no straight- jacket formula can be prescribed by law. As already noted the principle of due diligence is by nature. incapable of being defined in precise terms and has therefore been left open or flexible to be determined in each case as per the existing acts and circumstances. Hon'ble Supreme Court in the case of Chander Kanta Bansal Vs. Rajender Singh Anand reported in MANU/SC/7310/2008 : 2008 (5) SCC 117 held that due diligence in law means reasonable diligence and doing "everything reasonable, not everything possible".

124. In this regard, it would be relevant to refer to Bibby Cheshir v. Golden Wonder Ltd where the Queen's Bench, England concluded that 'due diligence' means taking all reasonable precaution and if such precaution has been taken, then a person cannot be accused of lack of diligence.

125. Further, the Hon'ble SAT, in the matter between Mehta Equites Limited v. AO, SEBI ("Mehta Equities"),17 has held that a stock broker cannot be found guilty of not exercising due diligence if he had not aided or abetted any malpractice executed by the sub-broker for the client.

"The adjudicating officer then went on to hold that the appellant "being a registered broker has failed to maintain high standards of due diligence. " He, therefore, found that the appellant failed to exercise due diligence and was guilty of violating Clause A(2) of the Code of Conduct. Accordingly, by the impugned order he imposed the aforesaid penalty. Hence this appeal.

3*. We have heard the learned counsel for the parties who have taken us through the record and the impugned order. In view of the finding that the appellant had not aided and abetted Crystal. the sub-broker in regard to manipulation and malpractice as alleged we do not find any ground to hold the appellant guilty of not maintaining "high standards of due diligence". When the appellant did not aid and abet the sub-broker, it is obvious that the sub-broker acted on its own and executed manipulative trades on behalf of the clients. In these circumstances. we cannot uphold the findings that the appellant was guilty of not exercising due diligence. It is clear from the record that the manipulative trades were executed by the sub-broker only on three trading days. If the sub-broker has played mischief without the appellant knowing about it the charge of not exercising due diligence cannot stand."*

126. In view of the above, it must be noted that the settled legal standard for due diligence is premised on whether the entity concerned did everything reasonable to discharge its legal obligation and not everything possible. Further, the logic and rationale applied by the Hon'ble SAT in Mehta Equites, squarely applies to this case as well. As long as the Noticee has not aided or abetted malpractice on the part of its trading member, it cannot be made guilty for failure to maintain a very high standard of due diligence.

127. Furthermore, in Imperial Corporate Finance & Services Private Limited v. SEBI the Hon'ble SAT has stressed on the requisite for a higher degree of proof and a higher standard of preponderance of evidence to demonstrate or level a charge for lack of due diligence. It has laid down as follows:

" ....No other pronouncement of any court has been brought to our notice on the definition of 'due diligence' but it can be safely said that lack of due diligence should run from the facts of each case and ultimately there can be no hard and fast rule as to what constitutes lack of due diligence. It depends entirely on the facts of each case. We however hold that before any person is found to have violated the concept of 'due diligence' there must be an enquiry and the finding must be sustained by a higher degree of proof than that required in a civil suit yet falling

short of the proof required to sustain a conviction in a criminal prosecution. There must be convincing preponderance of evidence (see AIR 1984 SC 110). This we state because a Lead Manager if found guilty of lack of due diligence can suffer penal consequences which could adversely affect his business."

128. In view of the above, it is clear that the standard of diligence applicable would be premised on the test of reasonableness. Further, the obligation to conduct due diligence has to be enquired and found out on a higher degree of preponderance of probabilities taking into account the facts and circumstances.

129. The allegation that the Noticee did not report non-sharing of data by the depositories to SEBI is devoid of any merit. It is submitted that neither did the Noticee follow a casual approach nor did it limit its scope for verification of client securities in case of KSBL in violation of the Relevant Circulars by not approaching SEBI when the depositories were reluctant to share pledge details with regard to the demat accounts of KSBL in 2017.

130. In this regard, it may be noted that the Noticee acted in utmost good faith in the fulfillment of all its obligations. The onus to verify the pledge related information was not on the Noticee, but rather, on the other MIIs given that the Noticee was precluded from accessing such data by virtue of a direction of SEBI, as set out in its letter dated February 21, 2006.

131. From the facts set out above, it is apparent that the Noticee already adhered to very high standards of due diligence. It regularly conducted inspections of its members in accordance with its obligations set out under the applicable legal framework. Additionally, the Noticee had adopted multiple measures and systems in addition to the regulatory prescribed requirements to conduct broker inspections effectively and efficiently.

132. Further, when the Noticee conducted an inspection of KSBL in FY 2017-18, it independently verified the books and records of KSBL used for carrying out

transactions on NSE, including the pledge verification and took requisite action, where discrepancies were observed.

133. In 2019, when the Noticee identified certain discrepancies in its examination of KSBL in June and July 2019, it promptly initiated a limited purpose inspection, alerted SEBI and other MIIs, conducted a joint inspection, submitted multiple reports to SEBI in respect of the concerned matter, appointed a forensic auditor and regularly liaised with both SEBI and KSBL to protect the interests of investors in the securities market. The diligence of Noticee is evident in terms of the SEBI KSBL orders, which have been passed basis the reporting and inspection conducted by the Noticee.

134. From the above, it is evident that the Noticee has undertaken all measures, activities and steps to independently verify the information and satisfy itself as to the nature of such information. The Noticee's actions are such as may be reasonably expected from or ordinarily exercised by a reasonable and prudent man under the circumstances existing at the time when the actions were undertaken.

135. Therefore, it is submitted that the Noticee is in complete and full compliance with its obligations to exercise due diligence under the Relevant Circulars.

136. The Market Regulator was aware about non-sharing of pledge information by depositories with stock exchanges. SEBI was well aware of the fact that stock exchanges did not have access to data from depositories. In fact, the exchanges had repeatedly discussed this with SEBI. This is evinced from the initiative introduced by the WTM at SEBI through 2018-19, where there were multiple communications between SEBI and the MIIs including regarding the sharing of data between exchanges and depositories.

137. The Noticee had copied SEBI on its email to the depositories seeking pledge related information in 2017. Therefore, the Noticee kept SEBI abreast at all times regarding its requisitions and need for information in lieu of its broker inspections.

138. In view of the above, it was also well known that in the absence of details regarding pledging of client securities from the depositories, the Noticee was generally relying on the submissions made by its trading members, including KSBL, as a part of its regular inspections.

139. In fact, during SEBI's joint meetings held on July 12, 2018 and September 28, 2018 for offsite supervision and standardization of books of accounts/ records, SEBI itself agreed to reconcile holding data between exchanges and depositories and share mismatch reports since it was clearly known that stock exchanges did not have any means to access the records of depositories and undertake the reconciliation themselves. In practice also, SEBI reconciled the holding data and shared mismatch reports with the Noticee, which then had to be further examined by the Noticee. In the very same meeting of July 2018, SEBI also decided to draft a data sharing agreement between the stock exchanges and depositories.

140. The allegation contained in the Notice that the Noticee first informed SEBI about unavailability of pledge information in May 2019 during the "2nd review meeting - Reconciliation of holding statements with depository data" is incorrect since the minutes of that meeting itself makes a reference to an earlier review meeting with SEBI, held on April 9, 2019.

141. Further, pursuant to the implied scope of examination for the joint inspection, it was presumed that the responsibility of verifying the pledge related information would be borne by SEBI since exchanges did not have access to such information and were not positioned to exercise such functions.

142. In view of the above, it is submitted that since depositories were precluded from sharing pledge related information of client securities with stock exchanges by

virtue of a SEBI circular, and it was well known that there existed information asymmetry between stock exchanges and depositories on account of non-sharing of data, which apparently impaired the ease of carrying out broker inspections, it cannot be alleged that the Noticee should have immediately approached SEBI when the depositories were reluctant to share information with the Noticee in 2017. An allegation of failure to inform the regulator in case of non-sharing of data by depositories can be fastened on the Noticee only in those circumstances where the regulator is unaware about it. To the contrary, the regulator is in fact the progenitor of the restriction cast upon the depositories and therefore, clearly aware of the information asymmetry that existed between stock exchanges and the depositories.

143. In addition to the submissions made above, it is submitted that the Noticee acted responsibly in the examination of its trading members and reconciliation of their demat accounts, including in respect of KSBL. On November 14, 2017, the depositories shared a list of demat accounts with the Noticee. The list contained one demat account no. 11458979, which was one of 5000 demat accounts relating to approximately 1100 members of the Noticee.

144. In line with how regulatory inspections are ordinarily carried out, the Noticee would seek information from its trading members and verify it against the material available on record. The Noticee would examine compliances relating to pledging of client securities to assess the possibility of any misappropriation of clients' funds or securities by the stock broker.

145. As the Noticee did not have access to DP records, it would primarily rely on the declarations made and records submitted by its trading members. However, none of the records submitted by KSBL, including statement of holdings from the depository, contained any information that appeared to the Noticee as a red flag or suspicious or that even indicated to the Noticee that client securities had been pledged by KSBL from account no. 11458979 to raise funds.

146. At this juncture, it is important to note that account no. 11458979 was not specifically reported as a mismatch account, and in the absence of any red flags or indication of pledge or indeed the amount of client securities held in the account, the Noticee did not have any reason to suspect that client securities were pledged from that account.

147. In fact, the list also contained 71 other demat accounts of KSBL, which were unreported to the Noticee. Hence, the Noticee immediately wrote to KSBL regarding the mismatches that it had identified, which go on to indicate the prompt, efficient and bonafide approach maintained by the Noticee throughout. In response, KSBL informed the Noticee that the concerned demat accounts pertained to other exchange's margin account and was reported to the respective stock exchange.

148. Prior to 2019, all stock exchanges including the Noticee conducted exchange-wise inspections of books and records of its members in order to avoid any duplication of examination and enforcement actions by the exchanges and to reduce the supervisory burden on the members. Further, since account no. 11458979 was a BSE tagged account, NSE reasonably believed that the onus was not upon it to conduct an inspection and examination of the same, in view of the manner in which responsibilities were apportioned in practice.

149. In fact, based on the consistent follow up with the trading members to report such demat accounts to the Noticee, currently there are a considerably insignificant number of accounts which are yet to be reported to the Noticee.

150. It is worth noting that KSBL actively sought to conceal account no. 11458979 from the Noticee, which it used to pledge clients' securities.

151. The facts alleged in the Notice seek to impose liability on the Noticee for following a casual approach and for failure to comply with its due diligence standards, despite the fact that KSBL actively concealed its misconduct from not only the

Noticee but also all MIIs and the Regulator itself in spite of thorough checks, supervisions, reporting and monitoring systems in place.

152. Therefore, in view of the above, it is submitted to SEBI that the Noticee acted responsibly, exercised prudence and took due care and caution at all times in the discharge of its obligations. The Noticee fully complied with the applicable legal framework. It proactively took measures to protect the interests of investors in the securities market by independently verifying and satisfying itself as to the information received from the trading members and by exercising continuous oversight.

153. SEBI must not proceed against the Noticee with the benefit of hindsight: It is submitted that the allegations levied in the Notice are rooted in and premised on the benefit of hindsight. The nature of inspection carried out by the Noticee was adequate and sufficient to meet its obligations under the Relevant Circulars. However, the allegations in the Notice expect that additional and unconventional measures should have been adopted by the Noticee only because KSBL's default was of a significant size and magnitude.

154. It is useful to understand that hindsight bias is the tendency for people with knowledge of an outcome to exaggerate the extent to which they believe that outcome could have been predicted. The language of the Notice clearly suggests that the allegations against the Noticee are founded in hindsight.

155. The Hon'ble SAT, while considering the appeal of the auditor against the order of SEBI in Price Waterhouse & Co & Ors v. SEBI in relation to, inter alia, minimum level of diligence in connection with the matter of Satyam Computers, referred to the following judgments whilst warning against hindsight bias:

"73. In Bolam vs Friern Hospital Management Committee [1957] 1 WLR 582 it was held:-

"No matter what profession it may be the common law does not impose on those who practice it any liability for damage resulting from what in the result turn out to have been errors of judgment unless the error was such as no reasonably well-informed and competent member of that profession could have made:"

156. In Eckersley & Others vs. Binnie & Others, the Court of Appeal (Civ Div) held:-
"*In deciding whether a professional man has fallen short of the standards observed by ordinarily skilled and competent members of his profession, it is the standards prevailing at the time of his acts or omissions which provide the relevant yardsticks. He is not as the learned Judge in this case correctly observed (at p. 20H of his judgment) to be judged by the wisdom of hindsight. This of course means that knowledge of an event which happened later should not be applied when judging acts and omissions which took place before that event; a very relevant consideration here because knowledge of the Abbeystead catastrophe has (as the evidence shows) had a profound educational effect ......* ""

157. In *Re Citigroup Inc. Shareholder Derivative Litigation*, the Delaware Chancery Court strictly warned against the consequences of hindsight bias or alternatively put, evaluation by adjudicatory bodies with the benefit of hindsight. In this case, the plaintiffs sought to impose "oversight liability" on the directors of Citigroup Inc. for failure to monitor the corporation's exposure to excessive risk in relation to the problems in the subprime mortgage market, which was disregarded by the court on account of hindsight bias.

158. In light of the facts and judicial precedents cited above, it is submitted that the Noticee acted responsibly in the inspection and reconciliation of the accounts of its trading members, including KSBL during FY 2016-17 and 2017-18. It is also urged that SEBI should examine the facts as they existed at the time of the incident and not let subsequent events which were triggered by KSBL's deliberate and contumacious conduct, impact its assessment of the Noticee's compliances or bona fides.

159. Response in respect of allegation 3 that NSE failed to notice that KSBL's demat accounts were not tagged as per the nomenclature prescribed under law is as follows:

160. Noticee submit that pursuant to the Enhanced Supervision Circular, trading members are required to tag their demat accounts with depositories in the prescribed manner and report the same to exchanges. For example, "NAME OF STOCK-BROKER-CLIENT ACCOUNT" or."NAME OF STOCK BROKER-POOL ACCOUNT", etc.

161. The primary responsibility of tagging DP accounts lies with the members and a stock exchange can only monitor whether this process has been done or not.

162. In the absence of any information about the details/nature of the account and failure by the depositories to furnish details of the pledge accounts, NSE was not in a position to comment on the correctness or accuracy of the nomenclature of the demat accounts.

163. As stated above, these deadlines were postponed by SEBI from time to time. Besides, NSE cannot be in a position to answer a charge based on a provision that did not cast any specific obligation or a specific standard required of it. Merely because a provision uses the phrase "ensure" it would not follow that it would be a guarantee that brokers would become compliant, with any failure leading to an automatic allegation of failure by the stock exchange.

164. Pursuant to the Enhanced Supervision Circular, trading and clearing members are required to tag their demat accounts with depositories in the prescribed manner and report the same to exchanges. Whilst the primary responsibility of tagging of DP accounts lies with the members, exchanges are required to exercise monitoring functions.

165. When the reconciliation process began as per paragraph 2.3.8 of the Enhanced Supervision Circular, the Noticee identified a list of 5000 accounts that had not been reported by the brokers for a variety of reasons including that DP accounts were opened for trades on another exchange, DP accounts held PMS stock, etc.

166. In the absence of any information about the details/nature of the account and failure by the depositories to furnish details of the accounts on being asked, the Noticee was not equipped to examine the correctness or accuracy of the nomenclature of the demat accounts during its inspection in FY 2016-17. Additionally, since this information was not available with stock exchanges, it was expected that the monitoring and oversight functions would have been carried out by the depositories in their capacity as the concerned Mil.

167. Accordingly, it is submitted that the Noticee should not be penalized for KSBL's failure to ensure tagging as per the nomenclature prescribed in terms of the Enhanced Supervision Circular, since it was impossible for it to comply with the same, in the absence of information.

168. Response in respect of allegation 4 that NSE failed to take action based on the alerts received from depositories in terms of Early Warnings Circular, is as follows:

169. At the outset, none of the alerts shared by NSDL indicate any pledging of securities by KSBL. In any case, NSE has specifically dealt with all alerts shared by NSDL to demonstrate why it did not observe irregularities based on the alerts that it received from NSDL. The limited information shared by NSDL with NSE did not contain the ISIN wise balances and covered only off-market transfers between client accounts to the broker's in the absence of any further details, it was impossible for NSE to identify any irregularity in the said account. Also, the demat account from which securities were transferred into the Impugned Demat Account, was reported as a collateral account by KSBL.

170. It may be noted that the alerts generated by clearing corporations and/or depositories may sometimes also be inaccurate, particularly in situations where the clients of a trading member have opted to maintain a running account, off-market transfer of securities between the client's beneficiary account and the brokers' pool account, etc. NSE has flagged the practical difficulties associated with reviewing such alerts in its meeting held with SEBI on January 24, 2019 and vide email dated March 20, 2019.

171. The allegation that the Noticee has failed to take appropriate action against KSBL despite reminders from NSDL is devoid of merit. It is submitted that the provisions more specifically para 2 and para 5 read with para 8.1 of the SEBI circular which according to SEBI, the Noticee has violated, requires collaborative action on part of the Exchanges, Clearing Corporations and Depositories. The facts indicated below and the action of the Noticee would demonstrate that the Noticee has acted in compliance with the SEBI Circular be it initiating forensic audit, carrying out inspection etc. It is submitted that in light of the actions of the Noticee, the charges in the Supplementary Notice should be set aside.

172. As per SEBI circular dated September 26, 2016 on Enhanced Supervision of Stock Brokers/ Depository participants, transfer of securities between Stock Brokers' client account, individual client's account, Stock Broker's Pool Account and Stock Broker's Collateral Account is permitted. It is pertinent to note that in accordance with the provisions of SEBI Circular, the Noticee on receipt of the information shared by the depositories is required to check for irregularities by way of transfer of client securities (from client accounts) to the own accounts of the Member or transfers to any third party (non-client entities). In so far as off-market transfer intimation shared by NSDL for KSBL during the period from March to October 2019 (for transactions executed between February to September 2019), NSE observed that transfers had been made from the Impugned Demat Account number IN300394 - 11458979 to other 7 demat accounts, details of which are enumerated in the below table:

Date of Email	Particulars	NSE Observations
March 11, 2019	NSDL shared 345 instances of off market transfers during February 2019.	The Noticee observed that out of the said 345 instances, in 331 instances transfers were made from Impugned Demat Account number to the collateral account of KSBL and for the remaining 14 instances transfers had been made to 4 registered clients of KSBL. In view of the aforesaid, no irregularities were observed by the Noticee.
April 15, 2019	NSDL shared 367 instances of off market transfers during March 2019.	The Noticee observed that out of the said 367 instances, in 347 instances transfers were made from Impugned Demat Account number to the collateral account of KSBL and for the remaining 20 instances transfers had been made to 4 registered clients of KSBL In view of the aforesaid, no irregularities were observed by the Noticee.
May 17, 2019	NSDL shared 278 instances of off market transfers during April 2019.	The Noticee observed that out of the said 278 instances, in 259 instances transfers were made from Impugned Demat Account number to the collateral account of KSBL and for the remaining 19 instances transfers had been made to 4 registered clients of KSBL. In view of the aforesaid, no irregularities were observed by the Noticee.
June 14, 2019	NSDL shared 243 instances of off market transfers during May 2019.	The Noticee observed that out of the said 243 instances, in 237 instances transfers were made from Impugned Demat Account number to the collateral account of KSBL and for the remaining 6 instances transfers had been made to 3 registered clients of KSBL. In view of the aforesaid, no irregularities were observed by the Noticee.

July 12, 2019	NSDL shared 178 instances of off market transfers during June 2019.	The Noticee observed that out of the said 178 instances, in 161 instances transfers were made from Impugned Demat Account number to the collateral account of KSBL and for the remaining 17 instances transfers had been made to 2 registered clients of KSBL. In view of the aforesaid, no irregularities were observed by the Noticee.
August 22, 2019	NSDL shared 205 instances of off market transfers during July 2019.	The Noticee observed that out of the said 205 instances, in 204 instances transfers were made from Impugned Demat Account number to the collateral account of KSBL and for the remaining instance transfers had been made to a registered client of KSBL. In view of the aforesaid, no irregularities were observed by the Noticee.
September 20, 2019	NSDL shared 228 instances of off market transfers during August 2019.	The Noticee observed that in all the said 228 instances, transfers were made from Impugned Demat Account number to the collateral account of KSBL. In view of the aforesaid, no irregularities were observed by the Noticee.
October 29, 2019	NSDL shared 147 instances of off market transfers during September 2019.	The Noticee observed that out of the said 147 instances, in 146 instances transfers were made from Impugned Demat Account number to the collateral account of KSBL and the remaining transfer had been made to a registered client of KSBL. In view of the aforesaid, no irregularities were observed by the Noticee.

173. It is relevant to note that, in line with previous guidance issued by SEBI, information shared by NSDL with the Noticee contained the source demat account and target demat account details along with ISIN wise quantity transferred by way of off-market transfer mode and did not contain the ISIN wise balances. In the absence of the list of ISIN wise balances lying in the Impugned Demat Account, it was

impossible for the Noticee to identify any irregularity in the said account. It is relevant to mention here that the demat account in which the securities were observed by the Noticee, to have been transferred from the KSBL's Impugned Demat Account, was reported as its collateral account by KSBL.

174. The underlying objective, as stipulated in the SEBI Circular, for sharing the alert by depositories with stock exchanges on "Transfer of large value of shares through off-market transfers other than for settlement purposes", is to prevent diversion of client's securities and assist with identification of irregularities by way of transfer of client securities (from client accounts) to the own accounts of the broker itself or to third parties. Unlawful pledging of client securities did not form part of such alerts and hence, in the absence of any other alert from depositories on the quantum of pledging of securities in the Impugned Demat Account, the Noticee did not have any information of unlawful pledging of client securities by KSBL.

175. Further based on the alerts shared by NSDL, no further action including surveillance actions as per the SOP decided by MIIs, were required to be taken by the Noticee.

176. Further the Noticee had, in fact, sought KSBL's pledge details from the Depositories in January 2017 and September 2017, in view of certain findings during an inspection conducted in the month of October 2016 for the FY 2016-17 and on the verification of KSBL's Balance Sheet and financial statements. Being a responsible MII, the Noticee also apprised SEBI regarding these findings in terms of letters dated March 01, 2017, emails dated March 07, 2017, August 21, 2017 and February 14, 2018 and sought guidance in the matter.

177. In fact, from the scope of examination shared by SEBI for all joint inspections conducted by the exchanges, depositories and regulators, it is evident that SEBI had decided to verify the area relating to pledges by itself. A joint inspection of KSBL was conducted by SEBI and all the MIIs during February 2018. Noticee was assigned the scope of verification related to actual settlement of client accounts

and segregation of client funds. Review of data related to pledging of client securities was verified by SEBI and depositories.

178. Further a joint inspection of KSBL by all MIIs including Depositories (SEBI, NSE, BSE, NSDL & CDSL) was also scheduled in June 2019 and the same was conducted based on the scope defined and allocated by SEBI to MIIs. It is submitted that even during the said joint inspection, no alerts with regard to pledging in Impugned Demat Account were shared with the Noticee, in spite of the fact that securities worth Rs. 1685 crores were pledged by KSBL with Banks/NBFCs, during Qtr-4 of FY 2018-19, from the Impugned Demat Account. Had Depositories shared the details of pledge information of KSBL during the Joint inspection, the issue of pledging of client securities from the Impugned Demat Account would have been found out. It was only during the limited purpose inspection conducted by the Noticee in August 2019, at the request made by Noticee on September 05, 2019, that the pledge information was shared by NSDL on September 06, 2019 through email.

179. It may be noted that the information which was shared by the Depositories only considered the actual transfer of securities between the client's beneficial owner accounts and trading member's pool account which is only for the purposes of settlement. It is required to be understood that the data shared by Clearing Corporations cannot capture or consider the following cases:
    a) Client securities that are lying with the trading member's client beneficiary accounts as part of the running account which are utilized for meeting the client settlement obligation.
    b) Client securities that are transferred on off-market basis between the client's beneficial owner accounts and trading member's pool account.
    c) Details of auction in cases where client has not paid/received securities from the clearing corporation in the settlement are also not included in the alerts shared with stock exchanges.
    d) The details of actual transfers from/to client's beneficiary account to/from member's pool account matched by the depositories with trade obligation

received from the clearing corporation does not contain the inter depository transfers. This results in further increase in the count of the instances of mismatch in spite of actual transfers of securities between client's beneficial owner accounts and trading member's pool account.

180. In line with the regulatory obligations emanating from SEBI Circular dated December 03, 2009 (applicable during the period covered by this present Supplementary Notice) a client may specifically authorize the stock broker to maintain a running account for securities. Therefore, most members maintain a running account of the clients wherein the securities are retained in the broker's client beneficiary account, instead of actual transfer to the clients. The Noticee has also flagged the practical difficulties associated with reviewing such data in the meeting held with SEBI on January 24, 2019. Reference is also drawn to emails dated March 20, 2019 to SEBI by the Noticee, where the concerns were raised with respect to information of mismatches.

181. Apart from the above, the Noticee had already initiated the monitoring of KSBL based on the concerns noted in the reconciliation exercises undertaken by SEBI in April 2019, May 2019 and July 2019 of the weekly reporting of securities balance. The concerns observed therein were also shared by the Noticee in the joint meeting between stock exchanges and depositories at SEBI on July 05, 2019.

182. Noticee also took the following steps:
   i. In May 2019, SEBI undertook a reconciliation of the client wise, ISIN wise weekly reporting done by members to NSE and shared the mismatch report for the month of April 2019 with the NSE.
   ii. Based on the mismatch report shared by SEBI, the Noticee on May 23, 2019 sought explanation from KSBL. However, KSBL responded that the securities had been incorrectly recorded in their back-office records and were being reconciled. The above information was shared by the Noticee with SEBI in the meeting dated May 30, 2019.

iii. In June 2019, SEBI undertook a client-level reconciliation of security balances as on May 16, 2019 and shared the mismatch alert with the Noticee on June 25, 2019.

iv. Based on the mismatch alert shared by SEBI, the Noticee on June 26, 2019 sought explanation from KSBL. It is relevant to note that KSBL was unable to give explanation for all instances shared despite multiple follow-ups and reminders.

v. As part of its offsite supervision measure in July 2019, the Noticee undertook a reconciliation of the monthly security balances provided as a part of the Enhanced Supervisions provisions for the month of June 2019 with the records of KSBL received from SEBI and observed that shortfall of securities amounting to INR 957 crore in its depository participant account. The Noticee also reconciled the said monthly reporting for the months of May and June 2019 with the weekly client wise, Depository Participant and ISIN wise weekly securities holding reporting done by KSBL and observed that KSBL had reported excess securities holdings to the tune of INR 1196 crores and INR 965 crores respectively in its monthly reporting as compared to weekly reporting.

vi. Thereafter on August 01, 2019, a meeting was called by the Noticee which was attended by the MD and CEO of KSBL at which time it was informed to the Noticee that the mismatches arose due to incorrect reporting of the weekly holding data which was due to software issue at their end and sought additional time for complete response.

vii. Meanwhile, the Noticee also initiated a limited purpose inspection of KSBL's books, operations, records on August 19, 2019.

viii. In view of its observations during the inspection, the Noticee promptly took the lead and suo motu alerted SEBI vide its emails dated August 27, 2019, September 03, 2019 and September 11, 2019. It submitted its preliminary inspection report to SEBI on Sep 22, 2019.

183. It is therefore, evident that the Noticee had already initiated the monitoring of KSBL based on the concerns noted in the reconciliation exercises undertaken by SEBI and NSE even before the alerts were shared by NSDL. It is therefore hereby

submitted that the Noticee has remained in compliance with the spirit of the SEBI Circular.

184. <u>The facts in the notice do not merit imposition of penalty:</u> At the outset, it is submitted that since no contravention has been made out, there cannot be an imposition of any penalty on the Noticee.

185. Further, at the outset, it must be noted that the Noticee performs a variety of quasi-regulatory functions, and accordingly, it is submitted that the Noticee's liability for performance of such quasi-regulatory functions must be reviewed with the lens of such administrative responsibility, including the requirement to exercise oversight over its active trading members to ascertain compliance with relevant provisions of the applicable legal framework. For instance, in the United States, it is settled law that when a stock exchange performs quasi-regulatory functions or such functions as would otherwise have been performed by the market regulator, the exchange will not be open to any liability, the underlying principle being that the stock exchange's exercise of such quasi-governmental functions would be unduly hampered by disruptive and recriminatory lawsuits.

186. In the present case, it is submitted that the Noticee, as a quasi-regulator should not be made liable for a member's failure to comply with applicable law. If SEBI chooses to impose liability for inadequacy in the extent of oversight and vigilance exercised by stock exchanges over its members, despite compliance with all legal obligations, it will create serious legal and litigations risks for and impose an unjustifiably heavy onus on MIIs and open the floodgates to civil and tortious claims being raised against regulators and quasi-regulators such as MIIs. Such an approach, especially in cases where MIIs act in good faith and make best efforts to remedy the egregious market misconduct perpetrated by the intermediary, would be a complete travesty of justice and set an unwieldy judicial precedent.

187. <u>Mitigating Factors:</u> However, without prejudice to any of the submissions above, it is submitted that it is a well-settled principle that the penalty provisions are not to

be mechanically applied. In this regard, reference may also be made to the decision of the Hon'ble Supreme Court in the matter between Siddharth Chaturvedi v. SEBI where, while determining penalty under Section 15A of the SEBI Act, the Apex Court made the following observations:

"*We also find it a little difficult to accept what is stated in paragraph 5 of the judgment. 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 I5A, 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 I5A, 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. What has been done by the appellants here is to fail to adhere to Regulation 13, as alleged in the show cause notice which failure has occurred on three days and consequently has allegedly not been repeated by the appellants anytime thereafter.*

188. In Adjudicating Officer, *SEBI vs Bhavesh Pabari*, the Hon'ble Supreme Court held that the factors laid down in section 15J of the SEBI Act, 1992 are illustrative in nature. Factors other than those can also be considered in mitigating the quantum of penalty sought to be imposed on the Noticee.

189. Further, in Piramal Enterprises Limited vs. SEBI, the Hon'ble SAT held as follows: *"24. ...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. In the absence of any direct or clinching evidence of insider trading or misuse of*

UPSI a reasonable benefit of doubt should be extended to the PEL instead of mechanically imposing a penalty ... "

190. In this context, it is also important to note certain mitigating factors, which have been set out as follows:

    (i) At all times, the Noticee has complied with all its obligations, as prescribed under applicable statutory and regulatory law;

    (ii) The Noticee proactively sought to obtain information from the depositories, and carried out all its inspections regularly and diligently;

    (iii) The Noticee had adequate processes and procedures in place to ensure proper and regular inspections of its members;

    (iv) The Noticee acted as the lead MII in taking multiple actions against KSBL, including meetings with KSBL, limited purpose inspection, joint inspection, appointment of forensic auditor, submitting reports to SEBI, suspension and expulsion, which eventually emerged as the blueprint for the standard operating procedure in case of potential default set out by SEBI vide its circular dated July 1, 2020;

    (v) The depositories were precluded from sharing the concerned data regarding pledging of securities with stock exchanges by virtue of a SEBI letter dated February 21, 2006, and it was well known that there existed an information asymmetry between the MIIs which hindered complete inspection of trading members;

    (vi) KSBL actively concealed certain demat accounts from the Noticee, and could therefore, not be identified in regular inspections by the Noticee; and

    (vii) There were no red flags or serious issues to arouse reasonable suspicion in the mind of the Noticee during FY 2016-17 and 2017-18;

191. KSBL had perpetrated and concealed a market wide illegality, wherein it misused clients' funds and securities, and transferred significant amounts of funds and securities to its group companies. Given the nature of the facts at hand, the Noticee cannot be held responsible for any purported inadequacy in oversight measures and for following a "casual approach" in respect of KSBL.

192. It is submitted that no irregularity has been committed by the Noticee that may attract or call for any penalty. The Noticee has always adhered to high standards of oversight, monitoring and due diligence in furtherance of its obligations and role as a semi-regulator and has acted in good faith throughout this process, consistently prioritizing the interest of investors.

193. As set out above, it is highlighted that the Noticee adopted best practices by initiating a joint inspection by all MIIs and also conducting a forensic audit of KSBL, without any legal requirement to do so. In fact, the process that was followed by the Noticee in respect of KSBL's default went on to become the blueprint for the SEBI's Circular titled 'Standard Operating Procedure in the cases of trading member/clearing member leading to default' dated July 1, 2020. Moreover, the lead taken by the Noticee to protect the interests of market investors and its endeavours to work hand in hand with the market regulator have been recognized across media reports as well.

194. With specific reference to section 15J of the SEBI Act, 1992, it is submitted that:

(i) The Noticee has not committed any act or default which has resulted in loss to investors. Every year, the Noticee inspects thousands of its trading members, in compliance with its legal obligations and with a view to protect the interests of investors in the securities market.

(ii) KSBL's situation is unique and peculiar, in that, KSBL actively concealed its misconduct from not only all MIIs but also the market regulator, despite best efforts to ensure compliance with SEBI's prescribed legal framework.

(iii) During FY 2016-17 and 2017-18, when the Noticee was conducting inspection of KSBL, it would be absurd to argue that its acts were in default of its legal obligations and such that could plausibly result in losses or adversely impact the interests of investors in the securities market. An argument to the contrary can only be taken with the sole benefit of hindsight.

195. In view of the aforesaid submissions, it is submitted that no case has been made out to support the allegations against NSE. NSE's conduct was well within the letter and spirit of the Circulars. Consequently, it is submitted that no penalty should be imposed against NSE, and the SCN and Supplementary SCN should be discharged entirely without any adverse findings.

196. 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

197. 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)** r/w para 2.5 of the Circular SEBI/HO/MIRSD/MIRSD2/ CIR/P/2016/95 dated September 26, 2016 **(2016 circular)** and para 2 of the Circular SMD/SED/CIR/93/23321 dated November 18, 1993 **(1993 circular)**

(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.

(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 r/w para 2.5 of the Circular SEBI/HO/MIRSD/MIRSD2/ CIR/P/2016/95 dated September 26, 2016 and para 2 of the Circular SMD/SED/CIR/93/23321 dated November 18, 1993.**

198. Before going into the merits of the case, I note that the Noticee has contended that the issuance of Supplementary SCN indicates incomplete investigation in the matter, and seems to be purportedly issued post facto to improve the case, and to defeat explanations put forward by Noticee in its reply to the SCN. I note that by the time NSE filed reply to SCN on February 23, 2021, which was received by SEBI on February 24, 2021, SEBI was in receipt of additional information from depositories and clearing corporations in response to ongoing examination in regard to due diligence carried out by MIIs in the matter of KSBL. SEBI had sought information from depositories on February 5 and 8, 2021 in response to which reply was received by SEBI on February 24, 2021. Similarly information was sought from clearing corporation on February 22 and 23, 2021, and reply was received from them on February 23 and 24, 2021. As new facts came to light before SEBI regarding the alerts provided by depositories to exchanges and clearing corporations which had a bearing on the case, and required addition of charges, supplementary SCN was issued in the matter. SEBI cannot ignore new facts which have a bearing on the proceedings, and issuance of supplementary SCN is necessary in order to enable the Noticee to respond to additional facts or charges. Further, sufficient time was given to Noticee to submit its reply to supplementary SCN, which it submitted. In view of the same, the aforesaid contention of the Noticee is not acceptable.

199. Noticee has also contended that the proceedings were initiated with benefit/bias of hindsight. It is a fact that the KSBL wrongdoings were detected and action

initiated by SEBI pursuant to a joint inspection of KSBL by SEBI, NSE and BSE from June 2019. It was found during the joint inspection of KSBL 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. To examine the supervisory role of MIIs in the context of the KSBL wrongdoings is part of regulatory function of SEBI. A failure to detect misutilisation of securities during inspection process by exchanges resulted in delayed detection of large scale misuse of securities, causing loss to investors. SEBI cannot ignore or overlook any such failure once it is brought to its notice. Misuse of client securities by KSBL was identified in September 2019, and in December, 2019 SEBI initiated examination of the due diligence by Stock Exchange in monitoring of compliance of different circulars by KSBL, pursuant to which instant proceedings were initiated. The bias of hindsight would apply in case the outcome of failure to detect wrongdoings by KSBL in 2017 or 2018 could be attributed to an error of judgment by the Noticee, despite having performed its functions with due care and diligence. Noticee has cited several judgments which clarify standard of reasonable due diligence, including the judgment by Hon'ble Supreme Court in the case of Chander Kanta Bansal Vs. Rajender Singh Anand reported in MANU/SC/7310/2008 : 2008 (5) SCC 117 which held that due diligence in law means reasonable diligence and doing *"everything reasonable, not everything possible".* This aspect is examined in the following paragraphs.

200. 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 and regulations of stock exchange and cirulars 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. This was emphasized in SEBI Circular No. MRD/DOP/SE/Cir – 11/2008 dated 17 April 2008, wherein it was, 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.' It was

reiterated in Clause 2.5 of Annexure to 2016 circular, that a broker can pledge client securities only upto the extent of clients indebtedness to the stock broker. Thus, as per para 4(a) of 2010 circular, it was incumbent upon Noticee to check and confirm compliance with these stipulations relating to client securities maintained by broker.

201. Noticee has contended that the provisions of circular alleged to be violated by it are applicable to brokers and are generic in nature without a demarcated role and standard for their provisions to be used in penalty proceedings. In this regard, I note that the 2010 circular casts an unambiguous responsibility upon exchange to check compliance with applicable SEBI circulars by brokers. The provisions of 1993 and 2016 circulars are applicable to brokers, compliance of which was to be inspected by the Noticee, as per para 4(a) of 2010 circular. Hence, the provisions are clear on the role of Noticee in inspecting brokers, with reference to the specified provisions of 1993 and 2016 circular, and contention by the Noticee in this regard is not acceptable.

202. Noticee conducted inspection of KSBL in October 2016, for the period September 1, 2015, to August 31, 2016. During Inspection, Noticee observed that KSBL had provided corporate guarantees amounting to Rs. 1917 crores towards credit facilities availed by its subsidiaries. Further, Noticee also observed that KSBL had raised funds by issuing commercial paper to banks amounting to Rs. 370 crores and loans & advances given by it to associates amounted to Rs 110.21 crores, resulting in negative net worth of Rs. 79.75 crores. In view of the same, Noticee sought information from depositories on January 2, 2017, to analyse if there had been any pledging of client securities by KSBL from all their demat accounts during the past 12 months. Subsequently, Noticee also sought information CDSL.

203. In response, both the depositories declined to give information on the basis that they were not authorized to share information other than data pertaining to off-market transfers of beneficial owner account holders with the exchanges. It is alleged that by not approaching SEBI immediately when Depositories declined to

provide information with respect to pledge details of demat accounts of KSBL, Noticee followed a casual approach towards verification of client securities in case of KSBL in its inspection during the FY 2016-17 and 2017-18. Further, if SEBI had been alerted immediately on the need for the Depositories data, the default would have come to light much earlier enabling SEBI to take appropriate measures.

204. With regard to verifying pledge of client securities, in reference to account no.11458979 of KSBL with NSDL, it is alleged in the SCN that NSE was verifying pledge of client securities as per the initial records of pledge made available by the member viz KSBL. Such approach is not helpful in ensuring the availability of client securities as member can always hide the demat accounts in which the illegal pledge was done. Had the exchange verified the details of client collateral with the member and then availability of such encumbrance free collaterals in demat accounts of members (irrespective of exchange), it could have helped exchange to find any wrongdoing by the trading member.

205. In its defense, Noticee has argued that it informed SEBI through its letter of March 01, 2017 regarding negative networth of KSBL, and borrowing by KSBL/ KSBL subsidiaries. I note from this letter that the issue raised by NSE was potential violation of Rule 8(1)(f) and/ or 8(3)(f) of SCRR, 1957. The said Rules of SCRR prohibit a broker from engaging in any business other than that of securities except as a broker or agent not involving any personal financial liability. Upon perusal of the content of this letter, I find that Noticee has not raised the issue of their inability to seek necessary information from depositories relating to details of securities pledged by KSBL. The contention by the Noticee that SEBI did not direct depositories to provide information or did not intervene to say that the stance of the depositories was wrong is not correct as SEBI was not apprised of their inability to get pledge data of KSBL from depositories in the March 01, 2017 letter or even their subsequent emails dated March 7, 2017, August 21, 2017 and February 14, 2018. I further note that SEBI had responded to the March 01, 2017 letter and email dated March 07, 2017 asking NSE to conclude its analysis and to inform SEBI about concerns, if any, for further action.

206. I note from the material on record that SEBI was copied on requests seeking pledge data of 25 brokers including KSBL from depositories made by NSE in email of September 22, 2017. However, there is nothing on record to show that SEBI was informed that said information was not provided by depositories, or that the matter was escalated to SEBI for resolution. The reply of the depositories was not marked to SEBI, and the matter of non-receipt of information in this particular respect was not subsequently escalated to SEBI by the Noticee.

207. NSE has stated that throughout 2018 and 2019, the Noticee specifically raised the issue of non-sharing of data by depositories and the systemic information asymmetry between depositories and stock exchanges with SEBI. On July 12, 2018, SEBI, NSE and BSE held a meeting on the joint inspection of brokers. However, from the record of minutes of the meeting, I note that these discussions related to formalizing and automating method of sharing data amongst the MIIs for the purpose of broker supervision. In none of the records submitted, I find any reference to escalation by NSE regarding specific request pertaining to KSBL inspection or the pledge related information of KSBL or of 25 brokers (including KSBL) sought by them from depositories in January 2017 and September 2017 respectively. Hence, I find that general discussion for mechanisms of sharing information cannot be conflated with the specific request pertaining to information needed in respect of KSBL pursuant to findings of inspection in 2016.

208. It is evident that during inspection in 2016-17, NSE noticed a red flag i.e. negative networth of KSBL and borrowing by KSBL / KSBL subsidiaries. As part of inspection, there was obligation on NSE to examine whether client securities are kept separately and that pledging of client securities is not beyond clients indebtedness to KSBL with reference to compliance with 1993 and 2016 circulars. In order to verify pledging of client securities by KSBL, NSE sought information from depositories pursuant to their findings in said inspection. However, NSE failed to follow up in obtaining necessary information, which could have been obtained through SEBI, as SEBI has the power to obtain such information from depositories.

Noticee as first level regulator was certainly aware that required information can be obtained through SEBI.

209. Noticee has contended that they acted with reasonable due diligence while inspecting KSBL, and that their inspection was based on internal inspection checklist in terms of which sample data on aspects such as margins, settlements, pledging, etc. is reviewed. NSE has also submitted that prior to 2019, exchanges were conducting inspections of records pertaining to respective exchange. NSE has also submitted that in February 2018, when a joint inspection of KSBL was conducted between market infrastructure institutions ("MIIs") and SEBI, no adverse observations in relation to the Noticee's inspection process was raised by SEBI at that stage, neither were there any red flags identified by the Noticee in terms of the specific areas of diligence that were demarcated to it. Further, during the inspection of KSBL in FY 2017-18, the Noticee verified the books and records of KSBL used for carrying out transactions on NSE and did not observe any violations in its pledge verification.

210. From the material on record, I note that during the joint inspection of NSE in 2017-18, the issue of non-sharing of pledge data by depositories to exchanges was not raised by NSE nor dealt with during inspection. It was only in 2019, pursuant to another joint inspection of KSBL that data was finally sought from NSDL through SEBI. Vide email dated September 06, 2019, NSDL shared the relevant details with the Noticee, on review of which the Noticee observed that KSBL had pledged around INR 2,800 crores worth of client securities with banks and NBFCs and had raised funds to the tune of INR 851 crores.

211. I have taken note of the sequence of events narrated by Noticee which led to detection of KSBL's wrongdoings, which is reproduced below:

i. In May 2019, SEBI undertook a reconciliation of the client wise, ISIN wise weekly reporting done by members to NSE and shared the mismatch report for the month of April 2019 with the NSE.

ii. Based on the mismatch report shared by SEBI, the Noticee on May 23, 2019 sought explanation from KSBL. However, KSBL responded that the securities had been incorrectly recorded in their back-office records and were being reconciled. The above information was shared by the Noticee with SEBI in the meeting dated May 30, 2019.

iii. In June 2019, SEBI undertook a client-level reconciliation of security balances as on May 16, 2019 and shared the mismatch alert with the Noticee on June 25, 2019.

iv. Based on the mismatch alert shared by SEBI, the Noticee on June 26, 2019 sought explanation from KSBL. KSBL was unable to give explanation for all instances shared despite multiple follow-ups and reminders.

v. As part of its offsite supervision measure in July 2019, the Noticee undertook a reconciliation of the monthly security balances provided as a part of the Enhanced Supervisions provisions for the month of June 2019 with the records of KSBL received from SEBI and observed that shortfall of securities amounting to INR 957 crore in its depository participant account. The Noticee also reconciled the said monthly reporting for the months of May and June 2019 with the weekly client wise, Depository Participant and ISIN wise weekly securities holding reporting done by KSBL and observed that KSBL had reported excess securities holdings to the tune of INR 1196 crores and INR 965 crores respectively in its monthly reporting as compared to weekly reporting.

vi. Thereafter on August 01, 2019, a meeting was called by the Noticee which was attended by the MD and CEO of KSBL at which time it was informed to the Noticee that the mismatches arose due to incorrect reporting of the weekly holding data which was due to software issue at their end and sought additional time for complete response.

vii. Meanwhile, the Noticee also initiated a limited purpose inspection of KSBL's books, operations, records on August 19, 2019.

viii. In view of its observations during the inspection, the Noticee alerted SEBI vide its emails dated August 27, 2019, September 03, 2019 and September 11, 2019. It submitted its preliminary inspection report to SEBI on Sep 22, 2019.

212. From the foregoing, it is evident that the problem came to light after SEBI carried out reconciliation of the client wise, ISIN wise weekly reporting done by members to NSE. Following repeated mismatches in case of KSBL, a joint inspection was carried out, and the misuse of client securities by KSBL was determined after data on securities pledged in demat accounts of KSBL was obtained from depositories in September 2019. It is pertinent that Noticee had found sufficient reason in 2017 itself to seek this information on the basis of its finding in KSBL inspection of 2016-17. The issue to be decided here is whether the duty of due diligence by the Noticee ended with seeking information from depositories, or whether Noticee fell short by not escalating the matter to SEBI. The subsequent findings in September 2019 of extent of misutilisation of client securities by KSBL provide the context of cost of failure in timely detection of misutilisation.

213. While Noticee has explained that it carried out its duties with due diligence as per its checklist for inspections, 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 noticed by it in the 2016 inspection itself. The Noticee found it serious enough to take the steps to seek necessary information from depositories twice in January 2017 and September 2017. However, it is also evident that Noticee failed to follow through on this request by escalating the matter to SEBI, and precious time was lost in detection of fraud by KSBL due to the laxity in escalating the issue and obtaining the necessary information from depositories.

214. Noticee is a stock exchange, and in terms of Rule 8 of Securities Contract (Regulation) Rules, 1957, Noticee is responsible, inter alia, for framing rules relating to members of stock exchange, and in ensuring compliance with such rules. The main object of the Noticee as per its Memorandum of Association is to, inter alia, regulate dealings in securities, and to ensure trading in transparent fair and open manner. 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. This is also accepted by the Noticee in its reply to the SCN. 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 detection of any perceived irregularity, it is incumbent upon Noticee as a frontline regulator to follow through till a point of satisfaction regarding compliances by the trading member is achieved. Thus, upon completion of inspection, the finding should indicate satisfactory compliance, and if not, then, move towards further action to determine extent of non-compliance as well as corrective action. An inspection which merely notes compliance or non-compliance is fruitless unless accompanied by corrective action. The 2016 inspection did not indicate satisfactory compliance, and Noticee initiated certain actions based on its findings. Seeking information on pledge data from depositories shows that Noticee had sufficient reason to doubt compliance by KSBL. The standard of reasonable due diligence required that the Noticee follow through on its findings and red flags in the 2016 inspection and after having sought information from NSDL, pursue the matter further to the point of where compliance or non-compliance by KSBL could be established with certainty. This was not only possible, but also reasonable. However, the Noticee failed to do so.

215. Noticee has raised contention that the standards of due-diligence which are applicable on NSE should also be applicable on SEBI and the proceedings should not be basis hindsight. In this regard I note that, in the instant matter, SEBI took the initiative of automation of inspection, reconciliation of stock broker reported securities balances with actual balances held by the depository, standardization of books, data sharing between exchanges and depositories. As stated by the Noticee in its reply, SEBI held and chaired several multiple meetings with MIIs for

such automation which culminated into creation of Early Warning Mechanism for preventing diversion of client securities. Specifically in the instant matter, it was the reconciliation exercise conducted by SEBI, pursuant to which mismatches were identified for Stock Brokers including for KSBL, which were eventually taken up by Noticee for clarification with Stock Broker. It was non-satisfactory response of KSBL to these mismatches, pursuant to which Noticee sought information from NSDL regarding pledge details in DP accounts of KSBL. Further, when the issue of non-sharing of data by depositories was brought to the knowledge of SEBI, SEBI promptly directed depositories to share the relevant data with the exchanges.

216. From the aforesaid, I conclude that the failure by Noticee to follow through on its preliminary action including by escalating to SEBI for seeking necessary information from depositories cannot be considered as a benign and routine action and the response of the Noticee in failing to pursue or escalate information requirement for examining suspected misutilisation of securities in 2017 cannot be considered to be within the bounds of reasonable due diligence. The standard of due diligence for the Noticee has to be seen in the context of its function as first level regulator and the onerous responsibility cast upon it to provide a safe and reliable infrastructure for trading in securities. By not pursuing the matter including by obtaining necessary information through SEBI despite having found it necessary to seek such information during the course of inspection, the Noticee failed to act with the standard of due diligence expected of it as a front line regulator.

217. **Hence, 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 r/w para 2.5 of the Circular SEBI/HO/MIRSD/MIRSD2/ CIR/P/2016/95 dated September 26, 2016 and 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.

218. In terms of para 2.3 of the annexure to the 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*."

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

220. NSE received the details of the demat accounts of Trading Members including KSBL vide NSDL's email dated November 14, 2017. The DP account details of KSBL as received by NSE from NSDL indicated separately account type/category as 'beneficiary client', 'house client' etc. 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.

221. 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.

222. 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.

223. Noticee vide email dated September 04, 2017 advised KSBL with respect to non-reporting/tagging of certain accounts (including the impugned demat account), to which KSBL responded vide email dated September 08, 2017, and informed Noticee 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 that the impugned demat a/c was a BSE tagged account and reported to the respective exchange.

224. As per 2016 circular and subsequent clarifications, KSBL's DP Account No. 11458979 with name "Karvy Stock Broking Limited (BSE)" could be considered deemed to be proprietary since it was not tagged as any other account type in terms of nomenclature guidelines of 2016 Circular. However, upon seeking of explanation by NSE vide email dated September 04, 2017 as to why 72 demat accounts including the impugned account was not reported/ tagged, KSBL vide its email dated September 08, 2017 informed that the account was on other exchange margin account and the account was tagged as 'Karvy Stock Broking LTD (BSE)'. Hence, it was evident from the reply that the impugned account was a margin account and should have been tagged as "collateral account" but was not so tagged by KSBL. However, NSE accepted at face value the submission of KSBL that the account was other exchange account and did not enquire or probe further or insist upon proper tagging of the account. I note that the 2016 circular does not state that nomenclature of accounts is to be ensured by exchange only in respect of accounts pertaining to that exchange. Such an interpretation is a recipe for leaving gaps in monitoring.

225. Noticee has submitted that it received information regarding demat accounts of members of NSE from Depositories and upon reconciliation of information Noticee found that over 5000 demat accounts pertaining to 1100 active trading members were not reported by members. Out of these 72 accounts were maintained by KSBL but not reported to NSE, which included the impugned demat account.

226. Further, Noticee contends that KSBL gave false information or incomplete information to the exchange in regard to its demat accounts, hence compliance with the indicative deadlines could not be achieved. Noticee has also contended that in the absence of any information about the details of nature of the account and failure by the depositories to furnish details of the accounts on being asked, the Noticee was not equipped to examine the correctness or accuracy of the nomenclature of the demat accounts during its inspection in FY 2016-17.

227. In this regard, I note that the list of accounts shared by depositories, clearly illustrated that there were many demat accounts of KSBL which were not tagged, and the same was taken up by the Noticee with KSBL. It is pertinent that Noticee did take some action for ensuring proper nomenclature but stopped half-way by taking at face value responses from KSBL and took no further action on obviously non-proprietary accounts which were untagged, and thus deemed proprietary, including impugned account, which was admittedly a margin account as stated by KSBL.

228. Noticee has contended that clause 2.3 of the 2016 circular generically refers to certain deadlines and guidelines for change of nomenclature of the demat accounts to be ensured by Stock Exchanges and/or Depositories. The provision does not stipulate a specific action and a specific responsibility for each MII, in connection with the nomenclature of demat account, which is consistent with it being an indicative guideline. Neither a Stock Exchange nor a depository can force the change of the name and nomenclature of a demat account on its own. 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. Responsibility for penal action in case of non-compliance is clearly placed on stock exchange in para 2.3.7 of the said circular.

229. Though the Stock exchange/Depository cannot force stock broker to change name of a bank/demat account, but 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*". 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 impugned account was 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.

230. Noticee has made the contention that the primary responsibility of tagging DP accounts lies with the members and a stock exchange can only monitor whether this process has been done or not, that in the absence of any information about the details/nature of the account and failure by the depositories to furnish details of the pledge accounts, NSE was not in a position to comment on the correctness or accuracy of the nomenclature of the demat accounts, and that deadlines for nomenclature were postponed by SEBI from time to time. Noticee has also said that it cannot be in a position to answer a charge based on a provision that did not cast any specific obligation or a specific standard required of it. Merely because a provision uses the phrase "ensure" it would not follow that it would be a guarantee that brokers would become compliant, with any failure leading to an automatic allegation of failure by the stock exchange.

231. It is correct that the primary responsibility of tagging DP accounts lies with the members. The stock exchange is required to monitor tagging, and as part of monitoring, to ensure that the tagging is done for all accounts. As per the changes made to the initial circular on nomenclature, all non-tagged accounts were deemed to be proprietary accounts as clarified by SEBI in its circular of June 22, 2017. However, even though untagged, the impugned demat account was evidently not a proprietary account if it was stated by KSBL to be a BSE margin account. As part of its monitoring, Noticee was required to question this apparent discrepancy, but Noticee failed to determine whether impugned account was a proprietary account wrongly mentioned as a margin account, or a margin account not properly tagged as a collateral account. Noticee assumed from the submission of KSBL that said account was a BSE account, and it need not examine it further. This assumption created the regulatory gap which allowed misuse of the account. The requirement for monitoring tagging of accounts did not allow for examining by Noticee of only NSE tagged accounts. The standard of reasonable of due diligence when examining tagging of demat accounts of KSBL required Noticee to examine all accounts and look further into obvious wrong tagging. This action was not just possible, but a reasonable expectation from the Noticee.

232. KSBL was successfully able to evade detection of client security pledging because it misinformed NSE that the account was margin account of the other exchange and did not pertain to NSE transactions. Accepting the claim of KSBL at face value that the account was a BSE margin account also shows lack of reasonable due diligence on the part NSE in ensuring required compliance.

233. 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 'collateral account' despite these being admittedly margin accounts.

(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.

234. 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.

235. 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 accounts or large value shares to stock broker proprietary accounts and vice a versa.	Transfer of Securities to/from > 10 clients	9
	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

236. 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.

237. NSE submitted that the information shared by NSDL did not contain the ISIN wise balance lying in the said demat account. In its absence NSE was not able to identify any irregularity in the said account. Accordingly, NSE did not observe any irregularities by way of transfer of client securities (from client accounts) to the own accounts of the member or transfer to any third party (non-client entities).

238. I take note of Noticee's submission that in most instances of alerts, the transfers were made from the impugned account, which though untagged, was evidently from its name, a collateral account. The transfers were made from this collateral account to other collateral accounts of KSBL, due to which fact, Noticee found that

there was no irregularity. It has already been noted in preceding paras that Noticee failed to take action on the obvious discrepancy of the impugned account being a deemed proprietary account, but named as a collateral account. It was on account of this discrepancy that Noticee considered the alerts generated by NSDL as not being indicative of irregularity. The first such set of alerts was received on March 11, 2019, followed by April 15, 2019 and May 17, 2019.

239. Noticee has contended that it already initiated the monitoring of KSBL based on the concerns noted in the reconciliation exercises undertaken by SEBI in April 2019, May 2019 and July 2019 of the weekly reporting of securities balance. The concerns observed therein were also shared by the Noticee in the joint meeting between stock exchanges and depositories at SEBI on July 05, 2019.

240. I note that 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.

241. In view of the same, Noticee sought clarifications supported by documents for 23109 mismatches as of June 26, 2019 from KSBL. The initial responses of KSBL claimed that the mismatches are on account of software issues in KSBL System. On July 31, 2019 Noticee provided KSBL with the mismatches observed in client securities reporting in weekly reporting and monthly upload of the client balances for the month of May and June 2019 for Rs. 1196 crores and Rs. 965 Crores. Thereafter, further action was taken by Noticee, along with SEBI and BSE which led to detection of misutilisation of securities by KSBL.

242. From the aforesaid, I note that although Noticee found no irregularities in respect of alerts relating to transfer of large value of securities through off-market transfers, due to considering the impugned demat account as a collateral account, Noticee took up with SEBI the issue of large number of alerts on mismatch of securities between holding statement of brokers and balance in depository account of brokers. Although these alerts were not a part of the EWS, they were part of a separate initiative taken by SEBI. It was these alerts and resulting reconciliation exercise which led to the finding of pledge of Rs.2,800 crores worth of client securities made by KSBL. During the reconciliation exercise, NSE once again sought details of pledge securities in DP accounts of KSBL which was provided to them with SEBI intervention.

243. In view of the above, I find that whereas, because of considering the impugned account as a collateral account, NSE did find any irregularity and did not act on alerts of large off-market transfers which were first generated on March 11, 2019, there were other alerts generated due to reconciliation exercise around the same time, and Noticee did act on alerts on mismatch of securities between holding statement of brokers and balance in depository account of brokers. The purpose of the EWS mechanism was to have a system to detect wrongdoing, what is relevant in determining effective compliance with such a system is the detection of wrongdoing, irrespective of which alerts were used for arriving at conclusion of wrongdoing. Hence, I am inclined to hold that Noticee took sufficient action on the alerts provided by NSDL in compliance 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?

244. As it is established that Noticee violated

(i) para 4(a) of the SEBI Master Circular SEBI/MIRSD/Master Cir-04/2010 dated March 17, 2010 read with para 2.5 of the Circular SEBI/HO/MIRSD/MIRSD2/ CIR/P/2016/95 dated September 26, 2016 and para 2 of the Circular SMD/SED/CIR/93/23321 dated November 18, 1993; and

(ii) 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,

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.*

245. 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.

246. 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 NSE, 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.

247. 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 2.5 of the Circular SEBI/HO/MIRSD/MIRSD2/ CIR/P/2016/95 dated September 26,

2016 and para 2 of the Circular SMD/SED/CIR/93/23321 dated November 18, 1993 and (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, which attract penalty under Section 15 HB of SEBI Act. The maximum penalty that can be levied under Section 15 HB of SEBI Act is Rs.1 Crore. In view of the large scale 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 for each violation. Hence, I am of the view that a penalty of Rs. 2,00,00,000/- will be commensurate with the violations committed by the Noticee.

ORDER

248. 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. 2,00,00,000/- (Rupees Two Crores only) under Section 15HB of SEBI Act,1992 on National Stock Exchange of India Ltd. for violation of para 4(a) of the SEBI Master Circular SEBI/MIRSD/Master Cir-04/2010 dated March 17, 2010 read with para 2.5 of the Circular SEBI/HO/MIRSD/MIRSD2/ CIR/P/2016/95 dated September 26, 2016 and para 2 of the Circular SMD/SED/CIR/93/23321 dated November 18, 1993; and 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.

249. 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

250. 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

251. 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 20:23:38 +05'30'

DATE: April 12, 2022
PLACE: MUMBAI

MANINDER CHEEMA
ADJUDICATING OFFICER