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National Institute of Securities Markets
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Workbook for

NISM-Series-III-A: Securities Intermediaries Compliance (Non-Fund) Certification Examination

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This workbook has been developed to assist candidates in preparing for the National Institute of Securities Markets (NISM) Certification Examination for Securities Intermediaries Compliance, in particular for those intermediaries who do not involve in any fund based activity and are registered with SEBI as either Stock Brokers, Sub-Brokers, Depository Participants, Merchant Bankers, Underwriters, Bankers to the Issue, Debenture Trustees and Credit Rating Agencies.

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About NISM

In pursuance of the announcement made by the Finance Minister in his Budget Speech in February 2005, Securities and Exchange Board of India (SEBI) has established the National Institute of Securities Markets (NISM) in Mumbai.

SEBI, by establishing NISM, has articulated the desire expressed by the Indian government to promote securities market education and research.

Towards accomplishing the desire of Government of India and vision of SEBI, NISM has launched an effort to deliver financial and securities education at various levels and across various segments in India and abroad. To implement its objectives, NISM has established six distinct schools to cater the educational needs of various constituencies such as investor, issuers, intermediaries, regulatory staff, policy makers, academia and future professionals of securities markets.

NISM brings out various publications on securities markets with a view to enhance knowledge levels of participants in the securities industry.

NISM is mandated to implement certification examinations for professionals employed in various segments of the Indian securities markets.

Acknowledgement

This workbook has been developed by NISM. This version of the workbook has been reviewed by Ms. Ramadevi Iyer, Empanelled Resource Person, NISM.

About the Author

This workbook has been developed by the Certification Team of National Institute of Securities Market.

About the Certification Examination for Securities Intermediaries Compliance

The examination seeks to create a common minimum knowledge benchmark for persons engaged in compliance function with any intermediary registered with SEBI as Stock Brokers, Sub-Brokers, Depository Participants, Merchant Bankers, Underwriters, Bankers to the Issue, Debenture Trustees and Credit Rating Agencies.

The certification aims to enhance the quality of services as rendered by those engaged in compliance activities. It also aims at ensuring that the compliance officers are aware of the different regulations which govern the Securities Market.

Examination Objectives

This examination is broadly categorised in two parts. Part 'A' is generic in the sense that it gives the candidates a sense of the Financial and Regulatory Structure in India, the different Regulations which the intermediaries should be aware of and Part B specifically deals with the specific rules and regulations governing the Stock Brokers, Sub-Brokers, Depository Participants, Merchant Bankers, Underwriters, Bankers to the Issue, Debenture Trustees and Credit Rating Agencies. On successful completion of the examination, the candidate should:

- Understand the financial structure in India; know the financial intermediaries and the types of products available in the Indian market.
- Understand the regulatory framework and the role of the various regulators in the financial system.
- Understand the importance of compliance activity and the scope and role of the compliance officer in the Indian securities market.
- Understand the various regulations and rules of the Indian securities market.
- Understand the importance of compliance of the rules and regulations and the penal actions initiated in case of any default or failure.

Assessment Structure

The examination consists of 100 questions of 1 mark each and should be completed in 2 hours. The passing score on the examination is 60%. There shall be negative marking of 25% of the marks assigned to a question.

Examination Structure

The exam covers knowledge competencies related to the understanding of the financial structure in India and the importance of the different rules and regulations governing the Indian securities market.

How to register and take the examination

To find out more and register for the examination please visit *www.nism.ac.in*

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Part A – Understanding Financial Structure in India

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Unit 1: Introduction to the Financial System

1.1 Financial System

The Financial System refers to the entire set of institutionalized arrangements by which funds are transferred from surplus units to deficit units at terms acceptable to both sides. Households as a sector represent the surplus unit, whereas corporations and governments collectively represent deficit units. An efficient financial system plays an important role in the economic development and it consists of financial market, financial instruments and financial intermediaries. The role of the financial system is to gather or pool money from surplus units i.e. people and businesses that have more than they need currently and transmit or allocate those funds to deficit units i.e. those who can use them for either consumption or investment. Larger flow of funds and efficient allocation of them leads to better economic output and welfare of the economy and society. In addition to this, the financial market should also function efficiently and at a minimal cost in cooperation with the other constituents of the financial system.

1.1.1 Financial Market

A Financial Market can be defined as the market in which financial assets such as equities, bonds, currencies and derivatives are created or transferred. It is as mechanism that allows traders to deal in financial securities, commodities, etc at low costs which reflects the efficiency of the market.

Financial Market can be classified into different subtypes:

Money market is a market for financial assets that are close substitutes for money. It is a market for short term funds and instruments having a maturity period of one or less than one year. Money market provides short term debt financing and investment. The money market deals primarily in short-term debt securities and investments, such as banker's acceptances, negotiable Certificates of Deposit (CDs), repos and Treasury Bills (T-bills), call/notice money market, commercial papers.

Capital market is a market for securities, where business enterprises and government can raise long term funds. It is generally defined as a market in which money is provided for periods longer than a year. It can be sub classified into **Stock Market** which provide raising funds through the issue of shares or stock and **Bond Market** which helps in raising funds through the issue of bonds. Bonds in India are issued by Government (both State and Central), Corporates and Municipal Bodies. Capital Markets also provides the mechanism for subsequent trading of stocks and bonds.

Both the capital market and the money market have two interdependent and inseparable segments, *the primary market and the secondary market*. The primary market is used by issuers for raising fresh capital from the investors by making initial public offers or rights issues or offers for sale of equity or debt; on the other hand the secondary market provides liquidity to these instruments, through trading and settlement on the stock exchanges. An active secondary market promotes the growth of the primary market and capital formation, since the investors in the primary market are assured of a continuous market where they have an option to liquidate their investments. Thus, in the primary market, the issuer has direct contact with the investor, while

in the secondary market, the dealings are between two investors and the issuer does not come into the picture.

The Forex market deals with the multicurrency requirements, which are met by the exchange of currencies. Depending on the exchange rate that is applicable, the transfer of funds takes place in this market. This is one of the most developed and integrated market across the globe.

Credit market is a place where banks, FIs and NBFCs provide short, medium and long-term loans to corporate and individuals.

Insurance market which facilitate the transfer of various risks from individuals, business houses and corporates to the insurance companies.

1.2 Financial Intermediaries

A large variety and number of intermediaries provide intermediation services in the Indian securities market. They are the entities who are involved in the business of managing individual portfolios, executing orders, dealing in or distributing securities etc.

Merchant Bankers are entities that specialize in assisting companies to originate issues of securities. The range of assistance would cover the following:

1. Advising the client on the timing of an issue
2. Advising the company on the selection of underwriters, brokers, bankers and others, e.g., printers to an issue, drafting the prospectus and verifying the accuracy of the claims made therein.

Bankers to Issues are scheduled banks that are engaged by companies to accept application moneys, allotment or call moneys, undertake refund of application moneys and pay dividend or interest warrants.

Registrars are persons registered under the SEBI (Registrars to an Issue) Regulations, 1993. They provide services relating to a public or rights issue. It includes collating data on subscriptions to an issue, furnishing alternative bases of allotment and completing allotment by crediting shares to the demat accounts of the allottees or dispatching refund orders, according to the selected basis.

Transfer Agents are persons that maintain record of holders of securities and deal with all matters connected with transfer or redemption of securities or incidental activities of a company, so that it reflects changes in ownership of shares consequent upon trading and also handle dividend payouts and communications relating to other corporate actions.

Depositories are institutions that hold securities of investors in electronic (dematerialized) form, for a fee. The investors remain the beneficial owners of the securities. A Depository Participant (DP) is the registered agent of the Depository concerned and it is through the DP that an investor gets the services of the depository. It can be compared to a branch of a bank where individuals maintain their savings accounts. The DP interacts with the investor and furnishes the record pertaining to an investor's portfolio. The DP also facilitates the release of securities when sold, or the recording of securities when bought or obtained on allotment.

Stock Exchanges are an important constituent of the secondary market of Capital Market. Stock Exchange means a body of individuals or a body incorporated, under the Companies Act, for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities.

Stock Brokers who are registered with SEBI provide different types of services which include undertaking of secondary market transactions on behalf of their clients. That is, by executing buy or sell transactions communicated by investors. For their service, stock brokers earn commission, commonly referred to as brokerage. Stock brokers also play a role in the marketing of new issues of securities by informing and advising investors of new issues. For their service of canvassing applications for allotment in new issues, stock brokers earn brokerage from companies, i.e., the issuers.

Clearing House is the intermediary which performs two important functions: a) aggregating transactions over a trading period, netting the positions to determine the liabilities of members and ensures movement of funds and securities to meet respective liabilities; and b) guarantee those trades, in the event of default by either buyer or seller.

Portfolio Managers are individuals or firms that administer the portfolios of individuals or provide advice or direction to that effect, for a fee or a share in the profits or a combination of the two.

Mutual Funds are organizations that mobilize funds from investors by issuing units or shares and undertake to invest the money in a manner consistent with the specified investment objective. The objective could be to maximize capital growth or to maximize current income or some other. There are two types of investment schemes: open-end and closed-end. In the former, a demand for units is met by a fresh supply, so there is no limit on the number of units that can be issued. With closed-end funds, there is a limit on the number of units that can be issued and following issuance, units are traded in the secondary market. Closed-end funds have a specified maturity unlike open-end funds.

Custodians are entities that hold securities or gold or gold-related instruments on behalf of institutional investors, e.g., mutual funds and insurance companies. Custodians maintain and reconcile the records relating to the assets held and also monitor corporate actions such as dividend payments or rights issues on behalf of their clients. In short, custodians are mainly into trade settlement, safekeeping, benefit collection, reporting and accounting. One point of distinction is that a Depository has the right to effect transfer of beneficial ownership while a custodian does not.

1.3 Financial Securities

According to the Securities Contracts (Regulation) Act, 1956, the term, “securities” encompasses:

a) shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate
b) derivative
c) units or any other instrument issued by any collective investment scheme to the investors in such schemes

d) security receipt as defined in section 2 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002
e) units or any other such instrument issued to the investors under any mutual fund scheme
f) any certificate or instrument (by whatever name called), issued to an investor by any issuer being a special purpose distinct entity which possesses any debt or receivable, including mortgage debt, assigned to such entity, and acknowledging beneficial interest of such investor in such debt or receivable, including mortgage debt, as the case maybe;"
g) Government securities
h) such other instruments as may be declared by the Central Government to be securities
i) rights or interest in securities

Stock means a type of security that signifies ownership in a corporation and represents a claim on part of the corporation's assets and earnings.

Equity shares represent ownership interest in a company. The claim of equity shareholders on earnings and assets (in the event of liquidation) comes last and hence is residual in nature. Equity shareholders expect to benefit from dividends and price appreciation. They have both collective and individual rights such as right to elect directors, right to sell shares.

Preference shares are securities which have a preferential right to dividend and repayment of capital. These shares do not carry voting rights except when their rights are affected. These are hybrid securities as they combine features of equity and debt securities. They are similar to equity in that they bear dividends, which may or may not be paid, and offer no collateral as security. They are similar to debt securities in that the dividend is a stated percent of par value and they have a finite life.

Debentures are debt securities having a definite life during which they pay coupon, which is interest at a specified rate on the par value, at regular intervals, typically every six months. Bonds too are debt securities with similar features except that internationally the distinguishing feature of bonds is that they are secured by specific collateral. In India, long-term debt securities issued by the Government of India or State Government or partially by any one of them are called bonds.

Warrants are long-term call options issued by a company, which give the holder the right to buy equity shares from the company at a specified price known as the subscription price or exercise price. Typically, warrants originate as a sweetener to an issue of debt securities, to induce investors into accepting a lower yield. Warrants are separately tradable and their price behaviour is linked to that of the underlying equity share.

Derivatives are contracts that give the holder the right to buy or sell some underlying asset. For example, a call option on an equity share gives the holder the right to buy the underlying at a specific price known as the exercise price or strike price. On the other hand, a put option gives the holder the right to sell the underlying at a specific price. A call option would be bought if the buyer expects the price of the underlying to rise, while a put option will be bought if the buyer expects the underlying to decline. The seller of the option is also known as the writer of the option. While the holder of the option is under no obligation to perform any action, it is the writer who is obligated to perform, that is, deliver securities on exercise of a call, or make payment on

exercise of a put. For granting the privilege of either buying or selling a stock, the writer receives a payment known as premium. Option positions can be offset prior to expiration.

Futures contracts guarantee delivery of a specific quantity of a specified asset on a specified future date, at the price currently quoted. If an investor anticipates the spot price on the delivery date to be higher than the quoted futures price today, then he or she may buy the contract hoping to make a profit. But, if an investor anticipates the spot price to be lower than today's quoted futures price, then the contract could be sold. Positions in futures contracts can be offset prior to the delivery date.

Exchange-traded derivative contracts are standardized in terms of the quantity, quality, time and place of delivery. They are transacted on an organised futures exchange.

ADR is an acronym for American Depository Receipt which is a security denominated in US Dollars, traded at US exchanges, representing a specific number of equity shares of a foreign company that are traded in the foreign country.

GDR is an acronym for Global Depository Receipt. It is an instrument denominated in foreign currency that allows foreign investors to invest in shares of foreign companies which are listed and traded in the foreign country. As an example, a Euro-denominated GDR issued by an Indian company will have a certain number of Rupee-denominated equity shares underlying it. The GDR may trade freely in the overseas security market where it is listed. A GDR holder may opt to liquidate the investment, in which case, the underlying shares will be released for sale by the custodian in India.

IDR is an acronym for Indian Depository Receipt. It is a Rupee-denominated security to be traded at Indian stock exchanges, representing a specific number of shares of a foreign company. An IDR offers Indian investors, access to foreign securities that are listed and traded at foreign exchanges. When a security is termed fungible, it refers to the feature that allows an instrument to be replaced by another of a similar description, as for instance, an ADR, vis-à-vis its underlying share.

Mutual Fund (MF) **units** are the shares issued by an investment company to mobilize funds from investors. The fund managers will proceed to invest the moneys collected to try and achieve the specified investment objective.

Exchange-traded Funds (ETFs) are open-ended mutual funds which allow intraday trading of their units. This facility is in contrast to conventional mutual funds; with the latter, buying and selling takes place at the closing Net Asset Value (NAV) of the day or of the following day, depending on the precise time at which the investor placed the order.

Currency Derivatives (CDs) are contracts between buyers and sellers, whose values are to be derived from the underlying assets, i.e. the currency amounts. These are risk management tools in the forex and money markets. These may be options or futures or swaps, which offer investors the facility to lock in the rate at which they wish to buy or sell a particular currency. As an example an Indian exporter with Kuwaiti Dinar receipts who expects an appreciation of the Indian Rupee could buy a put option, to sell Dinar. In contrast, an Indian importer with Euro liability and expecting the foreign currency to appreciate could buy a call option on Euros. Alterna-

tively, the Indian exporter could sell a futures contract in Kuwaiti Dinar and the Indian importer could buy a futures contract in Euros. Currency Swaps are agreements between parties that facilitate borrowing in foreign currencies at lower costs. For instance, a British firm may need Euros while a French firm may require Pounds Sterling. However, taking comparative advantage into account, it may be a better option for the British and French firms to raise funds in their respective currencies and then enter into a swap. The principals are also re-exchanged at maturity.

Interest-rate Derivatives are contracts which enable investors or borrowers to hedge against the risk of adverse interest-rate movement. These include interest-rate futures, interest-rate swaps, interest-rate options and Forward Rate Agreements (FRAs).

Interest-rate Futures are contracts in which the underlying asset is a debt security, for example futures on Treasury Bills (T-Bills), Commercial Paper (CP) or Government Securities. An investor may trade in interest-rate futures with the objective of locking in a certain yield or borrowing rate. To illustrate, if a corporate treasurer apprehends a fall in interest rates by the time surplus funds are received, he could lock in the higher yield currently quoted by buying an interest-rate futures contract. On the other hand, if a banker fears a rise in interest rates by the time he enters the market to raise funds, he could lock in the lower rate currently quoted by selling an interest-rate futures contract.

Interest-rate Swaps are agreements between two or more parties to exchange series of cash flows in the same currency over an agreed period of time. For instance, two prospective borrowers may have opposite views on the direction of interest rate movement in the future: 'A' expects rates to decline while 'B' thinks they will rise. On the basis of the comparative advantage enjoyed by one party, say, A, it may be beneficial for A to borrow fixed-rate and for B to borrow floating-rate and then for the two to enter into a swap. In an interest-rate swap, the principals are not exchanged.

Interest-rate Options is a derivative financial instrument. It can be caps or floors. A **cap** is bought to limit the interest rate to a specific ceiling on floating-rate borrowings, in the event that the benchmark rate starts rising. A **floor** is bought to earn a minimum rate of return on floating-rate investments, in the event that the benchmark rate begins to decline. Spread transactions and combinations involving multiple options to craft specific payout or receipt patterns are also possible.

Forward Rate Agreement (FRA) is a forward contract by which a borrower locks in a specified rate of interest for a pre-determined time period in the future. For example, assume that a company is planning to seek a six-month loan after three months. The company expects short-term rates to rise. So, it could buy a three-month FRA on six-month LIBOR at, say 7 % (using, LIBOR, that is, the London Inter-bank Offer Rate as the reference rate in the transaction). At the end of three months, if the six-month LIBOR is greater than 7 %, the bank which sold the FRA will pay the excess sum to the company. On the other hand, if the LIBOR turns out to be lower than 7 %, the company will pay the difference to the bank.

Securities Lending and Borrowing Scheme (SLB)Short Selling means selling of a stock that the seller does not own at the time of trade. Short selling can be done by borrowing the stock through Clearing Corporation/Clearing House of a stock exchange which is registered as Ap-

proved Intermediaries (AIs). Short selling can be done by retail as well as institutional investors. The Securities Lending and Borrowing mechanism allows short sellers to borrow securities for making deliver. SEBI has issued the circular dated August 22, 2008 with a view to providing this facility in the capital market.

Review Questions

1. Financial systems consist of banks, non-banks and _____.
   (a) Bullion Markets
   (b) Financial Markets
   (c) Money lenders
   (d) NGOs

Ans: (b)

2. Safekeeping and record keeping of securities is done by _____.
   (a) Custodians
   (b) Venture Capital Funds
   (c) Brokers
   (d) Mutual Funds

Ans: (a)

3. Who amongst the following collates data on subscriptions regarding primary issuances?
   (a) Banks
   (b) Custodians
   (c) Venture Capital Funds
   (d) Registrars

Ans: (d)

4. As per Securities Contract Regulation Act (SCRA), the term 'Security' excludes which of the following?
   (a) Shares
   (b) Bonds
   (c) Derivatives
   (d) Bullion

Ans: (d)

Unit 2: Regulatory Framework - General View

2.1 Regulatory System

Regulation of the securities market is motivated by the need to safeguard the interests of investors. What is paramount is to ensure that investors make informed decisions on the basis of complete transparency and fairness in both primary and secondary market transactions. The basic objective of SEBI is to:

a. To protect the interest of investors in securities markets
b. To promote the development of securities markets
c. To regulate the securities markets

There are many other issues which warrant regulation. For example, deliberately engineered speculative activities in the stock market or insider trading are undesirable as they can hurt investors at large or companies and mutual funds issuing securities and units ought to furnish adequate disclosures on all relevant facts and that stockbrokers ought to execute transactions in the most efficient manner and also refrain from charging excessive brokerage. There can become instances of unethical activities which can be detrimental to investors in general such as insider trading, misusing power of attorney given by investors to brokers, suspicious transaction reporting, front running, etc.

There are various regulatory institutions which regulate different sectors of the financial system. For instance, the Securities and Exchange Board of India (SEBI) regulates the Securities industry (Capital market), *the Reserve Bank of India (RBI) regulates the banking sector, the Insurance Regulatory and Development Authority (IRDA) regulates insurance companies, while the Pension Fund Regulatory and Development Authority (PFRDA) regulates the pension fund sector*. Additionally, intermediaries representing some segment of the securities market may form a Self-Regulatory Organization (SRO). For recognition as an SRO by SEBI, certain conditions have to be met as prescribed under the SEBI (Self Regulatory Organizations) Regulations, 2004. Ideally, an SRO will seek to uphold investors' interest by laying out and maintaining high ethical and professional standards of conduct and encouraging best practices among its members.

The ruling given by a regulator may be challenged by petitioning the prescribed authority. In the case of SEBI, for example, the appellate authority is the Securities Appellate Tribunal (SAT). Rulings of the SAT can be challenged in the Supreme Court of India. Importantly, no civil court shall entertain any suit or proceeding relating to a matter which an adjudicating officer appointed under the SEBI Act, or under a duly constituted SAT, is empowered under the said Act to decide upon. Further, no injunction can be granted by any court or any other authority with regard to any action taken or to be taken pursuant to any power conferred by the SEBI Act.

2.2Financial Market Regulators

As already discussed in the above sections, the role of a market regulator is to regulate markets to ensure integrity and protect the interests of investors. The different regulators who regulate the activities of the different sectors in the financial market are as given below:

- Ministry of Finance (MOF)
- Ministry of Corporate Affairs (MCA)
- Securities and Exchange Board of India (SEBI) regulates the Securities Industry.
- Reserve Bank of India (RBI) is the authority to regulate and monitor the Banking sector.
- Insurance Regulatory and Development Authority (IRDA) regulates the Insurance sector.
- Pension Fund Regulatory and Development Authority (PFRDA) regulate the pension fund sector.
- Forward Market Commission regulate the forward and future markets

We will discuss in brief the role of each regulator in brief in the subsequent sections.

2.2.1 Role of Securities and Exchange Board of India

SEBI was established on April 12, 1992 in accordance with the provisions of the SEBI Act, 1992. The preamble of the SEBI describes the basic functions of the Securities and Exchange Board of India as "...*to protect the interests of investors in securities and to promote the development of and to regulate the securities market and for matters connected therewith or incidental thereto...*"

As per Section 11(1) of SEBI Act, SEBI is empowered under the various regulations of the SEBI Act to;

a) Regulate the business in stock exchanges and any other securities markets.
b) Register and regulate the working of stockbrokers, sub-brokers, and share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and others associated with the securities market. SEBI's powers also extend to registering and regulating the working of depositories and depository participants, custodians of securities, foreign institutional investors, credit rating agencies, and others as may be specified by SEBI.
c) Register and regulate the working of venture capital funds and collective investment schemes including mutual funds
d) Promote and regulate SROs
e) Prohibit fraudulent and unfair trade practices relating to the securities market.
f) Promote investors' education and training of intermediaries in the securities market.
g) Prohibit insider trading in securities
h) Regulate substantial acquisition of shares and takeover of companies
i) Require disclosure of information, to undertake inspection, to conduct inquiries and audits of stock exchanges, mutual funds, other persons associated with the securities market, intermediaries and SROs in the securities market. The requirement of disclosure of information can apply to any bank or any other authority or board or corporation

j) Calling for information from or furnishing information to other authorities within India or abroad having functions similar to SEBI in matters relating to prevention or detection of violations in respect of securities laws
k) Perform such functions and to exercise such powers under the Securities Contracts (Regulation) Act, 1956 as may be delegated to it by the Central Government
l) Levy fees or other charges pursuant to implementation of this regulation
m) Conduct research for the above purposes
n) Calling from or furnishing to such agencies specified by the Board, information as may be considered necessary for discharge of its functions
o) Performing such other functions as may be prescribed

Further, SEBI is also empowered to enforce disclosure of information or to furnish information to agencies as may be deemed necessary. Some of the powers of SEBI as provided in SEBI Act include:

Section 11(2A): The power to inspect any book of accounts, register or other document or record of any listed company or a public company which intends to get its securities listed at a recognized stock exchange if SEBI has reasonable grounds to assume that the concerned company has been indulging in insider trading or other illegitimate practices such as fraudulent or unfair trade practices.

Section 11(3): SEBI shall have the same powers as are vested in a civil court under the Code of Civil Procedure in respect of certain matters, such as the inspection of books and registers and summoning and enforcing the attendance of persons and examining them on oath.

Section 11(4) empowers SEBI to take the following actions, if it is in the interest of investors or the Securities Market:

- suspend trading in any security at a recognized stock exchange
- restrain persons from accessing the Securities Markets, and prohibiting any persons associated with the securities market from buying, selling or dealing in securities
- suspend any office bearer of any stock exchange or SRO from holding the position
- impound and retain the proceeds or securities relating to any transaction which is under investigation
- direct any intermediary or person associated with the securities market not to dispose off or alienate an asset constituting a part of any transaction which is under investigation

Section 11(5): The amount disgorged pursuant to direction issued under Section 11B or 12A of the Securities Contracts (Regulation) Act, 1956 or section 19 of Depositories Act, 1996, shall be credited to the Investor Protection and Education Fund.

Section 11A: SEBI is vested with the power to regulate or prohibit issue of prospectus, offer document or advertisement which solicits money for issue of securities.

Section 11A (1) empowers SEBI to specify regulations with respect to matters relating to issue of capital, transfer of securities and other incidental matters as well as the manner in which such matters are required to be disclosed by the Companies. Apart from this, SEBI is empowered to issue general or special orders prohibiting any company from issuing the prospectus or offer

document or advertisement soliciting money from the public for issue of securities and specify the conditions subject to which the prospectus or offer document or advertisement may be issued.

Section 11A (2) empowers SEBI to specify the requirements for listing and transfer of securities and matters incidental thereto.

Section 11B: SEBI has been vested with the powers to issue direction to any intermediary, if after making an enquiry it is found that the investor's interest is at stake or action of the intermediary is obstructing the orderly development of the securities market. If need be, SEBI can also in the interest of the market/investors secure the proper management of any such intermediary or person against whom enquiry have been made. This power includes the power to direct any person who made profit or averted loss by indulging in any transaction or activity in contravention of the provisions of this Act or regulations made thereunder, to disgorge an amount equivalent to the wrongful gain made or loss averted by such contravention.

Section 11C: In cases where SEBI has reasonable ground to believe that the transaction in securities are being dealt with in a manner detrimental to the investors or the securities market or that the intermediary or any person associated with the securities market have violated any of the provisions of the SEBI act or any other rules or regulation, by order in writing may direct any person to investigate the affairs of such intermediary or person associated with the securities market and also report to SEBI such investigation.

We would be discussing the SEBI Act in greater detail in Unit 4 of this workbook.

2.2.2 Role of Reserve Bank of India (RBI)

Reserve Bank of India (RBI) is the central bank of the country vested with the responsibility of administering the monetary policy. Therefore, its key concern is to ensure the adequate growth of money supply in the economy so that economic growth and financial transactions are facilitated, but not so rapidly which may precipitate inflationary trends. This is borne out in its Preamble, in which the basic functions of the Bank are thus defined: *"…to regulate the issue of Bank Notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage*". In addition to the primary responsibility of administering India's monetary policy, RBI has other onerous responsibilities, such as financial supervision.

The main functions of RBI are:

1. **As the monetary authority**: to formulate, implement and monitor the monetary policy in a manner as to maintain price stability while ensuring an adequate flow of credit to productive sectors of the economy.
2. **As the regulator and supervisor of the financial system**: To prescribe broad parameters of banking operations within which Indian banking and financial system functions. The objective here is to maintain public confidence in the system, protect the interest of the people who have deposited money with the bank and facilitate cost-effective banking services to the public.

3. **As the manager of Foreign Exchange**: To administer the Foreign Exchange Management Act 1999, in a manner as to facilitate external trade and payment and promote orderly development and maintenance of the foreign exchange market in India.
4. **As the issuer of currency**: To issue currency and coins and to exchange or destroy the same when not fit for circulation. The objective that guides RBI here is to ensure the circulation of an adequate quantity of currency notes and coins of good quality.
5. **Developmental role**: To perform a wide range of promotional functions to support national objectives.
6. **Banking functions**:
   a) It acts as a banker to the Government and manages issuances of Central and State Government Securities.
   b) It acts as a banker to the banks by maintaining the banking accounts of all scheduled banks.

The general superintendence and direction of RBI's affairs are looked after by a Central Boards of Directors which is appointed by the Government of India. Further, each of the four regions in the country is served by a Local Board which advises the Central Board on local issues and represents territorial and economic interests of local co-operative and indigenous banks. The Local Boards will also perform other functions as delegated by the Central Board.

RBI performs the important function of financial supervision under the guidance of the **Board for Financial Supervision (BFS)** which was constituted in 1994 as a committee of the Central Board of Directors. The primary objective of the BFS is to carry out consolidated supervision of the financial sector consisting of commercial banks, financial institutions and non-banking finance companies. The BFS oversees the functioning of the Department of Banking Supervision, the Department of Non-Banking Supervision and Financial Institutions Division and issues directions on regulatory and supervisory issues. Some of the initiatives undertaken by the BFS are:

- A restructuring of the system of bank inspections
- Introduction of offsite surveillance
- Strengthening the role of statutory auditors
- Strengthening the internal defences of supervised institutions

Currently, the Board for Financial Supervision is focused on:

- Supervision of financial institutions
- Consolidated accounting
- Legal issues in bank frauds
- Divergence in assessments of non-performing assets
- Supervisory rating model for banks

RBI's functions are governed by the Reserve Bank of India Act 1934, whereas the financial sector is governed by the Banking Regulation Act 1949.

2.2.3 Insurance Regulatory and Development Authority (IRDA)

Insurance Regulatory and Development Authority's (IRDA's) mission is to regulate, promote and ensure orderly growth of the insurance sector, including the re-insurance business, while ensuring protection of the interests of insurance policyholders. IRDA was constituted by an act of parliament and according to Section 4 of the IRDA Act 1999 the Authority comprises ten members who are all government appointees.

The powers and functions of the authority include the following:

1. Issuing a certificate of registration or renewing, modifying, withdrawing, suspending or cancelling such registration.
2. Protecting the interests of policyholders in matters relating to assignment of policy, nomination by policyholders, insurable interest, settlement of insurance claim, surrender value of policy and other clauses of insurance contracts.
3. Spelling out the required qualifications, code of conduct and practical training for intermediaries including insurance intermediaries and agents.
4. Specifying the code of conduct for surveyors and loss assessors.
5. Seeking information, undertaking inspection, conducting inquiries and investigations including audit of the insurer, intermediaries and others.
6. To control and regulate the rates and terms and conditions that may be offered by insurers with regard to general insurance, which are not covered by the Tariff Advisory Committee.
7. Regulating the investment of funds by insurance companies

2.2.4 Pension Fund Regulatory and Development Authority (PFRDA)

PFRDA was first constituted by the Government of India in October 2003 with the following responsibilities: (a) To promote old age income security by establishing, developing and regulating pension funds, (b) To protect the interests of subscribers to schemes of pension funds and related matters.

It is an interim body, under the administrative control of the Ministry of Finance, pending enactment of a comprehensive legislation. The Authority consists of a Chairperson and up to five members.

The new pension system will be based on defined contributions. It will also offer a menu of investment choices and Fund Managers. Though the new system is voluntary, it would be mandatory for new recruits to the Central Government, except the armed forces. It will also be available on a voluntary basis to all persons including self-employed professionals and others in the unorganized sector. However, mandatory programmes under the Employees Provident Fund Organization (EPFO) and other special provident funds will continue to operate according to the existing system, under the Employees Provident Fund (EPF) and Miscellaneous Provisions Act 1952 and other special acts governing these funds.

Subject to the overall directions and guidelines of the government, the PFRDA shall:

a. Deal with all matters relating to the promotion and orderly growth of the pension market
b. Propose appropriate legislation for the purpose indicated above
c. Carry out such other functions as may be delegated to the authority

The PFRDA shall be free to determine its own procedures and will have powers to call for records and other material relevant to its working, from official and non-official bodies and will also hold discussions with them. The PFRDA will also submit periodical reports to the government on various aspects of the pension sector and on matters required by the government.

2.2.5 Forward Markets Commission (FMC)

Forward Markets Commission is the chief regulator of Forwards and Futures market in India. It was established in 1953 under the provisions of Forward Contract (Regulation) Act, 1952. There are more than 20 recognised commodity futures exchange in India under the purview of FMC and they are divided into national and regional exchanges.

Following are the functions of FMC:

- To advise the Central Government in respect of the recognition or the withdrawal of recognition from any association or in respect of any other matter arising out of the administration of the Forward Contracts (Regulation) Act 1952.
- To keep forward markets under observation and to take such action in relation to them, as it may consider necessary, in exercise of the powers assigned to it.
- To collect and whenever the Commission thinks it necessary, to publish information regarding the trading conditions in respect of goods to which any of the provisions of the act is made applicable, including information regarding supply, demand and prices
- To submit periodical reports to the Central Government on the working of forward markets relating to such goods;
- To make recommendations generally with a view to improving the organization and working of forward markets;
- To undertake the inspection of the accounts and other documents of any recognized association or registered association or any member of such association whenever it considers it necessary

2.3 Role of the other Regulators in the Financial Market

There are several government departments / agencies / organisations that also help in the regulation of the financial market such as the Ministry of Finance (MoF).

Ministry of Finance governs the entire fiscal system of the government of India. It centralizes around all the issues in India pertaining to economy and finance. It also includes the task of mobilization of resources in terms of execution of developmental programmes. Department of Economic Affairs (DEA), Department of Expenditure, Department of Revenue, Department of Financial Services etc are the various departments which are headed by the MoF.

Department of Economic Affairs is the nodal agency of the central government to formulate and monitor India's economic policies having a bearing on domestic and international aspects of

economic management. Main function of the DEA is formulation and monitoring of macroeconomic policies relating to fiscal policy and public finance etc as well as functioning of the capital market including stock exchanges. Other responsibilities include the mobilization of external resources, foreign investments and monitoring foreign exchange resources including balance of payments, production of bank notes and coins of various denominations etc.

Department of Financial Services administers government policies relating to:

- Public sector banks
- Term-lending financial institutions
- Life insurance and general insurance
- Pension reforms

Department of Disinvestment oversees, among other things, all matters relating to the disinvestment of Central Government equity from Central Public Sector undertakings. The department is also concerned with the financial policy relating to the utilization of proceeds of disinvestment.

The ***Ministry of Corporate Affairs*** is mainly concerned with the administration of the Companies Act, 1956 and other allied acts, rules and regulations pertaining to the corporate sector. The Ministry is also responsible for administering the Competition Act 2002 which has replaced the Monopolies and Restrictive Trade Practices Act, 1969 (MRTP). The Ministry also supervises three professional bodies, viz., the Institute of Chartered Accountants of India (ICAI), the Institute of Company Secretaries of India (ICSI) and the Institute of Cost and Works Accountants of India (ICWAI).The Ministry of Corporate Affairs is also vested with the responsibility of administering the Partnership Act, 1932, the Companies (Donations to National Funds) Act, 1951 and Societies Registration Act, 1980.

2.3.1 Registrar of Companies (ROC)

Pursuant to Section 396(1) of the Companies Act, 2013, the Central Government has appointed Registrars at different places to discharge the function of registration of companies as provided in Section 7. Registrar of Companies (ROC) cover the various States and Union Territories and are vested with the primary duty of registering companies created in the respective states and the Union Territories and ensuring that such companies comply with statutory requirements under the Act. These offices function as registry of records, relating to the companies registered with them, which are available for inspection by members of public on payment of the prescribed fee. The Central Government exercises administrative control over these offices through the respective Regional Directors.

The ROC also undertakes other important duties, some of which are given below:

Under Section 81, the Registrar has to maintain a register containing particulars of all charges in respect of each company.

Under Section 83, the Registrar on being given satisfactory evidence with respect to any registered charge:

a) The debt for which the charge was created has been paid or satisfied wholly or partly, or

b) The part of the property or undertaking charged has been released from the charge or has ceased to form a part of the company's property or undertaking;

the Registrar may enter in the Register of Charges a memorandum of satisfaction in whole or in part or about the fact that a part of the property or undertaking has been released from the charge or no longer forms a part of the company's property or undertaking as the case may be, even if no intimation is received by him from the company.

Section 206 confers power on the Registrar to call for information or explanation. On perusing any document which a company is required to submit to him under the Act, if the Registrar determines that any information or explanation pertinent to the document is necessary, the Registrar may by written order call for information in writing from the company. If no information or explanation is forthcoming within the time specified, or if the information or explanation is inadequate, then the Registrar may demand that the company produce for inspection such books and papers as he deems necessary.

Section 209 spells out the power of the Registrar to seek the seizure of documents and therefore, goes a step beyond Section 206, by which the Registrar may only demand the production of documents. If the Registrar has reasonable grounds to believe that books and papers of, or relating to, any company or body corporate or managing director or manager of such an entity may be destroyed, mutilated, altered, falsified or secreted, then the Registrar may make an application to a Magistrate having appropriate jurisdiction to obtain authority to search and seize the books and papers as he deems necessary.

Section 560 confers powers on the Registrar to strike a defunct company off the register, after completing the formalities prescribed in the section.

Under Section 570, the Registrar is empowered to require evidence, as he deems necessary, to satisfy himself on whether any company proposing to get registered is or is not a joint stock company as defined in Section 566 of the Act.

2.3.2 Economic Offences Wing (EOW)

The Economic Offences Wing (EOW) in the Central Bureau of Investigation was created in 1964 to deal with offences under various sections of the Indian Penal Code and notified Special Acts mainly relating to serious frauds in banks, stock exchanges, financial institutions, joint stock companies, public limited companies, misappropriation of public funds, criminal breach of trust, violation of Customs Act, counterfeiting of currency, narcotics, drug trafficking, arms peddling and offences relating to adulteration, black-marketing and others.

Following the securities and stock market scam of 1992, it was deemed desirable to strengthen and expand the EOW and accordingly, a full-fledged Economic Offences Division (EOD) was formed in 1994. The EOD has four zones of which one focuses exclusively on large and complicated security and bank frauds.

The areas currently covered by the EOD are:

1. Frauds relating to foreign trade

2. Banking frauds
3. Insurance frauds
4. Foreign exchange frauds
5. Frauds involving manipulation of share prices, insider trading and others
6. Smuggling of narcotics and psychotropic substances
7. Forgery of travel documents, identity papers and overseas job rackets
8. Counterfeit currency and fake Government stamps and paper
9. Smuggling of antiques, arts and treasures
10. Cyber crimes
11. Violation of Intellectual Property Rights, audio and video piracy and software piracy
12. Wildlife and environmental offences

State governments have also set up their own EOWs to deal with commercial crimes, thefts of idols, bogus lottery tickets and other offences.

2.3.3 Financial Intelligence Unit - India (FIU-I)

FIU-I was set up by the Government of India in 2004 as the central nodal agency responsible for receiving, processing, analyzing and disseminating information regarding suspicious financial transactions in order to support anti-money laundering efforts. FIU-I is an independent body reporting directly to the Economic Intelligence Council headed by the Finance Minister. More specifically, the functions of FIU-I are:

A. To serve as the nerve centre for receiving reports on cash and other suspicious transactions.
B. To analyze the information collected to trace patterns of transactions which could involve money laundering and other crimes.
C. To share information on suspicious transactions with its counterparts and regulatory bodies in other countries.
D. To establish and maintain a database on cash and suspicious transactions.
E. To co-ordinate and strengthen collection and sharing of financial intelligence through an effective national, regional and global network to fight money laundering and related crimes.
F. To undertake research and analysis in order to monitor and identify strategic areas on money laundering trends and other such developments.

Certain exclusive and concurrent powers under the Prevention of Money Laundering Act (PMLA) are conferred on the Director, FIU-I. For instance, under Section 13(2) of the PMLA, the Director may impose a fine on any banking company, financial institution or intermediary for failing to comply with obligations of maintenance of records or in furnishing information or in verifying the identities of clients. For the purposes of Section 13, the Director shall have the same powers as are vested in a civil court under the Court of Civil Procedure 1908, while trying a suit, such as discovery and inspection, compelling the production of records and so on. Under Section 66 of the PMLA, the Director or a specified authority may furnish or cause to be furnished any information received or obtained, to any officer, authority or body, if it is deemed to be in the public interest.

2.3.4 Police Authorities

The police authorities are responsible for maintaining law and order and for enabling the enforcement of The Indian Penal Code (IPC) which contains laws on crimes of various kinds. The IPC has 511 sections, some of which contain detailed descriptions of certain crimes. In the context of the securities market, sections which have particular relevance are the ones relating to specific offences, such as:

a. Giving false evidence and offences against public justice (sections 191 to 229)
b. Offences against property (sections 378 to 462)
c. Offences relating to documents and to property marks (sections 463 to 489E)
d. Attempts to commit offences (section 511)

To illustrate the relevance, some sections from the ones listed above are discussed as follows:

Section 192 relates to fabrication of false evidence. Examples of the same would be making a false entry in any book or record; or, making a document containing a false statement intending that such circumstances, false entry or false statement may appear in evidence in a judicial proceeding or in a proceeding taken by law so as to cause an erroneous opinion to be formed.

Section 403 relates to the criminal misappropriation of property. The offence is committed when a person dishonestly misappropriates or converts to his own use any movable property.

Section 405 is about criminal breach of trust. The offence is committed when a person who has been entrusted with property or dominion over property, misappropriates it or converts it to his own use or disposes off that property in violation of any direction of law or legal contract.

Offences relating to property marks and documents include forgery (sections 463 and 465) and making a false document (section 464); further, if a clerk, officer or servant wilfully and with intent to defraud destroys, alters, mutilates or falsifies any book, paper, writing, valuable security or account belonging to or in the possession of his employer, then it is an act of falsification of accounts, which is an offence under section 477A. Even the abetment of such an Actor of the omission or alteration of any material is held to be an offence.

*Section 511*deals with punishment for attempting to commit offences punishable with imprisonment for life or other imprisonment.

2.4Appellate Authority

2.4.1 Role of Appellate Authority -Securities Appellate Tribunal (SAT)

The Securities Appellate Tribunal has been set up under the SEBI act, which looks into the appeal of any person who has been aggrieved by any order of SEBI. This section elaborates on the different sections under the SEBI Act which discusses the establishment and the role of SAT. Section 15K (1) of the SEBI Act, 1992, empowers the Central Government to establish Securities Appellate Tribunal (SAT) to exercise jurisdiction, powers and authority under the said act or any other law in force. A SAT shall consist of a presiding officer and two other members, to be appointed by the Central Government. The qualification for appointment is that the person should be a sitting or retired judge of the Supreme Court or a retired Chief Justice of a High Court.

Any person aggrieved by the following may appeal to the SAT, provided the aggrieved person had not granted his consent to the order against which the appeal is being made. The appeal must be filed within a period of 45 days from the date on which a copy of the order is received:

a. An order of SEBI made on or after the commencement of the Securities Laws (Second Amendment) Act, 1999, under the SEBI Act 1992, or related rules and regulations.
   OR
b. By an order made by an adjudicating officer under the Act.

As per Section 15U (1), the SAT shall not be bound by the procedure laid down by the Code of Civil Procedure, 1908, but shall be guided by the principles of natural justice. Further, subject to other provisions of the SEBI Act, 1992, and other rules, the SAT shall have powers to regulate its own procedure.

As per Section 15U (2), the SAT shall have, for discharging its functions, the same powers as are vested in a civil court under the Code of Civil Procedure, 1908, while trying a suit, in respect of the following matters:

a) Summoning and enforcing the attendance of any person and examining him on oath
b) Requiring the discovery and production of documents
c) Receiving evidence on affidavits
d) Issuing commissions for the examination of witnesses or documents
e) Reviewing its decisions
f) Dismissing an application for default or deciding it ex-parte
g) Setting aside any order of dismissal of any application for default or any order passed by it ex-parte
h) Any other matter which may be prescribed

According to Section 15U (3), every proceeding before the SAT shall be deemed to be a judicial proceeding and SAT shall be deemed to be a civil court. Section 15V states that the appellant may either appear in person or authorize one or more chartered accountants or company secretaries or cost accountants or legal practitioners or any of its officers to present his or its case before the SAT.

Section 15W states that the provisions of the Limitation Act, 1963 shall apply to an appeal made to a SAT. Section 15Y specifies that no civil court shall have jurisdiction to entertain any suit or proceeding in respect of any matter which SAT constituted under the SEBI Act is empowered to decide upon. Further, no injunction shall be granted by any court or an authority in respect of any action taken or to be taken in pursuance of any power conferred by or under the SEBI Act.

Section 15Z states that any person aggrieved by any decision or order of the SAT may file an appeal to the Supreme Court within 60 days from the date of communication of the decision or order of the SAT to him, on any question of law arising out of the order.

2.5Legislative Framework Governing the Financial Market

Understanding the financial market, intermediaries and the regulators involved in efficient regulation of the system, in this section we however try to take a look at the main rules and regula-

tions pertaining to the securities market. The subsequent chapters in this workbook will delve deeper into each of the regulations as discussed hereunder.

2.5.1 SEBI Act, 1992

The SEBI Act, 1992 is an act to provide for the establishment of a Board to protect the interests of investors in securities and to promote the development of, and to regulate, the securities market and related matters. SEBI's regulatory ambit includes stock exchanges, stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and other intermediaries associated with the securities market. Further, SEBI is the authority to regulate depositories, custodians, foreign institutional investors, credit rating agencies, mutual funds and venture capital funds. SEBI is also vested with the responsibility of prohibiting fraudulent and unfair trade practices relating to the securities market, including insider trading.

2.5.2 Securities Contracts (Regulation) Act, 1956

The Securities Contracts (Regulation) Act, 1956 is a legislation to prevent undesirable transactions in securities by regulating the business of securities dealing and trading. In pursuance of its objects, the act covers a variety of issues, of which some are listed below:

1. Granting recognition to stock exchanges
2. Corporatization and demutualization of stock exchanges
3. The power of the Central Government to call for periodical returns from stock exchanges
4. The power of SEBI to make or amend bye-laws of recognized stock exchanges
5. The power of the Central Government (exercisable by SEBI also) to supersede the governing body of a recognized stock exchange
6. The power to suspend business of recognized stock exchanges
7. The power to prohibit undesirable speculation

2.5.3 Securities Contracts (Regulation) Rules, 1957

Section 30 of the Securities Contracts (Regulation) Act, 1956 empowers the Central Government to make rules for the purpose of implementing the objects of the said act. Pursuant to the same, the Securities Contracts (Regulation) Rules 1957 have been made. These rules contain specific information and directions on a variety of issues, as for example:

- Formalities to be completed including submission of application for recognition of a stock exchange
- Qualification norms for membership of a recognized stock exchange
- Mode of entering into contracts between members of a recognized stock exchange
- Obligation of the governing body to take disciplinary action against a member, if so directed by the SEBI
- Audit of accounts of members
- Maintaining and preserving books of accounts by every recognized stock exchange and by every member

- Submission of the annual report and periodical returns by every recognized stock exchange
- Requirements with respect to listing of securities on a recognized stock exchange
- Requirements with respect to the listing of units or any other instrument of a Collective Investment Scheme on a recognized stock exchange

2.5.4 Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992

The regulations prohibiting insider trading have been made pursuant to Section 30 of the SEBI Act, 1992.

The regulations define "insider" as any person who is, or was, connected with a company or is deemed to have been connected with the company and who is reasonably expected to have access to unpublished price sensitive information in respect of securities of the company, or who has received or has had access to such unpublished price sensitive information. Further, an explanation is provided of the expression, "person is deemed to be a connected person" in detail. Examples of such a person are:

1. A company under the same management or group.
2. An intermediary as specified in Section 12 of the SEBI Act, 1992, Investment Company, Trustee Company, Asset Management Company or an employee or director thereof or an official of a stock exchange or of clearing house or corporation.
3. A merchant banker, share transfer agent, registrar to an issue, debenture trustee, broker, portfolio manager and others, as specified.
4. A member of the Board of Directors or an employee of a public financial institution as defined in Section 2(72) of the Companies Act, 2013[1].
5. A relative of any of the aforementioned persons.
6. A banker of the company.
7. Relatives of the connected person.

Similarly, the regulations specify events that will be deemed as price-sensitive information, as for example:

1. Periodical financial results of the company
2. Intended declaration of dividends, both interim and final

[1]The financial institution specified herewith is regarded as a public financial institution for the purposes of the act, namely – (i) the Life Insurance Corporation of India, established under section 3 of the Life Insurance Corporation Act, 1956 (ii) the Infrastructure Development Finance Company Limited referred to in clause (vi) of sub-section (1) of section 4A of the Companies Act, 1956 so repealed under Section 465 of this Act (iii) specified company referred to in the Unit Trust of India (Transfer of Undertaking and Repeal) Act, 2002 (iv) institutions notified by the Central Government under sub-section(2) of section 4A of the Companies Act, 1956 so repealed under Section 465 of this Act(v) such other institution as may be notified by the Central Government in consultation with the Reserve Bank of India Provided that no institution shall be so notified unless – (A) it has been established or constituted by or under any Central or State Act or (B) not less than fifty-one per cent of the paid-up share capital is held or controlled by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments

3. Issue of securities, or buyback of securities
4. Any major expansion plans or execution of new projects

Regulation 12(1) of the SEBI Insider Trading Regulations requires listed companies and organizations associated with the securities market to frame a code of internal procedures and conduct, in line with the Model Code specified in Schedule I of the regulations. According to the Model Code, the compliance officer shall be responsible for setting forth policies, procedures, monitoring adherence to the rules for the preservation of price-sensitive information and other related critical tasks.

2.5.5 Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003

The Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003 prohibit fraudulent, unfair and manipulative trade practices in securities. These regulations have been made in exercise of the powers conferred by section 30 of the SEBI Act, 1992.

Regulation 2(1) (c) defines fraud as inclusive of any act, expression, omission or concealment committed to induce another person or his agent to deal in securities. There may or may not be wrongful gain or avoidance of any loss. However, that is inconsequential in determining if fraud has been committed. Some of the instances cited are as follows:

a) A wilful misrepresentation of the truth or concealment of material fact in order that another person may act, to his detriment
b) A suggestion as to a fact which is not true, by one who does not believe it to be true
c) An active concealment of a fact by a person having knowledge or belief of the fact
d) A promise made without any intention of performing it
e) A representation, whether true or false, made in a reckless and careless manner
f) Any such act or omission as any other law specifically declares to be fraudulent
g) deceptive behaviour by a person depriving another of informed consent or full participation
h) false statement made without reasonable ground for believing it to be true
i) the act of an issuer of securities giving out misinformation that affects the market price of the security resulting in investors being effectively misled even though they did not rely on the statement itself or anything derived from it other than the market price

Chapter II of the regulations prohibits certain dealings in securities covering buying, selling or issuance of securities. Further it specifies instances of fraud which includes the following:

a. Indulging in an act which creates a false or misleading appearance of trading in the securities market
b. Dealing in a security which is not intended to effect a transfer of beneficial ownership but to serve only as a device to inflate or depress or cause fluctuations in the price of such security for wrongful gain or avoidance of loss

c. Advancing or committing to advance any money to any person thus inducing the other to buy any security in any issue only with the intention of securing the minimum subscription to such issue
d. Paying, offering or agreeing to do either, directly or indirectly to any person any money or money's worth for inducing such person for dealing in any security with the motive of inflating, depressing, maintaining or causing fluctuation in the price of such security
e. Any act or omission which is tantamount to a manipulation of the price of a security
f. A person dealing in securities, publishing, or causing to publish or reporting or causing to report any untrue information or information which he does not believe to be true, prior to, or in the course of dealing in securities

Chapter III relates to investigation of transactions of the nature described above. In particular, under regulation 8(1), it shall be the duty of every person who is under investigation:

a. To produce books, accounts and documents that may be required by the Investigating Authority and also to furnish statements and information that is sought.
b. To appear before the Investigating Authority personally when required to do so and to answer questions posed by the authority.

2.5.6 Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011

The Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, are spread over five chapters dealing with issues such as disclosures of shareholding and control, substantial acquisition of shares or voting rights, bailout takeovers and investigation and action by SEBI.

The regulations begin with an explanation of important terms such as "acquirer", "control", "person acting in concert" and "promoter". Some of the subsequent regulations are discussed below, to illustrate the nature and scope of the regulations.

According to regulation 3(1), any acquirer who acquires shares or voting rights, which (taken together with shares or voting rights, if any held by him) would entitle him to exercise twenty five percent or more voting rights in a company, in any manner whatsoever, is required to make a public announcement of an open offer for acquiring shares of the target company

Regulation 3(2) states that no acquirer who together with persons acting in concert with him, has acquired and holds in accordance with these regulations shares or voting rights in a target company entitling them to exercise twenty-five per cent or more of the voting rights in the target company but less than the maximum permissible non-public shareholding, shall acquire within any financial year additional shares or voting rights in such target company entitling them to exercise more than five per cent of the voting rights, unless the acquirer makes a public announcement of an open offer for acquiring shares of such target company in accordance with these regulations:

Regulation 29(1) states: Any acquirer who acquires shares or voting rights in a target company which taken together with shares or voting rights, if any, held by him and by persons acting in

concert with him in such target company, aggregating to five per cent or more of the shares of such target company, shall disclose their aggregate shareholding and voting rights in such target company in such form as may be specified.

Regulation 29(2) states: Any person, who together with persons acting in concert with him, olds shares or voting rights entitling them to five per cent or more of the shares or voting rights in a target company, shall disclose the number of shares or voting rights held and change in shareholding or voting rights, even if such change results in shareholding falling below five per cent, if there has been change in such holdings from the last disclosure made under sub-regulation (1) or under this sub-regulation; and such change exceeds two per cent of total shareholding or voting rights in the target company, in such form as may be specified Regulation 29(3) states as under: The disclosures required under sub-regulation (1) and sub-regulation (2) shall be made within two working days of the receipt of intimation of allotment of shares, or the acquisition of shares or voting rights in the target company to,—
(a) every stock exchange where the shares of the target company are listed; and
(b) the target company at its registered office.

As per Regulation 30, the following continual disclosures are required to be made:

30(1) Every person, who together with persons acting in concert with him, holds shares or voting rights entitling him to exercise twenty-five per cent or more of the voting rights in a target company, shall disclose their aggregate shareholding and voting rights as of the thirty-first day of March, in such target company in such form as may be specified.
(2) The promoter of every target company shall together with persons acting in concert with him, disclose their aggregate shareholding and voting rights as of the thirty-first day of March, in such target company in such form as may be specified.
(3) The disclosures required under sub-regulation (1) and sub-regulation (2) shall be made within seven working days from the end of each financial year to,—
(a) every stock exchange where the shares of the target company are listed; and
(b) the target company at its registered office.

The other Regulations contain directions on various aspects of the public offer such as appointment of a merchant banker, timing and content of the public announcement of the offer, submission of letter of offer to SEBI and the offer price. Subsequent regulations deal with matters such as general obligations of the acquirer, merchant banker, BoD of the target company, provision of escrow to enable the acquirer to perform his obligations and a substantial acquisition of shares in a financial weak company.

Regulation 32 empowers SEBI to issue directions such as:

a. Appointment of a merchant banker for the purpose of causing disinvestment of shares acquired in breach of specified regulations
b. Directing the transfer of any proceeds or securities to the Investor Protection Fund of a recognized stock exchange
c. Directing the target company or depository to cancel the shares where an acquisition of shares pursuant to an allotment is in breach of specified regulations

2.5.7 Companies Act, 1956/Companies Act, 2013

The Companies Act, 1956/2013 is a legislation to consolidate and amend the law relating to companies and certain other associations.

This 1956 Act, for the first time, introduced a uniform law pertaining to companies throughout India. The legislation applies to all trading corporations and to those non-trading corporations whose objects extend to more than one State of India. Further, other entities not covered by the scope of the act are corporations whose objects are confined to one state, universities, co-operative societies and unincorporated trading, literary scientific and other societies and associations mentioned in item 32 of the State List in the Seventh Schedule of the Constitution of India. With some exceptions relating to Jammu & Kashmir, Goa, Daman and Diu and Sikkim, the act applies to the whole of India.

The voluminous legislation consists of thirteen parts covering 658 sections. A brief description of the parts is as follows:

Part I: Preliminary: This mentions the title, commencement, extent and also contains definitions of terms such as “company”, “private company”, “public company” and “officer who is in default”.

Part I-A has information about the Board of Company Law administration and about appeals against the Company Law Board.

Part II: Incorporation of a company and incidental matters. The sections cover matters such as registration of companies, Memorandum of Association, Articles of Association, membership of a company, private companies, investments of a company and power of company to have an official seal for use at places outside India.

Part III: Prospectus and Allotment and matters relating to the issue of shares and debentures

Matters covered include the contents of a prospectus, its registration, civil and criminal liabilities for misstatements in the prospectus, allotment of shares and debentures and issuance and redemption of preference shares.

Part IV: Share Capital and Debentures

The sections relate to, among other matters, the nature, numbering and certificate of shares, kinds of share capital, reduction of share capital and transfer of shares and debentures.

Part V: Registration of Charges

The sections explain the term “charge” and also cover various related aspects such as the Register of Charges, Certificate of Registration, penalties and so on.

Part VI: Management and Administration

Matters dealt with herein include the registered office and name, the Register of Members and debenture holders, Annual Returns, meetings and proceedings, managerial remuneration, payments of dividend, accounts and audit and the Board of Directors (BoD).

Part VII: Winding Up

The sections relate to modes of winding up and the legal processes and formalities pertaining to the same.

Part VIII dwells on the application of the act to companies formed or registered under previous companies' laws.
Part IX pertains to companies authorized to register under the act and deal with matters such as companies capable of being registered, definition of "joint stock company", requirements for their registration and notice to customers on registration of banking company with limited liability etc.

Part X pertains to winding up of unregistered companies and

Part XI relates to the obligations and formalities of companies incorporated outside India.

Part XII relates to registration offices, officers and fees.

Part XIII is general in nature and bears sections pertaining to matters such as collection of information and statistics from companies, application of the act to companies governed by special acts or to government companies, penalties for various offences and so on.

The new Companies Act, 2013 is divided into 29 Chapters and 470 sections. Many sections have been notified as on date and the notified sections will apply and the old Companies Act, 1956 will be repealed to that extent.

2.5.8 Indian Contract Act

The Indian Contract Act came into force in September 1872. It lays down general principles with regard to contracts and applies to the whole of India, except the state of Jammu & Kashmir.

The law of contracts represents the most important branch of mercantile law and rests at the foundation of trade and commerce. It is pervasive as it affects us in our daily lives, often without our realizing it. The main purpose of the law is to impart credibility about the fulfilment of obligations in mercantile transactions. The contracts become enforceable through the courts of law.

A contract primarily must satisfy two conditions;

1. There shall be an agreement; and
2. Such an agreement should be enforceable by law which creates legal obligations. Hence, agreements which are enforceable by law are contracts. An agreement is enforceable by law when it fulfils certain conditions as laid down in section 10 of The Indian Contract Act, 1872. As per section 10 of the Indian Contract Act "*All agreements are contracts if they are made by the free consent of parties competent to contract, for a lawful consideration and with a*

lawful object and are not hereby expressly declared to be void. Nothing herein contained shall affect any law in force in India and not hereby expressly repealed by which any contract is required to be made in writing or in the presence of witnesses, or any law relating to the registration of documents."

The sections of the Act relate to matters such as:

1. Essentials of a valid contract
2. Classification of contracts
3. Offer, acceptance and communication of offer, acceptance and revocation of either
4. Capacity of the parties to a contract
5. Free consent
6. Consideration
7. Legality of object and consideration
8. Performance of a contract
9. Remedies for breach of contract
10. Indemnity and guarantee
11. Bailment and pledge
12. Law of agency

A more detailed explanation on the essential elements of a contract is provided below.

- There must be at least two parties to a contract, with an offer by one and acceptance by the other. Such offer and acceptance must be legal.
- The parties to the agreement must intend to create legal relations between them. Mere social or domestic agreements do not constitute contracts.
- The agreement to be enforceable by law must be supported by valuable consideration. An agreement to perform for nothing in return is usually not enforceable. The consideration could be an act or abstinence or a promise to do or not to do something.
- The parties must be capable of entering into a valid contract, that is, they should have attained the age of majority, should be of sound mind and not disqualified from contracting by any law.
- The consent of the parties must be free, that is, it should not have been caused by coercion, undue influence, fraud, misrepresentation or mistake.
- The object of the agreement must be lawful, which implies that it must not be illegal, immoral or against public policy. Any agreement with an unlawful object is void.
- The terms of the agreement must be definite and certain. A court will not enforce a contract which contains vague or illusory terms.
- The agreement must be capable of performance. An agreement to perform an act which is impossible is void.
- The agreement must not have been expressly declared to be void. Examples of such agreements are:
    1. An agreement in restraint of trade
    2. An agreement in restraint of legal proceedings
    3. An agreement having uncertain meaning
- The agreement may be oral or written. However, those agreements which are required to be written or even attested and registered must be in the prescribed form. Examples are mortgage of immovable property and negotiable instruments.

From the perspective of the securities market, the law of agency is especially important and it governs the relationship between an investor (principal) and a broker (agent). The function of a broker is to establish privity of contract between two parties to a transaction for which he earns a commission, i.e., brokerage. Accordingly, section 226 makes it clear that contracts entered into through an agent and the resulting obligations may be enforced in the same manner and will have the same legal consequences as if the contracts had been entered into and the acts performed by the principal in person.

Certain sections spell out the agent's duties for example:

Section 211 states that an agent is bound to conduct the business of his principal according to the directions given by the principal

Section 212 makes it clear that an agent is bound to conduct the business of the agency skilfully (unless the principal is aware of his deficiencies) and with reasonable diligence.

Section 213 requires that an agent render proper accounts to his principal on demand.

Similarly, some regulations lay down the duties of the principal, as for instance, section 222 which lays down that the principal is bound to indemnify the agent against the consequences of all lawful acts done by such agent in exercise of the authority conferred on him.

2.5.9 Public Debt Act, 1944

The Public Debt Act, 1944 is an act to consolidate and amend the law relating to government securities and to the management by RBI of the public debt. Although government securities are typically long-term debt instruments issued by the Central or State Governments or by other entities, but bearing a government guarantee, the Act defines the expression broadly as to include promissory notes, bearer bonds and even Treasury Bills.

The Act confers considerable powers on RBI. As an illustration, section 19 lays down that no recognition by the bank of a person as the holder of a Government Security, and no order made by the Bank under the Act shall be called into question by any Court, as far as the recognition or order affects the relations of the Government or RBI with the person recognized as described above, or with any person claiming an interest in such security.

Section 24 relates to the period of limitation of government's liability in respect of interest. It states that the liability of the government with regard to interest payment due on a government security shall terminate on the expiry of six years from the date on which the amount became payable, unless a shorter period is fixed by any law.

A related notification of the Ministry of Finance (MoF), Government of India (GOI) dated May 6th, 2002 lays out the general terms and conditions applicable to all issues of government securities, as for example:

a. Eligibility for investment
b. Minimum subscription

c. Procedure for application
d. Payment for GS
e. The relevant laws, namely, The Public Debt Act, 1944 and The Public Debt Rules,1946, read with notifications and press releases

2.5.10 Prevention of Money-Laundering Act, 2002

Money laundering involves disguising financial assets so that they can be used without detection of the illegal activity that produced them. Through money laundering, the launderer transforms the monetary proceeds derived from criminal activity into funds with an apparently legal source.

The Prevention of Money-Laundering Act, 2002 (PMLA), is an act to prevent money-laundering and to provide for confiscation of property derived from, or involved in, money-laundering and for related matters. Chapter II, section 3 describes the offence of money-laundering thus: Whoever directly or indirectly attempts to indulge, or knowingly assists or knowingly is a party or is actually involved, in any process or activity connected with the proceeds of crime and projecting it as untainted property shall be guilty of the offence of money-laundering.

The offences are classified under Part A, Part B and Part C of the Schedule. Under Part A, offences include counterfeiting currency notes under the Indian Penal Code to punishment for unlawful activities under the Unlawful Activities (Prevention) Act, 1967. Under Part B, offences are considered as money laundering if the total value of such offences is Rs 30 lakh or more. Such offences include dishonestly receiving stolen property under the Indian Penal Code to breaching of confidentiality and privacy under the Information Technology Act, 2000. Part C includes all offences under Part A and Part B (without the threshold) that has cross-border implications.

We will be discussing this Act in detail in Unit 9 of this workbook.

2.5.11 Foreign Exchange Management Act, 1999

The Foreign Exchange Management Act (FEMA), 1999, is an act to consolidate and amend the law relating to foreign exchange, external trade and payments for promoting the orderly development and maintenance of foreign exchange market in India. As a consequence of this enactment, its predecessor, The Foreign Exchange Regulation Act (FERA), 1973 was repealed. FEMA extends to the whole of India and shall apply to all branches, offices and agencies outside India, owned or controlled by a person resident in India and also to any violation committed outside India by any person covered by FEMA. For illustrative purposes, some provisions of the Act are discussed below.

Section3 states that except as provided in FEMA and allied rules and regulations or under permission of RBI, no person shall:

a) Deal in or transfer any foreign exchange or foreign security to any person not being an authorized person
b) Make any payment to or for the credit of any person resident outside India in any manner

c) Receive otherwise through an authorized person, any payment by order or on behalf of any person resident outside India in any manner
d) Enter into any financial transaction in India, as consideration for or in association with the acquisition or creation or transfer of a right to acquire any asset outside India by any person

Section4 lays down that except as otherwise provided in FEMA, no person resident in India shall acquire, hold, own, possess or transfer any foreign exchange, foreign security or any immovable property situated outside India. Section 5 relates to Current Account transactions, while Section 6 pertains to Capital Account transactions.

Section 10 empowers RBI to authorize any person, on any application made to it, to deal in foreign exchange or in foreign securities as an authorized dealer, money changer or offshore banking unit or in any other manner as it considers fit. Further, sub-section (5) stipulates that an authorized person shall, before undertaking any transaction in foreign exchange on behalf of any person, require that person to make such declaration and to give such information as will reasonably satisfy him that the transaction will not involve and is not meant to contravene or evade any provisions of the FEMA or of any rule, regulation, notification, direction or order made under the legislation. If the person refuses to comply with any requirement or performs unsatisfactory compliance, the authorized person shall furnish written refusal to undertake the transaction and shall report the matter to RBI, if he has the reason to suspect that any violation or evasion is being contemplated by the person.

FEMA empowers the Central Government to appoint Adjudicating Authorities, Special Directors (Appeals) and an Appellate Tribunal. The latter two shall have for the purposes of discharging their functions under the Act, the same powers as are vested in a civil court under the Code of Civil Procedure, 1908 while trying a suit. Examples of some powers are:

a) Summoning and enforcing the attendance of any person and examining him on oath
b) Requiring the discovery and production of documents
c) Receiving evidence on affidavits
d) Subject to the provisions of regulations 123 and 124 of the Indian Evidence Act, 1872, requisitioning any public record or document or copy of such record or document from any office
e) Issuing commissions for the examination of witnesses or documents

Section 34 stipulates that no civil court shall have jurisdiction to entertain any suit or proceeding in respect of any matter which an Adjudicating Authority or the Appellate Tribunal or the Special Director (Appeals) is empowered under the FEMA to determine. Further, no injunction shall be granted by any Court or other authority in respect of any action taken or to be taken in pursuance of any powers conferred by the Act. Section 35 pertains to appeal against any decision or order of the Appellate Tribunal, to the High Court.

2.5.12 Bye-Laws of Stock Exchanges[2]

[2]Candidates may like to read the different provisions as given under the different bye-laws of the exchanges posted on the Exchange website.

Indian stock exchanges such as BSE, NSE, etc. frame their own Bye-Laws which are binding on all the trading members / brokers registered with the particular exchange. The bye laws framed by the stock exchanges need to be approved by the SEBI and shall be in conformity with the provisions of the SC(R)A, 1956, SC(R)R, 1957 and the SEBI Act, 1992. The bye laws lay down rules regarding the admission of trading members, listing requirements, fees, suspension of admission to the stock exchange, transaction and settlement, rights and liabilities of members, arbitration etc. It is the responsibility of the trading member or the compliance officer or any such person appointed by the trading member to ensure that all the different regulations of the bye-laws are adhered to.

2.5.13 Taxes on Securities

2.5.13.1 Income-Tax Act, 1961

The Income-Tax Act, 1961, (as amended by the Finance Act, 2008) is an Act to consolidate and amend the law relating to income-tax and super-tax, and it extends to the whole of India. It came into force from April 1962. It consists of twenty-three chapters, but the ones that are of common interest are as follows:

Chapter I: Preliminary
Chapter II: Basis of charge
Chapter III: Incomes which do not form part of Total Income
Chapter IV: Computation of Total Income
Chapter V: Income of other persons, included in total income of person being assessed
Chapter VI: Aggregation of income and set off or carry forward of loss
Chapter VIA: Deductions to be made in computing total income
Chapter VIII: Rebates and Reliefs

Income Tax on Securities

Financial securities (mostly shares, but also listed debentures and mutual funds) provide regular income in the form of dividends on shares and units of mutual funds, and interest on debt securities. Dividends from shares and mutual funds are totally exempt under section 10 of the Income Tax Act. Interest income from debentures, bonds and all forms of deposits are subjected to Income Tax. An exemption from interest from specific 'Tax Free Bonds' is sometimes granted by the Income Tax authorities.

When securities such as shares, listed debentures and mutual funds are sold, it could result in a gain or loss, depending on the cost of purchase (acquisition, including brokerage etc). Such securities, if held for at least 12 months before sale (called a transfer) could result in a Long Term Capital Gain or Long Term Capital Loss. If the holding period, however, is less than 12 months, the resultant Gain or Loss is called a Short Term Capital Gain or Short Term Capital Loss.

In addition to Income Tax (which is directly borne by the assessee), there is also a Securities Transaction Tax (STT), which, like VAT or Sales Tax, is an Indirect Tax. This is levied by the stockbroker through the contract note and recovered from the customer, and ultimately paid to the STT authorities. With the introduction of STT, after 2004, Long Term Capital Gain Tax has been

exempted for equities being traded through recognized Stock Exchanges. Short Term Gains on equities are taxed at 15% as of December 2012.

Long Term Capital Losses can be set off only against Long Term Capital Gains, if there is any such income to be taxed.

Short Term Capital Gains can be set off either against Short Term Capital Losses or even Long Term Capital Gains, if any.

Losses (both Long and Short Term) if not set off in a year due to lack of offsetting income, can be carried forward for 8 years.

The above provisions apply in respect of securities held as capital assets, not by persons regularly engaged in the Business of buying and selling securities. For persons holding financial securities as a business asset (inventory or stock) for sale and filing Income Tax returns specifically under Business Profits, the losses and gains are computed under the income head 'Business Profits'.

2.5.12.2 Securities Transaction Tax (STT)

The Securities Transaction Tax (STT) was introduced by Chapter VII of The Finance (No. 2) Act, 2004. It is a tax applicable on the purchase or sale of equity shares, derivatives, equity-oriented funds and equity-oriented mutual funds. Examples of transactions done in a recognized stock exchange on which STT applies are as follows:

- Purchase or sale of equity shares and units of equity-oriented mutual funds (delivery-based).
- Sale of equity shares and units of equity-oriented mutual funds (non delivery-based).
- Sale of derivatives

Section 100(1) of The Finance (No. 2) Act, 2004 lays down that every recognized stock exchange shall collect the STT from every person whether a purchaser or seller as the case may be, who enters into a taxable securities transaction in that stock exchange, at the rates prescribed in the Act.
Section 100(2) states that the prescribed person in the case of every mutual fund shall collect the STT from every person who sells a unit to that mutual fund, at the rate specified.

2.5.12.3 Service Tax (ST)

The Service Tax (ST) is a levy on specified services, collected and appropriated by the Union Government. It was introduced following the necessary Constitutional amendments, notably the insertion of a new article, 268A. The relevant legislation is Chapter V of The Finance Act, 1994.

The long list of taxable services figures in clause (105) of section 65 of the said Act and includes service provided or to be provided by a stockbroker in connection with the sale or purchase of securities listed on a recognized stock exchange. It applies to stock broking services.

Section 66 lays down that the rate at which the tax is to be levied as a percent of the value of taxable services. Section 68 relates to the prescribed time within which the tax must be paid. Section 69 pertains to registration by every person liable to pay the tax, section 70 stipulates furnishing the returns and section 78 relates to penalty for suppressing the value of taxable service(s).

Review Questions

1. Unhealthy practice in the Securities Markets includes which of the following?

   (a) Disclosure

   (b) Transparency

   (c) Insider Trading

   (d) Surveillance

Ans: (c)

2. Which is the central bank in India with the responsibility of administering the monetary policy?

   (a) State Bank of India

   (b) Reserve Bank of India

   (c) Central Bank of India

   (d) All of the above

Ans: (b)

3. Which authority was set up with the primary responsibility of promoting old age income security by establishing, developing and regulating pension funds?

   (a) Association of Mutual Funds in India

   (b) Insurance and Regulatory Development Authority

   (c) Pension Fund Regulatory Development Authority

   (d) Securities Exchange Board of India

Ans: (c)

4. "The bye-laws of the stock exchanges are same across exchanges and need to be approved by SEBI". State whether True or False?

   (a) True

   (b) False

Ans: (b)

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Unit 3: Introduction to Compliance

3.1 Compliance – Introduction

3.1.1 Meaning of Compliance

In general, compliance means conforming to a rule, such as a specification, policy, standard or law. Specifically in the context of the securities market, compliance however means a set of actions by which registered intermediaries in securities markets and issuer companies need to comply with the rules and regulations, notifications, guidelines and instructions issued by the Securities and Exchange Board of India (SEBI), the stock exchanges, depositories with whom the intermediary has taken membership, also policies laid down by the Board of Directors (BoD) of the Company and other competent authorities. The set of actions include maintenance of records, adoption of policies and procedures, preparation of reports, taking actions and making submissions to the competent authorities.

3.1.2 Compliance Officer

Compliance Officer (CO) is a person specifically designated by the regulated entity for monitoring the compliance with the provisions of the SEBI Act, 1992, rules and regulations thereunder, notifications, guidelines and instructions issued by the SEBI or the Central Government and for redress of investors' grievances. The compliance officer is also required to monitor the compliance of the rules, regulations and bye-laws of the concerned stock exchanges, or the Registrar of Companies, where applicable. In other words, the compliance officer is the first line regulator and all regulations require appointment of COs.

Compliance as a function, has been noted as one of the most important functions in the intermediaries across worldwide exchanges, commissions etc. International Organisation of Securities Commission (IOSCO) had come out with a discussion paper in 2005[3] on 'Compliance function at Market Intermediaries' in which they had defined compliance function as "*A function that, on an on-going basis, identifies, assesses, advises on, monitors and reports on a market intermediary's compliance with securities regulatory requirements, including whether there are appropriate supervisory procedures in place*".

3.1.3 Appointment of CO

As per the SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992, a Compliance Officer is mandatorily required to be appointed. The relevant extracts of this regulation is given hereunder:

[3] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD198.pdf

Regulation 18A

(1) Every stock broker shall appoint a CO who shall be responsible for monitoring the compliance of the Act, rules and regulations, notifications, guidelines instructions and so on, issued by the Board or the Central Government and for redress of investors' grievances
(2) The compliance officer shall immediately and independently report SEBI any non-compliance observed by him

A Compliance Officer is required to be appointed as per the SEBI (Intermediaries) Regulations, 2008 dated 26th May, 2008, the relevant extracts of which are given below:

Regulation 14

(1) An intermediary shall appoint a compliance officer for monitoring the compliance by it, of the requirements of the act, rules, regulations, notifications, guidelines, circulars and orders made or issued by SEBI or the Central Government, or the rules, regulations and bye-laws of the concerned stock exchanges, or the SRO, where applicable:
Provided that the intermediary may not appoint compliance officer if it is not carrying on the activity of the intermediary

(2) The compliance officer shall report to the intermediary or to its BoD, in writing, of any material non-compliance by the intermediary.

3.2 Role and Reporting Structure

3.2.1 Scope and Role of a Compliance Officer in the Indian Securities Market

The CO shall be responsible for monitoring the compliance with the SEBI Act, 1992, and more specifically with the rules and regulations, notifications, guidelines, orders passed and instructions issued by SEBI or the Central Government or the rules, regulations and bye-laws of the concerned stock exchanges, or the self regulatory organization (SROs), where applicable, by the concerned intermediary. The responsibility of the CO also extends to ensure redress of investors' grievances.

The specific role of the CO as given under the SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992 and the SEBI (Intermediaries) Regulations, 2008 has been discussed in the above section. Compliance looks into the different aspects of the culture and ethics of a market intermediary, and is an important tool in managing the risk of legal or regulatory sanctions, financial loss, or loss to reputation resulting from violation of regulatory requirements. The CO is responsible for monitoring the internal standards and policies put in place by the intermediary that also involves protecting the firm from any liability arising from false claims / abuses committed by its customers.

3.2.2 Reporting Structure

The CO is appointed by an entity or its Board of Directors (BOD) to comply with the SEBI Act and regulations, rules and so on. As such, the CO is required to report to the BoD of the Intermedi-

ary. However, where there is a non-compliance of the provisions of the SEBI Act or the allied regulations and rules, the CO is required to report to the SEBI immediately and independently any non-compliance of the intermediary.

3.2.3 The Importance of Independence for COs

The gap between regulatory intent and compliance will be minimal if there is a professional cadre of compliance officers in each organization of intermediaries. This is the rationale for the independent functioning of the CO, in any intermediary organization. CO shall participate in preparation of policies and procedures so that internal affairs of the intermediary are aligned with the regulatory objective than business expediency in case of conflict between the two.

This necessitates the level of reporting by the CO to the BoD/owners and to SEBI and other competent authorities. It frees the CO from elaborate internal reporting procedures and protocol with the delays and inadequate attention to compliance matters.

3.2.4 Reporting Responsibility of COs

It is the duty of the CO to immediately and independently report any non-compliance observed to the BoD and SEBI. The reporting responsibility can be classified into:

- *Mandatory reporting*: Periodic submission of reports as per provisions of regulations
- *Critical Reporting*: CO must immediately and independently report to SEBI and BOD any non-compliance observed.

As given under Regulation 12 of the SEBI (stock Brokers and Sub brokers) Regulations 1992, the intermediary is required to:

(1)Provide the SEBI with a certificate of its compliance officer on the 1st April of each year certifying:

a) the compliance by the intermediary with all the obligations, responsibilities and the fulfilment of the eligibility criteria on a continuous basis under these regulations and the relevant regulations

b) that all disclosures made in Form A and under the relevant regulations are true and complete

(2) Prominently display a photocopy of the certificate at all its offices including branch offices
(3) Prominently display the name and contact details of the compliance officer to whom complaint may be made in the event of any investor grievance
(4) Maintain books, accounts and records as specified in the relevant regulations

3.3 Responsibilities of COs towards Stakeholders

CO's are responsible to both external and internal stakeholders where

External Stakeholders include Central Government, SEBI, Stock Exchanges and other regulatory authorities like Registrar of Companies, Reserve Bank of India, Income Tax, investors, issuers and other intermediaries. The exchanges also issue their own circulars and bye laws based underlying being the SEBI Regulations, changes thereof and the circulars issued from time to time. The CO has to ensure that the intermediary also functions within the guidelines as given by the Exchanges, adheres to the monthly, quarterly or annual reporting.

Internal Stakeholders include the Board of Directors, Officers and employees.

A CO is required to report any non-compliance to the SEBI or the BoD of the Company. The purpose of this reporting is to ensure that the interests of both external and internal stakeholders are taken care of.

3.4 Compliance Requirements under the SEBI (Certification of Associated Persons in Securities Markets) Regulations, 2007

The SEBI (CAPSM) Regulations, 2007, Regulations 7 and 8, delegates the following powers and functions to National Institute of Securities Markets:

(a) The functions of NISM in respect of certification for associated persons in the securities market shall include putting in place and implementing the certification process, procedure and policies.

(b) NISM in consultation with SEBI may lay down standards which may, (i) specify that all or any portion of such standards shall be applicable to all or any category of associated persons working or associated with all or any class of intermediaries in securities market; (ii) specify that no associated person in any such class may be qualified to be employed or engaged or continued to be employed or engaged by an intermediary unless he is in compliance with such standards of examination, continuing professional education requirements and such other qualifications as NISM in consultation with the SEBI may specify.

3.4.1 Obligation of Obtaining Certification

Regulation 3 of the SEBI (CAPSM) Regulations, 2007 provides that SEBI may by notification in the official gazette require such categories of associated persons to obtain requisite certificate for engagement or employment with such classes of intermediaries and from such date as may be specified in the notification ***provided*** that an associated person employed or engaged by an intermediary prior to the date specified by SEBI may continue to be employed or engaged by the intermediary if he obtains the certificate within two years from the said date.

An associated person on being employed or engaged by an intermediary on or after the date specified by SEBI shall obtain the certificate within one year from the date of being employed or engaged by the intermediary.

An associated person, who as on the date specified by SEBI, holds a certificate for a category as recognised by SEBI shall not be required to obtain a fresh certificate for the same category during the validity of such certificate.

3.4.2 Manner of Obtaining Certification

Regulation 4 of SEBI (CAPSM) Regulations, 2007 specifies the manner of obtaining the certificate the first time. These are further detailed below:

A Principal[4] may obtain the certificate by any of the following manners:-

(a) Passing the relevant certificate examination, as may be specified by NISM.
(b) Successfully completing a related 2 day CPE Program[5], as may be specified by NISM.
(c) Delivering at least four sessions in specific 2 day CPE program, as may be specified by NISM.

A person other than a Principal, who has attained 50 years of age or who has 10 years of experience, may obtain the certificate by any of the following methods:

(a) Passing the relevant certificate examination, as may be specified by NISM.
(b) Successfully completing a related 2 day CPE Program, as may be specified by NISM.

All other persons may obtain the certificate by the following method:
(a) Passing the relevant certificate examination, as may be specified by NISM.

3.4.3 Validity Period of Certificate

The certificate given under regulation 3 of SEBI (CAPSM) Regulations, 2007 is valid for a period of 3 years from the date of the grant of the certificate or revalidation as the case may be. Upon the expiry of the validity of the certificate possessed by the associated person, the certificate shall be revalidated for a period of 3 years provided the associated person successfully completes a programme of continuing professional education as specified by NISM.

Associated persons engaged in the activities[6] as mentioned in sub-regulation 4 of regulation 3 of the SEBI (CAPSM) shall continue to be so engaged only upon holding a valid certificate.

3.4.4 Continuing Professional Education Requirements

Upon expiry of the validity of the certificate possessed by an associated person, the certificate may get revalidated, provided the associated person successfully completes a programme of continuing professional education, as may be specified by NISM during 12 months preceding the

[4]A Principal is a person who is actively engaged in the management of the intermediary's securities business including supervision, solicitation, conduct of business, and includes: a) Sole Proprietors, b) Managing Partners and c) Whole Time Directors

[5]The 2 day CPE Program is as per the new NISM communiqué Ref. No. NISM/Certification/ CPE General/2011/1 dated December 21, 2011.

[6]Activity wherein the (a) the associated person as part of his work or operation deals or interacts with the investors, issuers or clients of intermediaries;(b) the associated person deals with assets or funds of investor or clients; (c) the associated person handles redressal of investor grievances;(d) the associated person is responsible for internal control or risk management;(e) the associated person is responsible for compliance of any rules or regulations;(f) the associated person is engaged in activities that have a bearing on operational risk of the intermediary.

date of expiry of the certificate, or by passing the relevant NISM Certification Examination before the expiry of the existing certificate[7].

The certificate will be revalidated for a period of three years from the date of expiry of the existing certificate. Different categories of persons may get their certificate revalidated through different methods as follows:

A Principal may get his/her certificate revalidated by any of the following ways:

(a) Passing the relevant certificate examination, as may be specified by NISM.
(b) Successfully completing a related 2 day CPE Program, as may be specified by NISM.
(c) Delivering at least four sessions in specific 2 day CPE program, as may be specified by NISM.

A person other than a Principal, who has attained 50 years of age or who has 10 years of experience, may get the certificate revalidated by any of the following methods:

(a) Passing the relevant certificate examination, as may be specified by NISM.
(b) Successfully completing a related 2 day CPE Program, as may be specified by NISM.

All other persons may get their certificate revalidated by any of the following methods:

(a) Passing the relevant certificate examination, as may be specified by NISM.
(b) Successfully completing a related 2 day CPE Program, as may be specified by NISM.

[7] See NISM communiqué Ref. No. NISM/Certification/ CPE General/2011/1 dated December 21, 2011.

Review Questions

1. Primarily, compliance involves _____.

   (a) Conforming to a rule, policy, standard or law

   (b) Record keeping

   (c) Reporting

   (d) Preventing frauds

Ans: (a)

2. The SEBI (Intermediaries) Regulations, 2008, mandates the appointment of Compliance officer. State True or False?

   (a) True

   (b) False

Ans: (a)

3. Critical Reporting by Compliance officers include which of the following?

   (a) Money Laundering Activities

   (b) Submission of Books of Accounts

   (c) Sauda Book

   (d) All of the above

Ans: (a)

4. As per the SEBI (Certification of Associated Persons in Securities Markets) Regulations, 2007, a certificate is valid for a period of _____ from the date of grant of certificate or revalidation as the case may be.

   (a) 2 years

   (b) 5 years

   (c) 3 years

   (d) 7 years

Ans: (c)

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Unit 4: Securities and Exchange Board of India Act, 1992

4.1 Salient Features of SEBI Act, 1992

The SEBI Act of 1992 was enacted upon "*to provide for the establishment of a Board to protect the interests of investors in securities and to promote the development of, and to regulate, the securities market and for matters connected therewith or incidental thereto*".

4.1.1 Powers and Functions of the SEBI

The SEBI Act in the broader sense performs the functions as stated in the above para, however, without any prejudice to the generality, the act also provides for the following measures:

a. Regulating the business in stock exchanges and any other securities markets;
b. Registering and regulating the working of the stock brokers, sub-brokers, share transfer agents, bankers to an issue, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and such other intermediaries who may be associated with the securities manner in any manner;
c. Registering and regulating the working of the depositories and its participants, custodian of securities, foreign institutional, credit rating agencies and such other intermediaries as notified by the SEBI.
d. Registering and regulating the working of Venture Capital Funds and other Collective Investment Schemes.
e. Promoting and regulating self-regulatory organisations.
f. Prohibiting fraudulent and unfair trade practices relating to securities markets.
g. Promoting investors' education and training of intermediaries of securities markets.
h. Prohibiting insider trading in securities.
i. Regulating substantial acquisition of shares and take-over of companies.
j. Calling for information from, undertaking inspection, conducting inquiries and audits of the intermediaries and other persons associated with the securities market.
k. Performing all such functions and exercising such powers under the provisions of the Securities Contracts (Regulation) Act, 1956 as maybe delegated to SEBI by the central government.

According to sub-section 3 of Section 11 of the SEBI Act, notwithstanding anything contained in any other law for the time being in force while exercising the powers, SEBI shall have the same powers as are vested in a civil court under the Code of Civil Procedure, while trying a suit in respect of the following matters;

i. The discovery and production of books of account and other documents, at such place and such time as may be specified by the SEBI;
ii. Summoning and enforcing the attendance of persons and examining them on oath;
iii. Inspection of any books, registers and other documents of any person;
iv. Issuing commissions for the examination of witnesses or documents.

The Section 11A of the SEBI Act states that without any prejudice to the provisions of the Companies Act 1956, SEBI may for the protection of investors, -

(a) Specify, by Sections –

i. The matters relating to issue of capital, transfer of securities and other matters incidental thereto; and
ii. The manner in which such matters shall be disclosed by the Companies;

(b) By general or special orders –
i. Prohibit any company from issuing prospectus, any offer document, or advertisement soliciting money from the public for the issue of securities;
ii. Specify the conditions subject to which the prospectus, such offer document or advertisement, if not prohibited, may be issued.

4.1.2 Penalties and Adjudication

SEBI Act empowers SEBI to impose penalties and initiate adjudication proceedings against intermediaries who default on the following grounds such as failure to furnish information, return etc or failure by any person to enter into agreement with clients etc. In this section we discuss the various clauses of sub-Sections 15, failing to comply with any of these will lead to penalties and adjudication proceedings.

Section 15A: Penalty for failure to furnish information, return etc

Section15A prescribes penalty payable by an intermediary for failing to-

a) Furnish any document, return or report to the SEBI Board.
b) File any return or furnish any information, books or other documents within the time specified as in the regulations.
c) Maintain books of account or records or even maintain the same.

Section 15B: Penalty for failure by any person to enter into agreements with clients

Section 15B prescribes the penalty payable by an intermediary for failing to enter into an agreement with his/her client in violation of such a requirement under the SEBI Act, 1992.

Section 15C: Penalty for failure to redress investors' grievances

Section 15C prescribes the penalty applicable to a listed company or any person who is registered as an intermediary, for failing to redress investors' grievances after having been directed in writing by SEBI to do so within a specified time period.

Section 15D: Penalty for certain defaults in case of mutual funds

Section 15D relates to defaults by mutual funds (MFs) and prescribes penalties in the following cases:

a) If a person sponsors or carries on any collective investment scheme, including MFs, without obtaining the required certificate of registration
b) If a person registered with SEBI as a collective investment scheme including mutual funds, fails to comply with the terms and conditions of the certificate of registration
c) A failure, by a person registered with SEBI as a collective investment scheme including mutual funds, to submit an application for listing of the collective investment scheme(s), in accordance with the regulations governing such listing

d) A failure, by a person registered with SEBI as a collective investment scheme including mutual funds, to dispatch unit certificates of any scheme in accordance with the regulations governing such dispatch
e) A failure, by a person registered with SEBI as a collective investment scheme including mutual funds, to refund the application monies of investors within the period specified in the relevant regulations
f) A failure, by a person registered with SEBI as a collective investment scheme including mutual funds, to invest money collected by such schemes in the manner or within the period specified in the relevant regulations

Section 15E: Penalty for failure to observe rules and regulations by an asset management company (AMC)

Section 15E prescribes the penalty payable by an AMC of a mutual fund registered under the SEBI Act, on failing to comply with any of the regulations that place restrictions on the activities of asset management companies.

Section 15F: Penalty for certain default in case of stock brokers

Section 15F prescribes the penalty payable by a stock broker registered under the SEBI Act, under the following cases:

i. A failure to issue contract notes in the form and manner specified by the stock exchange of which the broker is a member
ii. A failure to deliver any security or to make payment of the amount due to the investor in the manner and within the period specified in the regulations
iii. Charging an amount of brokerage in excess of that specified in the regulations

Section 15G: Penalty for insider trading

Section 15G prescribes penalties for the following:

a) When an insider acting on his/her own behalf or on behalf of another deals in securities of a body corporate listed on any stock exchange on the basis of any unpublished price-sensitive information.
b) When an insider communicates any unpublished price-sensitive information to any person, with or without his request for such information except as required in the ordinary course of business or under any law.
c) When an insider counsels, or procures for any other person to deal in any securities of any corporate body on the basis of unpublished price-sensitive information.

Section 15H: Penalty for non-disclosure of acquisition of shares and takeovers

Section 15H prescribes the penalty for non-disclosure of acquisition of shares and takeovers. If any person fails to:
(i) disclose the aggregate of his shareholding in the body corporate before he acquires any shares of that body corporate; or
(ii) make a public announcement to acquire shares at a minimum price; or
(iii) make a public offer by sending letter of offer to the shareholders of the concerned company; or

(iv) make payment of consideration to the shareholders who sold their shares pursuant to letter of offer,

Section 15HA: Penalty for fraudulent and unfair trade practices

Section 15HA prescribes a penalty for people indulging in fraudulent and unfair trade practices relating to securities. Any person indulging in such activities would be liable to a penalty of Rs. 25 crore or three times the amount of profits made out of such practices, whichever is higher.

Section 15HB: Penalty for Contravention where no separate penalty has been provided

Section 15HB states that whoever fails to comply with any provision of the SEBI Act, the rules or the regulations made or directions issued by SEBI thereunder, for which no separate penalty has been provided, shall be liable to a penalty which may extend to Rs. 1 crore.

To understand the various statutes of the Securities market, it is also essential to understand the Jurisdiction, Authority and Procedure adopted by the Appellate Tribunal. Appeal against any ruling of the capital market regulator is petitioned to the appellate tribunal set up for this purpose i.e. Securities Appellate Tribunal.

4.1.3 Appellate Tribunal

The Securities Appellate Tribunal (SAT) according to Section 15U is not bound by the procedure laid down by the Code of Civil Procedure, but shall be guided by the principles if natural justice and shall have the powers to regulate their own procedures. The tribunal for the purpose of discharging its functions under this Act shall have the same powers as are vested in a civil court under the code of civil procedure while trying a suit in respect of the following matters, namely:-

- Summoning and enforcing the attendance of any person and examining him on oath;
- Requiring the discovery and production of documents;
- Receiving evidence on affidavits;
- Issuing commissions for the examination of witnesses or documents;
- Reviewing its decisions;
- Dismissing an application for default or deciding its *ex-parte;*
- Setting aside any order of dismissal of any application for default or any order passed by it *ex-parte*.

Any proceeding before the SAT shall be deemed to be a judicial proceeding within the meaning of provisions as given under the Indian Penal Code.

Section 15T: Appeal to Securities Appellate Tribunal

Section 15T of the SEBI Act gives the right to "Appeal to the SAT". It states that any person aggrieved by an order –

(i) Of the SEBI Board made, on and after the commencement of the Securities Laws (Second Amendment) Act, 1999, under the SEBI Act, or the rules and regulations made thereunder; or

(ii) Made by an adjudicating officer appointed under this Act;

may prefer an appeal to the SAT having jurisdiction in this matter. Every appeal should be filed within a period of 45 days from the date on which a copy of the order made by the SEBI Board or the Adjudicating Officer is received by him in a specified form along with the fee as prescribed.

Section 15Z: Appeal to Supreme Court

Any person aggrieved by any decision or order of the Securities Appellate Tribunal may file an appeal to the Supreme Court within 60 days from the date of communication of the decisions or order of the SAT to him.

4.1.4 Registration of Intermediaries

Section 12 of SEBI Act vests SEBI with the power to issue the ***certificate of registration*** without which no stockbroker, sub-broker, share transfer agent, banker to an issue, trustee of trust deed, registrar to an issue, merchant banker, underwriter, portfolio manager, investment adviser or such other intermediary who may be associated with the securities market shall buy, sell or deal in securities. These intermediaries also requires to comply with certain other provisions in certain other regulations while applying for certificate of registration such as a stock broker applying to SEBI for a certificate of registration needs to apply as per the FORM A of the SEBI (Stock Brokers and Sub-brokers) Regulations 1992. Similarly a sub-broker needs to apply as per the FORM B of the SEBI (Stock Brokers and Sub-brokers) Regulations 1992.These regulations would be discussed in length in the later sections of this workbook.

The Section12 also states that no person shall sponsor or cause to be sponsored or carry on or caused to be carried on any venture capital funds or collective investment schemes including mutual funds if the same does not obtain a certificate of registration from the SEBI. The application for registration and the payment of such feed shall be in accordance with the provisions of the regulations. SEBI may however by order, suspend or cancel a certificate of registration as under the provisions in the regulations after giving the person concerned a reasonable opportunity of presenting his/her case.

4.1.5 Prohibition of Manipulative and Deceptive Devices, Insider Trading etc

Section 12A prescribes that no person shall directly or indirectly -

a. Use or employ, in connection with the issue, purchase or sale of any securities, which are either listed or proposed to be listed on a recognised stock exchange, any manipulative or deceptive device or contrivance in contravention of the provisions of this Act or any rules made thereunder;
b. Employ any device, scheme or artifice to defraud in connection with issue or dealing in securities which are listed or proposed to be listed on a recognised stock exchange;
c. Engage in any act, practice, course of business which operates or would operate as fraud or deceit upon any person, in connection with the issue, dealing in securities which are listed or proposed to be listed on a recognised stock exchange, in contravention of the provisions of this act;
d. Engage in any insider trading activity;

e. Deal in securities while in possession of material or non-public information or communicate such material or non-public information to any other person, in a manner which is in contravention of the provisions of this Act or rules /regulations made hereunder
f. Acquire control of any company or securities more than the percentage of the equity share capital of a company whose securities are listed or proposed to be listed on a recognised stock exchange in contravention of the regulations made under this Act.

As stated in Chapter 3, section 3.1.2 the designated compliance officer in each intermediary should ensure that the intermediary is functioning in compliance with the provisions of the various regulations (as discussed in this chapter) of the SEBI Act. Non-compliance of the rules and regulations laid down by SEBI will attract a penalty either monetary or suspension.

Review Questions

1. All of the following are the functions of SEBI under SEBI Act of 1992, EXCEPT:

   (a) Regulating the business in other securities markets but not in stock exchanges

   (b) Promoting and regulating self-regulatory organisations

   (c) Regulating substantial acquisition of shares and take-over of companies

   (d) Prohibiting insider trading in securities

Ans: (a)

2. Can SEBI prohibit any company from issuing prospectus, any offer document, or advertisement soliciting money from the public for the issue of securities? State Yes or No?

   (a) Yes

   (b) No

Ans: (a)

3. Penalty may be payable by an intermediary under SEBI Act if it fails to:

   (a) File any return or furnish any information, books or other documents within the time specified as in the regulations

   (b) Maintain books of account or records

   (c) Both I & II

   (d) None of the above

Ans: (c)

4. Any intermediary can appeal to SAT, if it has been aggrieved by any order passed by SEBI. State whether True or False?

   (a) True

   (b) False

Ans: (a)

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Unit 5: Securities Contracts (Regulation) Act, 1956 and Securities Contracts (Regulation) Rule, 1957

5.1 Securities Contracts (Regulation) Act, 1956

As discussed in chapter 2 of this workbook, the Securities Contracts (Regulation) Act, 1956 provides for direct and indirect control of virtually all aspects of securities trading and the running of stock exchanges. This act aims to prevent undesirable transactions in securities. It gives the central government the regulatory jurisdiction over (a) stock exchanges through a process of recognition and continued supervision, (b) contracts in securities, and (c) listing of securities on stock exchanges. The objective of SC(R)A is to prevent undesirable speculation and to regulate contracts and transactions in securities. A transaction in securities between two persons is essentially a contract. The law that specifically applies in the case of a securities contract is the SC(R)A.

SC(R)A covers around 31 Sections. Sections 3 to 12 are specifically related to various aspects of stock exchange recognition. The Central Government[8] has the powers to prescribe admission criteria and qualifications for members. The members are required to maintain books and records in a prescribed manner, which are subject to inspection upon enquiry. The SCRA also specifies the manner in which derivative contracts and other contracts shall be dealt with in recognized stock exchanges. Contraventions to any of the provisions of this Act are liable to attract penalty. Sections 13 to 19 deals with the provisions for contracts and options in securities, Section 21 and 22 with listing of securities and Sections 23 to 26 on penalties and procedures imposed on non-compliance of the rules and regulations. Sections 27-31 deals with issues such as the power of SEBI to make regulations, power of Central Government to make rules etc.

In this chapter however, we would be more focussed on the various sections and sub-sections of this act related directly to the activities of the securities market and which is of importance from compliance point of view.

5.1.1Call for Periodical Returns

Section 6(2) of SCRA requires every member of a recognized stock exchange to maintain and preserve for such periods not exceeding 5 years such books of accounts and other documents as the Central Government may prescribe after consultation with the concerned stock exchange, and such books of accounts and other documents shall be subject to inspection by SEBI.

Section 6(3) of SCRA provides that SEBI, in the interest of trade or in the public interest, may by order in writing –

- Call upon any member of a recognized stock exchange to furnish in writing such information or explanation relating to the affairs of the member in relation to the stock exchange as SEBI may require; or
- Appoint person(s) to make inquiry into the affairs of any member of a stock exchange in relation to the stock exchange and submit a report of the same to SEBI or it may direct the governing body of the stock exchange to make the inquiry and submit its report to SEBI.

[8] Powers are exercisable by SEBI also.

Section 6(4) of SCRA provides that where an inquiry, as mentioned above, has been undertaken, every member of the concerned stock exchange shall be bound to produce before the inquiring authority all such books of accounts and other documents in its custody or power, which relates to or have bearing on the subject matter of such inquiry and shall also furnish such statement or information relating to the inquiry as the inquiring authority may require.

5.1.2 Contracts and Options in Securities

Section15 of SCRA provides that no member of a recognised stock exchange shall in respect of any securities enter into any contract as a principal with any person other than a member of a recognised stock exchange, unless he has secured the consent or authority of such person and discloses in the note, memorandum or agreement of sale or purchase that he is acting as a principal. However, a stock broker may enter into contract, as a principal with any other person only if written consent is received from such person within 3 days from the date of the contract and a disclosure to this effect is made on the contract note.

5.1.3Penalties and Procedures

The Section 23 to 26 provides for the different penalties and procedures to be imposed upon any person /intermediary on non-compliance with any of the provisions given under the various rules and regulations governing the securities market in India.

Section 23 states that any person who,

(a) Without reasonable excuse fails to comply with any requisition made under sub-section (4) of section 6, or
(b) Enters into any contract in derivative in contravention of section 18A[9] or the rules made under section 30; or
(c) Not being a member of a recognised stock exchange or his agent authorised as such under the rules or bye-laws of such stock exchange or not being a dealer in securities licensed under section 17 wilfully represents to or induces any person to believe that contracts can be entered into or performed under this Act through him;

Shall without prejudice to any award of penalty by the adjudicating officer under the Act on conviction, be punishable with imprisonment for a term which may extend to ten years or with fine which may extend to Rs. 25 crore or with both.

Section 23A of SCRA provides that any person, who is required under the SCRA or SCRR –

- to furnish any information, document, books, returns or report to a recognized stock exchange, fails to furnish the same within the specified time shall be liable to a penalty of Rs.1 lakh for each day during which such failure continues or Rs.1 crore, whichever is less.
- to maintain books of account or records as per the listing agreements, conditions or bye-laws of the stock exchange, fails to maintain the same, shall be liable to a penalty of Rs.1 lakh for each day during which such failure continues or Rs.1 crore, whichever is less.

[9] Section 18A states: Notwithstanding anything contained in any other law for the time being in force, contracts in derivatives shall be legal and valid if such contracts are (a) traded on a recognized stock exchange, and (b) settled on the clearing house of the recognised stock exchange, in accordance with the rules and bye-laws of such stock exchange.

Section 23B of SCRA provides that if a broker fails enter into an agreement with its client who is required to enter as per Act, he it shall be liable to a penalty of Rs.1 lakh for each day during which such failure continues or Rs.1 crore, whichever is less.

Section 23C of SCRA provides that if a broker fails to redress the grievances of any investor after having been directed by SEBI or Stock Exchange, in writing, to do so within the stipulated time, he shall be liable to a penalty of Rs.1 lakh for each day during which such failure continues or Rs.1 crore, whichever is less.

Section 23D of SCRA provides that if a broker fails to segregate securities or monies of client(s) from its own securities or funds or uses the securities or monies of client(s) for self or for any other client(s), he shall be liable to a penalty not exceeding Rs.1 crore.

Section 23JA of SCRA provides for application in writing to the SEBI proposing for settlement of proceedings initiated or to be initiated for the alleged defaults. The SEBI after taking into consideration the nature, gravity and impact of defaults, may agree to the proposal for settlement, on payment of such sum by the defaulter or on such other terms as may be determined by SEBI

Section 23JB of SCRA states the procedure to be followed by the Recovery Officer of SEBI in case of non-payment of the penalty imposed by the adjudicating officer for refund of monies or compliance of disgorgement order issued under Section 12A.

Sections 26A to 26E have been introduced in the SCRA with respect to establishment of Special Courts. The provisions state that the Central Government may establish or designate as may Special Courts as may be necessary. It also prescribes the rules for constitution of the Court as well as the offences triable by the Special Courts, Appeal and Revision, Application of Code to proceedings before Special Court etc.

5.2 Securities Contracts (Regulation) Rules, 1957

In exercise of the powers conferred by the section 30 of the SCRA, the Central Government has made the Securities Contracts (Regulation) Rules, 1957. In this section we discuss those rules formed under the SCRR which are of importance from compliance point of view.

5.2.1 Eligibility criteria for membership of a recognized stock exchange

Rule 8 of SCRR specifies the rules relating to admission of members of the stock exchange. No person is eligible to become a member if he

a. is less than 21 yrs of age
b. is not a citizen of India provided that the governing body may in suitable cases relax this condition with the prior approval of the SEBI
c. has been adjudged bankrupt or a receiving order in bankruptcy has been made against him or has been proved to be insolvent even though he has obtained his final discharge

d. has compounded with his creditors unless he has paid sixteen annas in the rupee

e. has been convicted of an offence involving fraud or dishonesty

f. engaged as principal or employee in any business other than that of securities or commodity derivatives except as a broker or agent not involving any personal financial liability unless he undertakes on admission to sever his connection with such business

Provided that no member may conduct business in commodity derivatives, except by setting up a separate company which shall comply with the regulatory requirements, such as, networth, capital adequacy, margins and exposure norms as may be specified by the Forward Market Commission, from time to time:
Provided further that nothing herein shall be applicable to any corporations, bodies corporate, companies or institutions referred to in items (a) to (n)of the proviso to sub-rule (4)

g. he has been at any time expelled or declared a defaulter by any other stock exchange;

h. he has been previously refused admission to membership unless a period of one year has elapsed since the date of such rejection.

No person eligible for admission as a member under the above mentioned shall be admitted as a member unless he:

(a) has worked for not less than two years as a partner with, or an authorised assistant or authorised clerk or remisier or apprentice to, a member

(b) agrees to work for a minimum period of two years as a partner or representative member with another member and to enter into bargains on the floor of the stock exchange and not in his own name but in the name of such other member

(c) succeeds to the established business of a deceased or retiring member who is his father, uncle, brother or any other person who is, in the opinion of the governing body, a close relative

Provided that, the rules of the stock exchange may authorise the governing body to waive compliance with any of the foregoing conditions if the person seeking admission is in respect of means, position, integrity, knowledge and experience of business in securities, considered by the governing body to be otherwise qualified for membership.

5.2.2Contracts between members

Rule 9 of the SCRR requires all contracts entered into between members of a recognized stock exchange to be confirmed in writing.

5.2.3Audit of accounts of members

Rule 12 requires all stock brokers to get their accounts audited by a chartered accountant whenever such audit is required by the SEBI.

5.2.4Books of account

Under Rule 15(1) every member of a recognized stock exchange is required to maintain and preserve the following books of account and documents for a period of 5 years:

- Register of transactions (*Sauda book*).
- Clients' ledger.
- General ledger.
- Journals.
- Cash book.
- Bank pass-book.
- Documents register showing full particulars of shares and securities received and delivered.

Rule 15(2) requires every member of a recognized stock exchange to maintain and preserve the following documents for a period of 2 years:

- Member's contract books showing details of all contracts entered into by the member with other members of the same exchange or counterfoils or duplicates of memos of confirmation issued to such other members.
- Counterfoils or duplicates of contract notes issued to clients.
- Written consent of clients in respect of contracts entered into as principals.

Review Questions

1. As per SCRR, the trading members of the stock exchanges are required to maintain the counterfoils or duplicates of contract notes issued to clients for how many years?

   (a) 3

   (b) 5

   (c) 2

   (d) 7

Ans: (c)

2. Members of the stock exchanges are required to preserve which of the following documents as per the SCRA.

   (a) Networth certificate

   (b) Books and accounts and other documents for specific period of time

   (c) Registration certificate

   (d) All of the above

Ans: (b)

3. SCRA provides for a provision that a stock broker of a recognised stock exchange can enter into a contract in securities with another stock broker after obtaining his consent. State whether True or False?

   (a) True

   (b) False

Ans: (a)

4. Manner in which the derivatives contracts and other contracts should be dealt in the securities market are prescribed in which of the following?

   (a) Public Debt Act

   (b) Depositories Act

   (c) Companies Act

   (d) SCRA, 1956

Ans: (d)

Unit 6: SEBI (Intermediaries) Regulations, 2008

6.1 Introduction

The SEBI (Intermediaries) Regulations, 2008 were notified in the official gazette on 26th May 2008. The provisions contained in Chapter V & VI of the regulations came into effect from the above date, while the other provisions shall become applicable to different classes of intermediaries as and when notified by SEBI. The provisions contained in Chapter V & VI of the regulations deal with the procedure for action in case of contravention of securities laws or directions or instructions or circulars by an intermediary. In this chapter, we have summarized and discussed some of them. Candidates however, are advised to go through the regulation in detail for better understanding.

6.2 General Obligations of Intermediaries

The SEBI (Intermediaries) Regulations, 2008 prescribes that an intermediary shall provide SEBI with a certificate of its compliance officer on the 1st of April every year, certifying the compliance by the intermediary with all the obligations, responsibilities and the fulfilment of the eligibility criteria on a continuous basis under these regulations and the relevant regulations. The intermediary also needs to display the copy of the certificate at all the offices including the branch offices.

6.2.1 Appointment of Compliance Officer

As already stated in the chapter 3, section 3.3.1, an intermediary is required to appoint a compliance officer for monitoring the compliance by it of the requirements of the Act, rules, regulations, notifications, guidelines, circulars and orders made or issued by SEBI, or the central government, or the rules and regulations and bye-laws of the concerned stock exchanges or the SRO, where applicable. The compliance officer shall report to the intermediary or its board of directors in writing or any material non-compliance by the intermediary.

6.3 Inspection and Disciplinary Proceedings

6.3.1 Obligation of the intermediary on Inspection

Under regulation 19 of the SEBI (Intermediaries) Regulations, 2008-

1. It shall be the duty of every director, proprietor, partner, trustee, officer, employee and any agent of an intermediary which is being inspected, to produce to the inspecting authority such books, accounts, records including telephone records and electronic records and documents in his custody or control and furnish to the inspecting authority with such statements and information relating to its activities within such time as the inspecting authority may require.
2. The intermediary shall allow the inspecting authority to have reasonable access to the premises occupied by such intermediary or by any other person on its behalf and also extend reasonable facility for examining any books, records including telephone records and electronic records and documents in the possession of the intermediary or any such

other person and also provide copies of documents or other material which in the opinion of the inspecting authority are relevant for the purposes of the inspection.

6.3.2 Appointment of Auditor

SEBI may also appoint a qualified auditor to inspect the books of account of the affairs of an intermediary. The SEBI may also appoint a qualified valuer or direct a qualified valuer to be appointed by the intermediary, if so considered necessary.

6.4 Action in Case of Default and Manner of Suspension and Cancellation of Certificate

- Where any intermediary fails to comply with any of the conditions of registration or contravenes any of the provisions of the securities laws (i.e. SEBI Act or SCRA or Depository Act or rules and regulations made thereunder) or directions, instructions or circulars issued thereunder, the designated member (which includes the Chairman or a Whole-time Member of the SEBI) may appoint an officer or a bench of 3 officers (not below the rank of Division Chief) as the designated authority to enquire into and to make recommendations as to the action to be taken. No officer who has conducted investigation or inspection in respect of the alleged violation can be appointed as a designated authority.
- The designated authority shall, if there are reasonable grounds to do so, issue a show-cause notice to the concerned person requiring it to show cause as to why the certificate of registration granted to it, should not be suspended or cancelled or why any other action provided in the regulations should not be taken. Every show-cause notice shall specify the contravention alleged to have been committed indicating the provisions of the Act, rules, regulations, circulars or guidelines which are alleged to have been contravened. Also, there shall be annexed to the notice copies of documents relied upon in making of the imputations and extracts of relevant portions of documents, reports containing the findings arrived at in an investigation or inspection, if any, carried out.
- The show-cause notice shall specify the period (not exceeding 21 days) within which reply should be submitted in written representation along with documentary evidence, if any, in support of the representation to the designated authority.
- If the noticee does not reply to the show-cause notice, the designated authority may proceed with the matter ex-parte recording the reasons for doing so and make appropriate recommendation on the basis of material facts available before it.

6.4.1 Action in case of Default

- After considering the representations, if any, of the noticee, the facts and circumstances of the case and applicable provisions of law, the designated authority shall submit a report to the designated member, where the facts so warrant, recommending any of the following actions:
  - (i) Suspension of certificate of registration for a specified period;
  - (ii) Cancellation of certificate of registration;
  - (iii) Prohibiting the noticee to take up any new assignment or contract or launch a new scheme for the period specified in the order;
  - (iv) Debarring a principal officer of the noticee from being employed or associated with any registered intermediary or other registered person for the period specified in the order;

(v) Debarring a branch or an office of the noticee from carrying out activities for the specified period;
(vi) Warning the noticee.

6.4.2 Procedure for action on receipt of the recommendation

- After considering the report of the designated authority, the designated member shall issue a show-cause notice to the noticee enclosing therewith a copy of the report submitted by the designated authority calling the noticee to show cause as to why the action, including passing of appropriate direction, as the designated member considers appropriate, should not be taken.
- Noticee shall reply to the above show-cause notice issued by designated member within 21 days of the receipt of the notice.
- The designated member may, after considering the reply, if any, and providing the person with an opportunity of being heard, pass such order as appropriate, as expeditiously as possible. The designated member shall endeavor to pass the order within 120 days of the date of receipt of reply to the notice or hearing.

6.4.3 Common Order

The Designated member may pass a common order in respect of a number of notices where the subject matter in question is substantially the same or similar in nature.

6.4.4 Surrender of certificate of registration

An intermediary may surrender the certificate of registration by making a request to the SEBI. SEBI, while disposing such request, may require the intermediary to satisfy SEBI as to the factors it deems fit, including but not limited to the following:

i. the arrangements made by the person for maintenance and preservation of records and other documents required to be maintained under the relevant regulations;
ii. redress of investor grievances;
iii. transfer of records, funds or securities of its clients;
iv. the arrangements made by it for ensuring continuity of service to the clients;
v. defaults or pending action, if any.

While accepting the surrender, SEBI may also impose such conditions upon the intermediary as it deems fit for protection of the investors or its clients or the securities market and such intermediary shall comply with such conditions.

6.4.5 Effect of debarment, suspension, cancellation or surrender

On and from the date of debarment or suspension of the certificate, the concerned person shall -

a) not undertake any new assignment or contract or launch any new scheme and during the period of such debarment or suspension it shall cease to carry on any activity in respect of which certificate had been granted;
b) allow its clients or investors to withdraw or transfer their securities or funds held in its custody or withdraw any assignment given to it, without any additional cost to such client or investor;
c) make provisions as regards liability incurred or assumed by it;
d) take such other action including the action relating to any records or documents and securities or money of the investors that may be in custody or control of such person,

within the time period and in the manner, as may be required under the relevant regulations or as may be directed by SEBI while passing order.

On and from the date of surrender or cancellation of the certificate, the concerned person shall -

a) return the certificate of registration so cancelled to SEBI and shall not represent itself to be a holder of certificate for carrying out the activity for which such certificate had been granted;
b) cease to carry on any activity in respect of which the certificate had been granted;
c) transfer its activities to another person holding a valid certificate of registration to carry on such activity and allow its clients or investors to withdraw or transfer their securities or funds held in its custody or to withdraw any assignment given to it, without any additional cost to such client or investor;
d) make provisions as regards liability incurred or assumed by it;
e) take such other action including the action relating to any records or documents and securities or money of the investors that may be in custody or control of such person, within the time period and in the manner, as may be required under the relevant regulations or as may be directed by SEBI while passing order.

6.4.6 Directions

Without prejudice to any order under the securities laws and the directions, guidelines and circulars issued thereunder, SEBI may, in the interest of the securities market, in the interest of the investors or for the purpose of securing the proper management of any intermediary, issue, necessary direction including but not limited to the following -

a) directing the intermediary or other persons associated with securities market to refund any money or securities collected from the investors under any scheme or otherwise, with or without interest;
b) directing the intermediary or other persons associated with securities market not to access the capital market or not to deal in securities for a particular period or not to associate with any intermediary or with any capital market related activity;
c) directing the recognized stock exchange concerned not to permit trading in the securities or units issued by a mutual fund or collective investment scheme;
d) directing the recognized stock exchange concerned to suspend trading in the securities or units issued by a mutual fund or collective investment scheme;
e) any other direction which SEBI may deem fit and proper in the circumstances of the case.

Provided that before issuing any directions, SEBI, shall give a reasonable opportunity of being heard to the persons concerned. In case of any interim direction, SEBI shall give a reasonable opportunity of hearing to the persons concerned after passing the direction, without any undue delay.

6.5 Code of Conduct

I. *High Standards of Service*: An intermediary shall ensure that it and its key management personnel, employees, contractors and agents shall in the conduct of their business, observe high standards of integrity, dignity, ethics and professionalism and all professional dealings shall be affected in a prompt, effective and efficient manner.

II. *Conflict of Interest*: An intermediary shall avoid conflict of interest and make adequate disclosure of his interest and shall put in place a mechanism to resolve any conflict of interest situation that may arise in the conduct of its business or where any conflict of interest arises, shall take reasonable steps to resolve the same in an equitable manner

III. *Compliance and Corporate Governance*:

An intermediary has to ensure that good corporate policies and corporate governance is in place. It has to ensure that they do not engage in any fraudulent and manipulative transactions in the securities listed on the stock exchanges. It shall also ensure that they do not indulge in any unfair competition which is likely to harm the interests of the other intermediaries or the investors.

The intermediary has to take adequate and necessary steps to ensure that continuity in data and record keeping is maintained and that the data and records are not lost or destroyed. It shall also ensure that for electronic records and data, up-to-date backup is always available with it. It shall not be a party to or instrumental in or indulge in:

(a) Creation of false market for securities listed or proposed to be listed on any stock exchange in India;

(b) Price rigging or manipulation of prices of securities listed or proposed to be listed on any stock exchange in India; or

(c) Passing of any unpublished price sensitive information in respect of securities which are listed or proposed to be listed on any stock exchange to any person or intermediary; or

(d) Any activity for distorting market equilibrium or which may affect the smooth functioning of the market or for personal gain.

The intermediary needs to maintain an appropriate level of knowledge and competency and abide by the provisions of any Act, regulations, circulars and guidelines of the central government, the Reserve Bank of India (RBI), SEBI, the stock exchanges or any other applicable statutory or self regulatory or other body as the case may be and as may be applicable to the intermediary in respect of the business carried on by such intermediary.

Review Questions

1. SEBI in the interest of the securities market may direct an intermediary to refund the money or securities collected from the investors with or without interest. State whether True or False?

   (a) True

   (b) False

Ans: (a)

2. If an applicant is not found to be a 'fit and proper person' can he get registration certificate under SEBI (Intermediaries) Regulations 2008?

   (a) Yes

   (b) No

Ans: (a)

3. All the employees, directors etc of the intermediary need to strictly adhere to the Code of Conduct as prescribed in the SEBI Regulations. State Whether True or False?

   (a) True

   (b) False

Ans: (a)

4. Can a common order be passed in respect of a number of noticees where the subject matter in question is substantially the same or similar in nature?

   (a) Yes

   (b) No

Ans: (a)

Unit 7: SEBI (Prohibition of Insider Trading) Regulations, 1992

7.1 Introduction

The SEBI (Prohibition of Insider Trading) Regulations, 1992 seek to govern the conduct of the person(s), defined as 'Insider', in respect of securities of a company listed on a stock exchange. ***The objective of this regulation is to prevent insider trading in securities by prohibiting dealing, communicating or counseling on matters relating to insider trading.***

The regulations defines an 'Insider' as any person who is or was a 'Connected Person' or a 'Deemed to be Connected Person' and who is reasonably expected to have access to unpublished price sensitive information in respect of securities of a company or who has received or has had access to such unpublished price sensitive information;

A *Connected Person*[10] as defined in the regulation is any person who -

i. is a director of a company, or is deemed to be a director of that company; or
ii. occupies the position as an officer or an employee of the company or holds a position involving a professional or business relationship between himself and the company (whether temporary or permanent) and who may reasonably be expected to have an access to unpublished price sensitive information in relation to that company;

Further, as per the regulations a person is deemed to be a connected person if such person –

(i) is a company under the same management or group, or any subsidiary company thereof;
(ii) is an intermediary as specified in regulation 12 of the Act, Investment company, Trustee Company, Asset Management Company or an employee or director thereof or an official of a stock exchange or of clearing house or corporation;
(iii) is a merchant banker, share transfer agent, registrar to an issue, debenture trustee, broker, portfolio manager, Investment Advisor, sub-broker, Investment Company or an employee thereof, or, is a member of the Board of Trustees of a MF or a member of the Board of Directors of the AMC of a MF or is an employee thereof who has a fiduciary relationship with a company;
(iv) is a member of the board of directors, or an employee, of a public financial institution as defined in section 2(72)of the Companies Act, 2013;
(v) is an official or an employee of a SRO recognized or authorised by the Board of a regulatory body;
(vi) is a relative of any of the aforementioned persons;
(vii) is a banker of a company;
(viii) relatives of the connected person; or
(ix) is a concern, firm, trust, Hindu undivided family, company or association of persons wherein any of the connected persons or any of the persons mentioned in sub-clause (vi), (vii) or (viii) of Regulation 2(h) of the SEBI (Insider Trading) Regulations, 1992 have more than 10 per cent of the holding or interest;

[10]For the purpose of the definition, the words 'connected person' shall mean any person who is a connected person six months prior to an act of insider trading.

7.2 Prohibition on Dealing, Communicating or Counseling

Regulation 3of the Prohibition of Insider trading Regulations, prohibits a connected or deemed to be connected person from dealing in securities of company listed on any stock exchange, on his own behalf or on behalf of any other person when in possession of unpublished price sensitive information and from communicating, counseling or procuring, directly or indirectly any unpublished price sensitive information to any person who while in possession of such unpublished price sensitive information shall not deal in securities. However, the above restrictions do not apply to any communication required in the ordinary course of business or under any law.

Regulation 3A prohibits a company from dealing in the securities of another company or associate of that other company while in possession of any unpublished price sensitive information.

Regulation 4 states that any insider who deals in securities in contravention of the provisions of regulation 3 or 3A shall be guilty of insider trading.

7.3 Disclosures and Internal Procedure for Prevention of Insider trading

All listed companies and organisations associated with securities markets including the intermediaries as mentioned in section 12 of the SEBI Act, AMC and trustee of the MFs, SROs, stock exchanges, public financial institutions and the professional firms such as auditors, accountancy firms, law firms etc shall frame a code of internal procedures and conduct. These entities will also abide by the code of Corporate Disclosures Practices as specified in the regulations and shall adopt appropriate mechanisms and procedures to enforce these codes.

7.3.1 Code of Conduct for Prevention of Insider Trading

As per the SEBI Act, an organisation / firm needs to appoint a compliance officer who is responsible for setting forth policies and procedures and monitoring adherence to the rules for the preservation of "Price Sensitive Information", pre-clearing of all designated employees and their dependants trades, monitoring of trades and the implementation of the code of conduct under the overall supervision of the partners / proprietors.

Price sensitive information is any information which relates directly or indirectly to a company and which if published, is likely to materially affect the price of securities of that company. The following are deemed to be price sensitive information:

- Periodic financial results of the company.
- Intended declaration of dividends (both interim and final).
- Issue of securities or buy back of securities.
- Any major expansion plans or execution of new projects.
- Amalgamation, mergers or takeovers.
- Disposal of the whole or substantial part of the undertaking.
- Any significant changes in policies, plans or operations of the company.

7.3.1.1 Preservation of 'Price Sensitive Information' and 'Need to Know'

Employees/directors/partners shall maintain the confidentiality of all Price Sensitive Information and must not pass on such information directly or indirectly by way of making a recommendation for the purchase or sale of securities.

The Price Sensitive Information is to be handled on a "need to now" basis i.e. such information should be disclosed only to those within the organisation/firm who need the information to discharge their duty and whose possession of such information will not rise to a conflict of interest or appearance of misuse of the information.

The Price Sensitive Information kept in the files should be secured and computer files must have adequate security of login and password etc.

7.3.1.2Chinese Wall

To prevent the misuse of confidential information the organisation / firm shall adopt a "Chinese Wall" policy which separates those areas of the organisation/firm which routinely have access to confidential information, considered "insider areas" from those areas which seal with sale/ marketing/investment advice or other departments providing support services considered "public areas".
The employees in the insider area shall not communicate any Price Sensitive Information to anyone in the public area. The employees in the inside area may also be physically segregated from the employees in the public area. The demarcation of the various departments as inside area may be implemented by the organisation / firm. However, in exceptional situations, employees from the public areas may be brought "over the wall" and given confidential information on the basis of "need to know" criteria. Such cases should necessarily be intimated to the Compliance Officer.

7.3.1.3 Pre-clearance of Trades
All directors / officers / designated employees of the firm who intend to deal in the securities of the client company shall pre-clear the transactions as per the pre-dealing procedure as prescribed in the regulations. An application may be made in such form as the firm may specify in this regard to the Compliance Officer indicating the name and estimated number of securities that the designated employees /director /partner intends to deal in, the details as to the depository with which he has a security account and other such details as may be required under any rule made by the firm.

7.3.1.4 Reporting Requirement for Transactions in Securities
All directors /designated employees /partners of the firm shall be required to forward following details of their securities transactions including the statement of dependent family members to the compliance officer. The compliance officer is required to maintain records of all the declarations given by the directors/designated employees/partners in an appropriate form for a minimum period of 3 years; and also shall place before the chief executive officer of the firm on a monthly basis all the details of the dealing in securities by the designated employees/directors etc and the accompanying documents that such persons had executed under the pre-dealing procedure as per the code of conduct.

7.3.1.5 Restricted /Grey List

In order to monitor Chinese wall procedures and trading in client securities based on inside information, the organisation/firm shall restrict trading in certain securities and designate such list as restricted/grey list. If the intermediary is handling any assignment of any listed company or is handling credit rating assignment and is privy to Price Sensitive Information, the securities of that company would be put on the restricted/grey list. Even when the security is being purchased or sold or is being considered for purchase or sale by the organisation/firm on behalf of its clients/schemes of mutual funds, the same shall be put on the restricted/grey list.

When the securities are on the restricted list, trading in these securities by designated employees/directors/partners may be blocked or may be disallowed at the time of pre-clearance.

7.3.1.6 Other Restrictions

The SEBI Insider Trading Regulation also provides for several other miscellaneous restrictions which are as given below:

(c) Directors/designated employees/partners shall execute order within one week after approval of pre-clearance is given. If the order is not executed within one week after approval is given, the employee/director/partners must pre clear the transaction again.

(d) Directors/designated employees/partners shall hold their investments for a minimum period of 30 days in order to be considered as being held for investment purposes. The holding period shall also apply to purchases in the primary market. In case of IPOs, the holding period would commence when the securities are actually allotted.

(e) Where the securities are sold off before the holding period due to some personal emergency, the Compliance officer shall waive off that period and make a record in writing with the valid reason.

(f) Analysts, if any, employed with the organisation/firm while preparing research reports of a client company shall disclose their shareholdings /interest in such company(s) to the Compliance Officer. Analysts who prepare research report of a listed company shall not trade in securities of that company for thirty days from preparation of such report.

Review Questions

1. As per SEBI Insider Trading Regulations, what is the minimum period of holding for any investment made by the Directors/partners to be considered as being held for Investment purpose?

   (a) 60 days

   (b) 45 days

   (c) 30 days

   (d) 15 days

Ans: (c)

2. Does 'Price Sensitive Information' include disposal of whole/substantial part of the undertaking?

   (a) Yes

   (b) No

Ans: (a)

3. The restrictions on communication under insider trading do not include communications under ordinary course of law. State whether True or False?

   (a) True

   (b) False

Ans: (a)

4. The objective of the SEBI (Prohibition of Insider Trading) Regulation is to prohibit insider from _____ on matters relating to insider trading?

   (a) Dealing

   (b) Communicating

   (c) Counselling

   (d) All of the above

Ans: (d)

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Unit 8: SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to securities Market) Regulations, 2003

8.1 Introduction

The Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003 prohibit fraudulent, unfair and manipulative trade practices in securities. These regulations have been made in exercise of the powers conferred by section 30 of the SEBI Act, 1992.

Regulation 2(1) (c) defines fraud as inclusive of any act, expression, omission or concealment committed to induce another person or his agent to deal in securities. There may or may not be wrongful gain or avoidance of any loss. However, that is inconsequential in determining if fraud has been committed. Some of the instances cited are as follows:

a) A wilful misrepresentation of the truth or concealment of material fact in order that another person may act, to his detriment
b) A suggestion as to a fact which is not true, by one who does not believe it to be true
c) An active concealment of a fact by a person having knowledge or belief of the fact
d) A promise made without any intention of performing it
e) A representation, whether true or false, made in a reckless and careless manner

8.2 Prohibition of Fraudulent and Unfair Trade Practices

8.2.1 Prohibition of Certain Dealing in Securities

Chapter II of the regulations prohibits certain dealings in securities covering buying, selling or issuance of securities. The regulations prohibit a person to, directly or indirectly:

- buy, sell or deal in securities in a fraudulent manner;
- use or employ in connection with issue, purchase or sale of any security listed or proposed to be listed, any manipulative or deceptive device or contrivance in contravention of the provisions of SEBI Act or rules or regulations made thereunder;
- employ any device, scheme or artifice to defraud in connection with dealing in or issue of any security listed or proposed to be listed;
- engage in any act, practice, course of business which would operate as a fraud or deceit in connection with any dealing in or issue of securities, which are listed or proposed to be listed.
- indulge in a fraudulent or an unfair trade practices in securities.

8.2.2 Prohibition of Manipulative, Fraudulent and Unfair Trade Practices

Dealing in securities shall be deemed to be a fraudulent or an unfair trade practice if it involves fraud and may include all or any of the following:

a) indulging in an act which creates false or misleading appearance of trading in the securities market;

b) dealing in a security not intended to effect transfer of beneficial ownership but intended to operate only as a device to inflate, depress or cause fluctuations in the price of such security for wrongful gain or avoidance of loss;
c) advancing or agreeing to advance any money to any person thereby inducing any other person to offer to buy any security in any issue only with the intention of securing the minimum subscription to such issue;
d) paying, offering or agreeing to pay or offer, directly or indirectly, to any person any money or money's worth for inducing such person for dealing in any security with the object of inflating, depressing, maintaining or causing fluctuation in the price of such security;
e) any act or omission amounting to manipulation of the price of a security;
f) publishing or causing to publish or reporting or causing to report by a person dealing in securities any information which is not true or which he does not believe to be true prior to or in the course of dealing in securities;
g) entering into a transaction in securities without intention of performing it or without intention of change of ownership of such security;
h) selling, dealing or pledging of stolen or counterfeit security whether in physical or dematerialized form;
i) an intermediary promising a certain price in respect of buying or selling of a security to a client and waiting till a discrepancy arises in the price of such security and retaining the difference in prices as profit for himself;
j) an intermediary providing his clients with such information relating to a security as cannot be verified by the clients before their dealing in such security;
k) an advertisement that is misleading or that contains information in a distorted manner and which may influence the decision of the investors;
l) an intermediary reporting trading transactions to his clients entered into on their behalf in an inflated manner in order to increase his commission and brokerage;
m) an intermediary not disclosing to his client transactions entered into on his behalf including taking an option position;
n) circular transactions in respect of a security entered into between intermediaries in order to increase commission to provide a false appearance of trading in such security or to inflate, depress or cause fluctuations in the price of such security;
o) encouraging the clients by an intermediary to deal in securities solely with the object of enhancing his brokerage or commission;
p) an intermediary predating or otherwise falsifying records such as contract notes;
q) an intermediary buying or selling securities in advance of a substantial client order or whereby a futures or option position is taken about an impending transaction in the same or related futures or options contract;
r) planting false or misleading news which may induce sale or purchase of securities.
s) mis-selling of units of a mutual fund scheme. Mis-selling means sale of units of a mutual fund scheme by any person, directly or indirectly by making false or misleading statement or concealing or omitting material facts of a scheme or concealing the associated risk factors of the scheme or not taking reasonable care to ensure suitability of the scheme to the buyer.
t) illegal mobilization of funds by sponsoring or causing to be sponsored or carrying on or causing to be carried on any collective investment scheme by any person.

Explanation– For the purposes of this sub-regulation, for the removal of doubts, it is clarified that the acts or omissions listed in this sub-regulation are not exhaustive and that an act or omission is prohibited if it falls within the purview of regulation 3, notwithstanding that it is not included in this sub-regulation or is described as being committed only by a certain category of persons in this sub-regulation.

8.3 Investigation

Chapter III of the Regulations relates to investigation of transactions of the nature described above. In particular, under regulation 8(1), it shall be the duty of every person who is under investigation:

a) To produce books, accounts and documents that may be required by the Investigating Authority and also to furnish statements and information that is sought.
b) To appear before the Investigating Authority personally when required to do so and to answer questions posed by the authority.

SEBI may without prejudice to the provisions contained in sub-sections (1), (2), (2A) and (3) of section 11 and section 11B of the SEBI Act, by an order in the interests of the investors and the securities market issue or take any of the following actions or directions either pending investigation or enquiry or on completion of the investigation or enquiry namely –

(a) Restrain persons from accessing the securities market,
(b) Impound and retain the proceeds or securities in respect of any transaction which is in violation or prima facie in violation of these regulations,
(c) Direct an intermediary or any person associated with the securities market in any manner not to dispose of or alienate an asset forming part of a fraudulent and unfair transaction.

SEBI may even take the following action against an intermediary:

i. Issue a warning or censure;
ii. Suspend the registration of the intermediary;
iii. Cancel the registration of the intermediary.

Review Questions

1. Fraud includes a willful misrepresentation of truth OR concealment of material fact, in order that another person may act, to his detriment. State whether True or False?

   (a) True

   (b) False

Ans: (a)

2. The SEBI Fraudulent and Unfair Trade Practices Regulations prohibit a person to, directly or indirectly _____ securities in a fraudulent manner.

   (a) Buy

   (b) Sell

   (c) Deal In

   (d) All of the above

Ans: (d)

3. Fraud includes an intermediary providing his clients with such information relating to a security as cannot be verified by the clients before their dealing in such security. State whether True or False?

   (a) True

   (b) False

Ans: (a)

4. In cases of fraud, SEBI can _____ the registration of an intermediary?

   (a) Cancel

   (b) Suspend

   (c) Both a & b

   (d) None of the above

Ans: (c)

Unit 9: Prevention of Money Laundering Act 2002

9.1 Introduction

The Prevention of Money Laundering Act, 2002 (PMLA) forms the core of the legal framework put in place by India to combat money laundering. The provisions of PMLA came into force on July 1 2005. The objective of PMLA is, "***to prevent money-laundering and to provide for confiscation of property derived from, or involved in, money-laundering and for matters connected therewith or incidental thereto.***"

Provisions of the PMLA stipulates that every banking company, financial institution and intermediary shall maintain a record of all transactions, the nature and value of which may be prescribed, whether such transactions comprise a single transaction or a series of transactions integrally connected to each other, and where such series of transactions take place within a month and furnish information of transactions and verify and maintain the records of the identity of all its clients. Such transactions include:

- All cash transactions of the value of more than Rs. 10 lakh or its equivalent in foreign currency.
- All series of cash transactions integrally connected to each other which have been valued below Rs. 10 lakh or its equivalent in foreign currency where such series of transactions take place within one calendar month and the aggregate value of such transaction exceeds Rs. 10 lakh.
- All suspicious transaction whether or not made in cash. For the purpose of suspicious transactions apart from 'transactions integrally connected', 'transactions remotely connected or related' shall also be considered.

The records which have been referred to in the above paragraphs have to be maintained for a period of 10 years from the date of cessation of the transactions between the clients and the banking company or financial institution or intermediary, as the case may be.

In the following section, we will discuss the highlights of the PMLA, 2002 and thereafter the master circular of on Anti-Money Laundering issued by SEBI.

9.2 Highlights of PMLA, 2002

Section 3 of the PMLA 2002, defines offence of money laundering as:

> *"Whosoever directly or indirectly attempts to indulge or knowingly assists or knowingly is a party or is actually involved in any process or activity connected with the proceeds of crime including its concealment, possession, acquisition or use and projecting and claiming it as untainted property shall be guilty of offence of money laundering."*

Any person found indulging in any offence of money laundering as defined in section 3 of the PMLA, shall be punished as per provisions mentioned in section 4 of the Act.

"Whoever commits the offence of money-laundering shall be punishable with rigorous imprisonment for a term which shall not be less than 3 years but which may extend to 7 years and shall also be liable to fine which may extend to Rs. 5 lakhs. In cases where the proceeds of crime involved in money-laundering relates to any offence as specified in the Part A of the Schedule to the PMLA, 2002, the term of imprisonment shall not be less than 3 years but which may extend to 10 years.

In cases , where the Director, or any other officer authorized by the Director, has reason to believe on the basis of the material in his possession that (a) any person is in possession of any proceeds of crime; (b) such person has been charged of having committed scheduled offence; and (c) such proceeds of crime are likely to be concealed, transferred or dealt with in any manner which may result in frustrating any proceedings relating to confiscation of such proceeds of crime, then he may order to attach such property for a period not exceeding 90 days from the date of such order.

The Central Government shall appoint one or more Adjudicating Authorities to exercise jurisdiction, powers and authority conferred by or under this Act. On receipt of a complaint if the Adjudicating Authority has reason to believe that any person has committed an offence as per section 3, it may serve a notice of not less than 30 days on such person calling upon him to indicate the sources of his income, earning or assets, out of which or by means of which he has acquired the property which has been attached , or, seized, and to show cause why all or any of such properties should not be declared to be the properties involved in money-laundering and confiscated by the Central Government.

The Obligations on banking companies, financial institutions and intermediaries has been specified in section 12 of the PMLA 2002:

"(1) Every reporting entity shall -

(a) maintain a record of all transactions, including information relating to transactions covered under clause (b) in such manner as to enable it to reconstruct individual transactions;

(b) Furnish to the Director within such time as may be prescribed, information relating to such transactions , whether attempted or executed the nature and value of which may be prescribed;

(c) verify the identity of all its clients, in such manner and subject to such conditions, as may be prescribed.

(d) identify the beneficial owner, if any, of such of its clients, as may be prescribed
(e) maintain record of documents evidencing identity of its clients and beneficial owners as well as account files and business correspondence relating to its clients

(2) Every information maintained, furnished or verified, save as otherwise provided under any law for the time being in force, shall be kept confidential
(3) The records referred to in clause (a) of sub-section (1) shall be maintained for a period of five years from the date of transaction between a client and the reporting entity
(4) The records referred to in clause (e) of sub-section (1) shall be maintained for a period of five years after the business relationship between a client and the reporting entity has ended or the account has been closed whichever is later

To ensure compliance, the Director has been conferred with the following powers as given in the Section 12 A and section 13 of the PMLA 2002.

Section 12A:
(1)The Director may call for from any reporting entity any of the records referred to in sub-section (1) of section 12 and any additional information as he considers necessary for the purposes of this Act
(2)Every reporting entity shall furnish to the Director such information as may be required by him under sub-section(1) within such time and in such manner as he may specify
(3) Save as otherwise provided under any law for the time being in force, every information sought by the Director under sub-section (1) shall be kept confidential

Section 13:
"(1)The Director may, either of his own motion or on an application made by any authority, officer or person, call for records as referred to in sub-section (1) of section 12 and may make such inquiry or cause such inquiry to be made, as he thinks fit to be necessary, with regard to the obligations of the reporting entity under this Chapter.

(1A) If at any stage of inquiry or any other proceedings before him, the Director having regard to the nature and complexity of the case, is of the opinion that it is necessary to do so, he may direct the concerned reporting entity to get its records, as may be specified, audited by an accountant from amongst a panel of accountants maintained by the Central Government for this purpose

(1B) The expenses of and incidental to any audit under sub-section (1A) shall be borne by the Central Government

(2) If the Director, in the course of any inquiry, fids that a reporting entity or its designated director on the Board or any of its employees has failed to comply with the obligations under this Chapter, then, without prejudice to any other action that may be taken under any other provision of this Act, he may issue a warning in writing or direct such reporting entity or its designated director on the Board or any of its employees to comply with specific instructions or direct such reporting entity or its designated director on the Board or any of its employees to send reports as such interval as may be

prescribed or by an order impose a monetary penalty on such reporting entity or its designated director on the Board or any of its employees which shall not be less than ten thousand rupees but may extend to one lakh rupees for each failure.

(3) The Director shall forward a copy of the order so passed to every banking company, financial institution or intermediary or person who is a party to the proceeding.

Explanation- For the purposes of this section, accountant shall mean a Chartered accountant within the meaning of the Chartered Accountants Act, 1949."

Any person aggrieved by the order passed by the Director or the Adjudicating Officer under the PMLA, 2002 may prefer to appeal to the Appellate Tribunal.

9.3 Highlights of SEBI Circular on AML/CFT

As per provisions of PMLA, intermediaries registered under SEBI Act, shall have to adhere to the provisions as given in the PMLA. A 'Principal Officer' needs to be designated who shall be responsible for ensuring compliance of the provisions of the PMLA. SEBI has issued necessary directives vide circulars from time to time, covering issues related to Know Your Client (KYC) norms, Anti-Money Laundering (AML), Client Due Diligence (CDD). These directives lay down minimum requirements and it is emphasised that the intermediaries may, according to their requirements specify additional disclosures to be made by the clients to address the concerns of money laundering and suspicious transactions undertaken by the clients.

9.3.1 Obligation to establish policies and procedures

To be in compliance with the guidelines of the anti-money laundering, senior management of a registered intermediary should be fully committed to establishing appropriate policies and procedures for the prevention of money laundering and terrorist financing and ensuring their effectiveness and compliance with all relevant legal and regulatory requirements. The registered intermediaries should:

a) Issue a statement of policies and procedures on a group basis where applicable for dealing with money laundering reflecting the current statutory and regulatory requirements;
b) Ensure that the content of these directives are understood by all staff members;
c) Regularly review the policies and procedures on the prevention of money laundering to ensure effectiveness. Further to ensure effectiveness the person who reviews should be different from the person framing the policies and procedures;
d) Adopt client acceptance policies and procedures which are sensitive to the risk of Money Laundering (ML) and Terrorism Financing (TF);
e) Undertake client due diligence (CDD) measures to an extent that is sensitive to the risk of money laundering depending on the type of client, business relationship or transaction;
f) Have a system in place for identifying, monitoring and reporting suspected money laundering to the law enforcement authorities;
g) Develop staff members' awareness and vigilance to guard against ML and TF.

9.3.2 Policies and Procedures

Policies and procedures to combat Money Laundering should cover:

- Communication of group policies relating to prevention of money laundering and terrorist financing to all management and relevant staff that handle account information, client records etc.
- Client acceptance policy and due diligence measures, including requirements for proper identification;
- Maintenance of records;
- Compliance with relevant statutory and regulatory requirements;
- Cooperation with the relevant law enforcement authorities, including timely disclosure of information; and
- Role of internal audit or compliance function to ensure compliance with the policies, procedures and controls relating to the prevention of money laundering and terrorist financing, including testing of the system for detecting suspected money laundering transactions.

9.3.3 Written Anti-Money Laundering Procedures

Each registered intermediary should adopt written procedures to implement the anti-money laundering provisions as envisaged under the PMLA. Such procedures should include the following three specific parameters which are related to the CDD process:

(a) Policy for acceptance of clients
(b) Procedure for identifying the clients
(c) Transaction monitoring and reporting especially Suspicious Transactions Reporting (STR)

9.3.4 Client Due Diligence

The CDD measures comprise the following:

(a) Obtaining sufficient information in order to identify persons who beneficially own or control securities account. Whenever it is apparent that the securities acquired or maintained through an account are beneficially owned by a party other than the client, that party should be identified using client identification and verification procedures. The beneficial owner is the natural person or persons who ultimately own, control or influence a client and/or persons on whose behalf a transaction is being conducted. It also incorporates those persons who exercise ultimate effective control over a legal person or arrangement.

(b) Verify the customer's identity using reliable, independent source documents, data or information;

(c) Identify beneficial ownership and control, i.e. determine which individual(s) ultimately own(s) or control(s) the customer and/or the person on whose behalf a transaction is being conducted;

(d) Verify the identity of the beneficial owner of the customer and/or the person on whose behalf a transaction is being conducted, corroborating the information provided in relation to (c);

(e) Conduct ongoing due diligence and scrutiny, i.e. perform ongoing scrutiny of the transactions and account throughout the course of the business relationship to ensure that the transactions being conducted are consistent with the registered intermediary's

knowledge of the customer, its business and risk profile, taking into account, where necessary, the customer's source of funds;

(f) Understand the ownership and control structure of the client; and

(g) Registered intermediaries shall periodically update all documents, data or information of all clients and beneficial owners collected under the CDD process.

All registered intermediaries should develop customer acceptance policies and procedures that aim to identify the types of customers that are likely to pose a higher than the average risk of money laundering or terrorist financing. By establishing such policies and procedures, the intermediaries will be in a position to apply CDD on a risk sensitive basis depending on the type of customer business relationship or transaction. In a nutshell, the following safeguards are to be followed while accepting the clients:

i. No account should be opened in a fictitious / benami name or on an anonymous basis.

ii. Factors of risk perception of the client should be clearly defined having regard to clients' location, nature of business activity, trading turnover etc. and manner of making payment for transactions undertaken. The parameters should enable classification of clients into low, medium and high risk.

iii. It should be ensured that an account is not opened where the intermediary is unable to apply appropriate CDD / KYC policies. The market intermediary should not continue to do business with such a person and file a suspicious activity report. It should also evaluate whether there is suspicious trading in determining in whether to freeze or close the account. The market intermediary should be cautious to ensure that it does not return securities of money that may be from suspicious trades. However, the market intermediary should consult the relevant authorities in determining what action it should take when it suspects suspicious trading.

iv. The circumstances under which the client is permitted to act on behalf of another person / entity should be clearly laid down. It should be specified in what manner the account should be operated, transaction limits for the operation, additional authority required for transactions exceeding a specified quantity / value and other appropriate details. Further the rights and responsibilities of both the persons (i.e. the agent- client registered with the intermediary, as well as the person on whose behalf the agent is acting should be clearly laid down). Adequate verification of a person's authority to act on behalf the customer should also be carried out.

v. Necessary checks and balances should be put into place before opening an account so as to ensure that the identity of the client does not match with any person having known criminal background or is not banned in any other manner, whether in terms of criminal or civil proceedings by any enforcement agency worldwide.

vi. The CDD process shall necessarily be revisited when there are suspicions of money laundering of financing of terrorism.

9.3.5 Client Identification Procedure (CIP)

The 'Know your Client' (KYC) policy should clearly spell out the client identification procedure to be carried out at different stages i.e. while establishing the intermediary – client relationship, while carrying out transactions for the client or when the intermediary has doubts regarding the

veracity or the adequacy of previously obtained client identification data. Intermediaries should comply with the following requirements while putting in place CIP:

(a) All registered intermediaries shall proactively put in place appropriate risk management systems to determine whether their client or potential client or the beneficial owner of such client is a politically exposed person.

(b) All registered intermediaries are required to obtain senior management approval for establishing business relationships with Politically Exposed Persons (PEPs).

(c) Registered intermediaries should also take reasonable measures to verify the sources of funds as well as wealth of clients and beneficial owners identified as PEP.

(d) The client should be identified by the intermediary by using reliable sources including documents / information. The intermediary should obtain adequate information to satisfactorily establish the identity of each new client and the purpose of the intended nature of the relationship.

(e) The information should be adequate enough to satisfy competent authorities (regulatory / enforcement authorities) in future that due diligence was observed by the intermediary in compliance with the Guidelines. Each original document should be seen prior to acceptance of a copy.

SEBI has prescribed the minimum requirements relating to KYC for certain class of the registered intermediaries from time to time. Taking into account the basic principles enshrined in the KYC norms which have already been prescribed or which may be prescribed by SEBI from time to time, all registered intermediaries should frame their own internal guidelines based on their experience in dealing with their clients and legal requirements as per the established practices. Further, the intermediary should also maintain continuous familiarity and follow-up where it notices inconsistencies in the Information provided. The underlying principle should be to follow the principles enshrined in the PML Act, 2002 as well as the SEBI Act, 1992 so that the intermediary is aware of the clients on whose behalf it is dealing.

9.3.6 Record Keeping

Registered intermediaries should ensure compliance with the record keeping requirements contained in the SEBI Act, 1992, Rules and Regulations made there-under, PMLA, 2002 as well as other relevant legislation, Rules, Regulations, Exchange Bye-laws and Circulars. They should also maintain such records as are sufficient to permit reconstruction of individual transactions (including the amounts and types of currencies involved, if any) so as to provide, if necessary, evidence for prosecution of criminal behaviour.

Registered Intermediaries should ensure that all customer and transaction records and information are available on a timely basis to the competent investigating authorities. Where appropriate, they should consider retaining certain records, e.g. customer identification, account files, and business correspondence, for periods which may exceed that required under the SEBI Act, Rules and Regulations framed there-under, PMLA 2002, other relevant legislations, Rules and Regulations or Exchange bye-laws or circulars.

In cases where there is any suspected drug related or other laundered money or terrorist property, the competent investigating authorities would need to trace through the audit trail for reconstructing a financial profile of the suspect account. To enable this reconstruction, registered Intermediaries should retain the following information for the accounts of their customers in order to maintain a satisfactory audit trail: (a) the beneficial owner of the account; (b) the volume of the funds flowing through the account; and (c) for selected transactions the origin of the funds; the form in which the funds were offered or withdrawn, e.g. cash, cheques, etc.; the identity of the person undertaking the transaction; the destination of the funds; the form of instruction and authority.

9.3.7 Retention of Records

Intermediaries need to ensure that they take appropriate steps to evolve an internal mechanism for proper maintenance and preservation of such records and information in a manner that allows easy and quick retrieval of data as and when requested by the competent authorities. Further, the records need to be maintained and preserved for a period of five years from the date of transactions between the client and intermediary. The records evidencing the identity of its clients and beneficial owners as well as account files and business correspondence shall be maintained ad preserved for a period of five years after the business relationship between a client and intermediary has ended or the account has been closed whichever is later.

- All necessary records on transactions, both domestic and international, shall be maintained at least for the minimum period prescribed under the relevant Act and Rules (PMLA and rules framed thereunder as well SEBI Act) and other legislations, Regulations or exchange byelaws or circulars.
- Records on client identification, account files and business correspondence shall also be kept for the same period.

In situations where the records relate to on-going investigations or transactions which have been the subject of a suspicious transaction reporting, they shall be retained until it is confirmed that the case has been closed.

9.3.8 Monitoring of Transactions

Regular monitoring of transactions is vital for ensuring effectiveness of the AML procedures. This is possible only if the intermediary has an understanding of the normal activity of the client so that it can identify deviations in transactions / activities. The intermediary has to pay special attention to all complex, unusually large transactions / patterns which appear to have no economic purpose. The intermediary may specify internal threshold limits for each class of client accounts and pay special attention to transactions which exceeds these limits. The background including all documents/office records /memorandums/clarifications sought pertaining to such transactions and purpose thereof should also be examined carefully and findings be recorded in writing. Further such findings, records and related documents shall be made available to auditors and also to SEBI/stock exchanges/FIU-IND/other relevant authorities, during audit, inspection or as and when required.

9.3.9 Suspicious Transaction Monitoring & Reporting

Intermediaries shall ensure that appropriate steps are taken to enable suspicious transactions to be recognized and have appropriate procedures for reporting suspicious transactions. While determining suspicious transactions, intermediaries shall be guided by the definition of a suspicious transaction contained in PML Rules as amended from time to time. SEBI in its master circular has given an illustrative list of circumstances, which may be in the nature of suspicious transactions. The same is reproduced below:

- Clients whose identity verification seems difficult or clients that appear not to cooperate;
- Asset management services for clients where the source of the funds is not clear or not in keeping with clients apparent standing /business activity;
- Clients based in high risk jurisdictions;
- Substantial increases in business without apparent cause;
- Clients transferring large sums of money to or from overseas locations with instructions for payment in cash;
- Attempted transfer of investment proceeds to apparently unrelated third parties;

Any suspicious transaction shall be immediately notified to the Money Laundering Control Officer or any other designated officer within the intermediary. The notification maybe done in the form of a detailed report with specific reference to the clients, transactions and the nature /reason of suspicion. However, it shall be ensured that there is continuity in dealing with the client as normal until told otherwise and the client shall not be told of the report/suspicion. In exceptional circumstances, consent may not be given to continue to operate the account, and transactions may be suspended, in one or more jurisdictions concerned in the transaction, or other action taken. The Principal Officer/Money Laundering Control Officer and other appropriate compliance, risk management and related staff members shall have timely access to client identification data and CDD information, transaction records and other relevant information.

9.3.10 Reporting to Financial Intelligence Unit-India

The Cash Transactions Reports for cases which have been discussed in bullet points 1 and 2 in section 9.1 for each month should be submitted to FIU-IND by 15th of the succeeding month. The Suspicious Transaction Report (STR) shall be submitted within 7 days of arriving at a conclusion that any transaction, is of suspicious nature. The Principal Officer is responsible for timely submission of the CTR and STR and these reports should be maintained with utmost secrecy.

In terms of the PML Rules, intermediaries are required to report information relating to cash and suspicious transactions to the

Director, FIU-IND,

Financial Intelligence Unit-India,

6th Floor, Hotel Samrat, Chanakyapuri,

New Delhi-110021

Website: http://fiuindia.gov.in

9.4 SEBI (Foreign Portfolio Investors) Regulations, 2014

As per the SEBI (Foreign Portfolio Investors) Regulations, 2014, the Foreign Portfolio Investors is a person who satisfies the eligibility criteria as provided under the Regulation 4 of the said SEBI regulations.

9.4.1 Eligibility Criteria of Foreign Portfolio Investors

As per the SEBI (Foreign Portfolio Investors), the designated depository participant shall not consider an application for grant of certificate of registration as a foreign portfolio investor unless the applicant satisfies the following conditions, namely-

a. The applicant is a person not resident in India

b. The applicant is resident of a country whose securities market regulator is a signatory to International Organisation of Securities Commissions Multilateral Memorandum of Understanding or a signatory to bilateral MoU with SEBI

c. The applicant being a bank, is a resident of a country whose central bank is a member of Bank for International Settlements

d. The applicant is not resident in a country identified in the public statement of Financial Action Task Force as:

    i. A jurisdiction having a strategic Anti-Money Laundering or Combating the Financing of Terrorism deficiencies to which counter measures apply; or

    ii. A jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with the Financial Action Task Force to address the deficiencies;

e. The applicant is not a non-resident Indian

f. The applicant is legally permitted to invest in securities outside the country of its incorporation or establishment or place of business

g. The applicant is authorised by its Memorandum of Association and Articles of Association or equivalent document(s) or the agreement to invest on its own behalf or on behalf of its clients

h. The applicant has sufficient experience, good track, is professionally competent, financially sound and has a generally good reputation of fairness and integrity

i. The grant of certificate to the applicant is in the interest of the development of the securities market

j. The applicant is a fit and proper person based on the criteria specified in Schedule II of the SEBI (Intermediaries) Regulations, 2008, and

k. Any other criteria specified by SEBI from time to time.

9.4.2 Categories of Foreign Portfolio Investor

An applicant shall seek registration as a foreign portfolio investor in one of the categories mentioned herein or any other category as may be specified by SEBI from time to time:

a. Category I foreign portfolio investor which shall include Government and Government related investors such as central banks, Governmental agencies, sovereign wealth funds and international or multilateral organisations or agencies;

b. Category II foreign portfolio investor which shall include:

   I. Appropriately regulated broad based funds such as mutual funds, investment funds, insurance/reinsurance companies;

   II. Appropriately regulated persons such as banks, asset management companies, investment managers/advisors, portfolio managers;

   III. Broad based funds that are not appropriately regulated but whose investment manager is appropriately regulated *provided* that the investment manager of such broad based fund is itself registered as Category II foreign portfolio investor. Provided further that the investment manager undertakes that it shall be responsible and liable for all acts of commission and omission of all its underlying broad based funds and other deeds and things done by such broad based funds under these regulations.

   IV. University funds and pension funds; and

   V. University related endowments already registered with sEBI as FII's or Sub-accounts

c. Category III foreign portfolio investor which shall include all others not eligible under category I and II foreign portfolio investors such as endowments, charitable societies, charitable trusts, foundations, corporate bodies, trusts, individuals and family offices.

9.4.3 Approval to act as designated depository participant

1. No person shall act as designated depository participant unless it has obtained the approval of the SEBI, *Provided* that a custodian of securities which is registered with SEBI as on the date of commencement of these regulations, shall be deemed to have been granted approval as designated DP subject to the payment of fees as specified in the regulations. Provided further the qualified DP which has been granted approval by the SEBI prior to the commencement of these regulations, having opened qualified foreign investor account as on the date of notification of these regulations shall be deemed to have been granted as designated DP subject to payment of fees.

2. An application for approval to act as designated DP shall be made to SEBI through the depository in which the applicant is a participant and hall be accompanied by the application fee.

3. The depository shall forward to SEBI, as early as possible, but not later than 30 days from the date of receipt by the depository, along with its recommendations and certifying that the participant complies with the eligibility criteria as provided for in these regulations.

9.4.4 Eligibility Criteria of designated Depository Participant

SEBI shall not consider an application for the grant of approval as designated depository participant unless the applicant satisfies the following conditions:

a. The applicant is a participant registered with the SEBI;

b. The applicant is a custodian of securities registered with SEBI;

c. The applicant is an Authorized Dealer Category-I bank authorised by RBI

d. The applicant has multinational presence either through its branches or through agency relationships with intermediaries regulated in their respective home jurisdictions;

e. The applicant has systems and procedures to comply with the requirements of Financial Action Task Force Standards, PMLA, 2002 Rules prescribed thereunder and the circulars issued from time to time by the SEBI;

f. The applicant is a fit and proper person based on the criteria specified in Schedule II of the SEBI (Intermediaries) Regulations, 2008; and

g. Any other criteria specified by SEBI from time to time.

Notwithstanding anything as mentioned above, SEBI may consider an application from a global bank, regulated in its home jurisdiction, for grant of approval to act as designated depository participant, if it is satisfied that it has sufficient experience in providing custodial services and the grant of such approval is in the interest of the development of the securities markets: *Provided* that such global bank shall be registered with the SEBI as a participant, custodian of securities and shall have tie up with Authorised Dealer Category-I bank.

9.4.5 Investment Conditions and Restrictions

1. A foreign portfolio investor shall invest only in the following securities, namely-

- Securities in the primary and secondary markets including shares, debentures and warrants of companies, listed or to be listed on a recognised stock exchanges in India;
- Units of schemes floated by domestic mutual funds, whether listed on a recognised stock exchange or not;
- Units of schemes floated by a collective investment scheme;
- Derivatives traded on a recognized stock exchange;
- Treasury bills and dated government securities;
- Commercial papers issued by an Indian company;
- Rupee denominated credit enhanced bonds;
- Security receipts issued by asset reconstruction companies;

- Perpetual debt instruments and debt capital instruments, as specified by the Reserve Bank of India from time to time;
- Listed and unlisted non-convertible debentures/bonds issued by an Indian company in the infrastructure sector, where 'infrastructure' is defined in terms of the extant External Commercial Borrowings (ECB) guidelines;
- Non-convertible debentures or bonds issued by Non-Banking Financial Companies categorized as 'Infrastructure Finance Companies'(IFCs) by the Reserve Bank of India;
- Rupee denominated bonds or units issued by infrastructure debt funds;
- Indian depository receipts; and
- Such other instruments specified by the Board from time to time.

(2) Where a foreign institutional investor or a sub account, prior to commencement of these regulations, holds equity shares in a company whose shares are not listed on any recognized stock exchange, and continues to hold such shares after initial public offering and listing thereof, such shares shall be subject to lock-in for the same period, if any, as is applicable to shares held by a foreign direct investor placed in similar position, under the policy of the Government of India relating to foreign direct investment for the time being in force.

(3) In respect of investments in the secondary market, the following additional conditions shall apply:

(a) A foreign portfolio investor shall transact in the securities in India only on the basis of taking and giving delivery of securities purchased or sold;

(b) Nothing contained in clause (a) shall apply to:

(i) any transactions in derivatives on a recognized stock exchange;

(ii) short selling transactions in accordance with the framework specified by the Board;

(iii) any transaction in securities pursuant to an agreement entered into with the merchant banker in the process of market making or subscribing to unsubscribed portion of the issue in accordance with Chapter XB of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009;

(iv) any other transaction specified by the Board.

(c) No transaction on the stock exchange shall be carried forward;

(d) The transaction of business in securities by a foreign portfolio investor shall be only through stock brokers registered by the Board;

(e) Nothing contained in clause (d) of this sub-regulation shall apply to:

(i) transactions in Government securities and such other securities falling under the purview of the Reserve Bank of India which shall be carried out in the manner specified by the Reserve Bank of India;

(ii) sale of securities in response to a letter of offer sent by an acquirer in accordance with the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011;

(iii)sale of securities in response to an offer made by any promoter or acquirer in accordance with the Securities and Exchange Board of India (Delisting of Equity shares) Regulations, 2009;

(iv) sale of securities, in accordance with the Securities and Exchange Board of India (Buy-back of securities) Regulations, 1998;

(v) divestment of securities in response to an offer by Indian Companies in accordance with Operative Guidelines for Disinvestment of Shares by Indian Companies in the overseas market through issue of American Depository Receipts or Global Depository Receipts as notified by the Government of India and directions issued by Reserve Bank of India from time to time;

(vi) any bid for, or acquisition of, securities in response to an offer for disinvestment of shares made by the Central Government or any State Government;

(vii) any transaction in securities pursuant to an agreement entered into with merchant banker in the process of market making or subscribing to unsubscribed portion of the issue in accordance with Chapter XB of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009;

(viii) any other transaction specified by the Board.

(f) A foreign portfolio investor shall hold, deliver or cause to be delivered securities only in dematerialized form, Provided that any shares held in non-dematerialized form, before the commencement of these regulations, can be held in non-dematerialized form, if such shares cannot be dematerialized.

(4) In respect of investments in the debt securities, the foreign portfolio investors shall also comply with terms, conditions or directions, specified or issued by the Board or Reserve Bank of India, from time to time, in addition to other conditions specified in these regulations.

(5) Unless otherwise approved by the Board, securities shall be registered in the name of the foreign portfolio investor as a beneficial owner for the purposes of the Depositories Act, 1996.

(6) The purchase of equity shares of each company by a single foreign portfolio investor or an investor group shall be below ten percent of the total issued capital of the company.

(7) The investment by the foreign portfolio investor shall also be subject to such other conditions and restrictions as may be specified by the Government of India from time to time.

(8) In cases where the Government of India enters into agreements or treaties with other sovereign Governments and where such agreements or treaties specifically recognize certain entities to be distinct and separate, the Board may, during the validity of such agreements or treaties, recognize them as such, subject to conditions as may be specified by it.

(9) A foreign portfolio investor may lend or borrow securities in accordance with the framework specified by the Board in this regard.

9.4.6 Conditions for Issuance of Offshore Derivative Instruments

(1) No foreign portfolio investor may issue, subscribe to or otherwise deal in offshore derivative instruments, directly or indirectly, unless the following conditions are satisfied:

(a) such offshore derivative instruments are issued only to persons who are regulated by an appropriate foreign regulatory authority;
(b) such offshore derivative instruments are issued after compliance with 'Know Your Client' norms Provided that those unregulated broad based funds, which are classified as Category II foreign portfolio investor by virtue of their investment manager being appropriately regulated shall not issue, subscribe or otherwise deal in offshore derivatives instruments directly or indirectly:
Provided further that no Category III foreign portfolio investor shall issue, subscribe to or otherwise deal in offshore derivatives instruments directly or indirectly.
(2) A foreign portfolio investor shall ensure that further issue or transfer of any offshore derivative instruments issued by or on behalf of it is made only to persons who are regulated by an appropriate foreign regulatory authority.
(3) Foreign portfolio investors shall fully disclose to SEBI any information concerning the terms of and parties to off-shore derivative instruments such as participatory notes, equity linked notes or any other such instruments, by whatever names they are called, entered into by it relating to any securities listed or proposed to be listed in any stock exchange in India, as and when and in such form as the Board may specify.
(4) Any offshore derivative instruments issued under the SEBI (Foreign Institutional Investors) Regulations, 1995 before commencement of these regulations shall be deemed to have been issued under thecorresponding provision of these regulations.

Review Questions

1. Record of transactions to be maintained under the Prevention of Money Laundering Act includes Cash transactions of the value of more than _____.

   (a) Rs.10 lakh

   (b) Rs. 20 lakh

   (c) Rs. 25 lakh

   (d) Rs. 1 crore

Ans: (a)

2. Fine in case of money laundering shall extend to Rs _____ and rigorous imprisonment.

   (a) Rs. 5 lakh

   (b) Rs. 10 lakh

   (c) Rs. 15 lakh

   (d) Rs. 20 lakh

Ans: (a)

3. A foreign portfolio investor shall invest only in which of the following securities:

   (a) Domestic Mutual Fund Schemes

   (b) Derivatives traded on a recognised stock exchange

   (c) Rupee denominated credit enhanced bonds

   (d) All of the above

Ans: (d)

4. In respect of investments in the debt securities, the foreign portfolio investors need not comply with any conditions or directions given by Reserve Bank of India, as long as it is meeting the restrictions and conditions as specified by SEBI in its SEBI (FPI) Regulations?

   (a) True

   (b) False

Ans: (b)

Unit 10: SEBI (KYC Registration Agency) Regulations, 2011

10.1 Introduction

The provisions of The Prevention of Money Laundering Act, 2002 (PMLA), has made it mandatory for all Intermediaries to comply with the 'Know Your Client' (KYC) norms of the applicants desirous of trading / investing / dealing in the securities market. KYC means the procedure prescribed by SEBI for identifying and verifying the proof of address and identity and compliance with rules, regulations, guidelines and circulars issued by SEBI or any other authority for Prevention of Money Laundering from time to time.

SEBI on December 1, 2011 has notified the SEBI (KYC Registration Agency) Regulations, 2011. SEBI further issued the guidelines on December 23, 2011[11] to effectively implement the Regulations.

The SEBI (KYC Registration Agency) Regulations, 2011, hereinafter referred as SEBI KRA Regulations provides that the KRA agency be registered with SEBI. The KRA is a centralized agency which will maintain and make available the information provided by a client to an intermediary to comply with the KYC norms.

10.2Registration as a KRA (Initial and Permanent)

SEBI shall consider the application for grant of certificate of initial registration as a KRA from an applicant who is fit and proper person[12] and who belongs to one of the following categories as given below provided that any conflict of interest does not exist between the role of the applicant as KRA and other commercial activities of the applicant, its associates and group companies, namely:
(a) A wholly owned subsidiary of a recognized stock exchange, having nation-wide network of trading terminals, or;
(b) A wholly owned subsidiary of a depository or any other intermediary registered with the Board or;
(c) A wholly owned subsidiary of a Self Regulatory Organization (SRO) registered under SEBI (Self Regulatory Organization) Regulations, 2004.

The applicant also has to ensure SEBI about the organizational capabilities, technology and systems and safeguards for maintaining data privacy and also measures undertaken for preventing unauthorized data sharing. Further the applicant should also have a networth of atleast Rs. 25 crore on a continuous basis.

SEBI shall grant an initial registration which shall be valid for a period of 5 years from the initial date of its issue to the applicant. The KRA three months before the expiry of the initial registration shall make an application for grant of certificate of permanent registration to SEBI. If any information has changed which was submitted during the initial registration, all those details/information should be submitted along with the application for permanent registration.

[11]SEBI Circular Ref. No. MIRSD/Cir- 26 /2011 December 23, 2011.
[12]As per the SEBI Intermediaries Regulations

SEBI may grant the permanent registration after being satisfied of the information submitted by the KRA. The KRA applicant shall pay non-refundable application fees of Rs. 50,000, Rs. 1 lakh for initial and permanent registration. An annual fee of Rs. 1 lakh is also required to be paid by the KRA.

10.3Obligations on Surrendering Certificate of Registration

A KRA who wishes to surrender the certificate of registration may do so after requesting for such surrender to SEBI. SEBI may require the KRA to satisfy SEBI about the factors, as it may deem fit, but not limited to the following:

- Arrangements made by KRA for maintenance and preservation of records and other documents required to be maintained under these regulations;
- Redressal of investor grievances;
- Transfer of records of its clients;
- Arrangements made by it for ensuring continuity of service to the clients;
- Defaults or pending action, if any.

On and from the date of the surrender or cancellation of the certificate, the KRA shall-

- return the certificate of registration which has been cancelled, to SEBI and shall not represent itself to be a holder of the certificate for carrying out the activity for which such certificate had been granted;
- cease to carry on any activity in respect of which the certificate had been granted;
- transfer its activities to another entity holding a valid certificate of registration to carry on such activity and allow its clients to withdraw any assignment given to it, without any additional cost to such client;
- make provisions as regards liability incurred or assumed by it;
- take such other action including the action relating to any records or documents that may be in custody or control of such person, within the time period and in the manner, as may be required under the these regulations, or as may be directed by SEBI.

10.4Functions and Obligations of KRA and Intermediary

The KRA shall obtain the KYC documents of the client from the intermediary. The documents shall be as prescribed by SEBI and in terms of the rules, regulations, guidelines and circulars issued by SEBI or any other authority for Prevention of Money Laundering, from time to time.

10.4.1 Functions and Obligations of KRA

KRA shall:

a) Prepare the Operating Instructions in co-ordination with other KRA(s) and issue the same to implement the requirements of these regulations.

b) Have electronic connectivity in order to establish interoperability[13]with KRAs.

c) Have a secure data transmission link with other KRA(s) and with each intermediary that uploads the KYC documents on its system and relies upon its data.

[13]Inter-operability means the ability of the KRA to determine whether the KYC documents of the client are in the custody of another KRA.

d) Be responsible for storing, safeguarding and retrieving the KYC documents and submit to SEBI or any other statutory authority as and when required.

e) Retain the KYC documents of the client, in electronic form for the period specified by Rules, as well as ensuring that retrieval of KYC information is facilitated within stipulated time period.

f) Any information updated about a client shall be disseminated by KRA to all intermediaries that avail of the services of the KRA in respect of that client.

g) Ensure that the integrity of the automatic data processing systems for electronic records is maintained at all times.

h) Take all precautions necessary to ensure that the KYC documents/records are not lost, destroyed or tampered with and that sufficient back up of electronic records is available at all times at a different place.

i) Have adequate mechanisms for the purposes of reviewing, monitoring and evaluating its controls, systems, procedures and safeguards.

j) Cause an audit of its controls, systems, procedures and safeguards to be carried out periodically and take corrective actions for deficiencies, if any and report to SEBI.

k) Take all reasonable measures to prevent unauthorized access to its database and have audit of its systems and procedures at regular intervals as prescribed by SEBI.

l) Have checks built in its system so that an intermediary can access the information only for the clients who approach him.

m) Appoint a compliance officer who shall be responsible for monitoring the compliance of the Act, rules and regulations, notifications, guidelines, instructions, etc., issued by the SEBI or the Central Government and for redressal of client's grievances. The compliance officer shall immediately and independently report to SEBI any non-compliance observed by him.

n) Send a letter to each client after receipt of the KYC documents from the intermediary, confirming the client's details thereof.

o) Take adequate steps for redressal of the grievances of the clients within one month of the date of receipt of the complaint and keep the client and SEBI informed about the number, nature and other particulars of the complaints from such investors. KRAs are also required to develop the monitoring mechanism through internal audit and inspections and encourage investor to use SCORES for lodging their grievances.

10.4.2 Functions and Obligations of the Intermediary

The Intermediary has the following functions and obligations –

a) The intermediary shall perform the initial KYC/due diligence of the client, upload the KYC information with proper authentication on the system of the KRA, furnish the scanned images of the KYC documents to the KRA, and retain the physical KYC documents:

   Provided that in the case of clients of a mutual fund, the Registrar to an Issue and Share Transfer Agent appointed by the mutual fund may perform the initial KYC/due diligence of the client, upload the KYC information with proper authentication on the system of the KRA, and furnish the scanned images of KYC documents to the KRA.

b) The intermediary or the mutual fund, as the case may be, shall furnish the physical KYC documents or authenticated copies thereof to the KRA, whenever so desired by the KRA.

c) When the client approaches another intermediary subsequently, intermediary shall verify and download the client's details from the system of KRA:.

Provided that upon receipt of information on change in KYC details and status of the clients by the intermediary or when it comes to the knowledge of the intermediary, at any stage, the intermediary shall be responsible for uploading the updated information on the system of KRA and retaining the physical documents

d) An intermediary shall not use the KYC data of a client obtained from the KRA for purposes other than it is meant for; nor shall it make any commercial gain by sharing the same with any third party including its affiliates or associates.

e) The intermediary shall have the ultimate responsibility for the KYC of its clients, by undertaking enhanced KYC measures commensurate with the risk profile of its clients.

10.5 Code of Conduct of KRA

1. A KRA shall make all efforts to protect the interest of its clients.
2. It should maintain high standards of integrity, dignity and fairness in the conduct of its business and fulfill its obligations in a prompt, ethical and professional manner.
3. A KRA shall at all times exercise due diligence, ensure proper care and exercise independent professional judgment. It should ensure that any change in registration status/any penal action taken by SEBI or any material change in financial position which may adversely affect the interests of clients is promptly displayed on its website.
4. A KRA shall not divulge to anybody either orally or in writing, directly or indirectly, any confidential information about the clients which has come to its knowledge, without taking prior permission of its clients, except where such disclosures are required to be made in compliance with any law for the time being in force.
5. A KRA shall not indulge in any unfair competition. It shall display on its website adequate and appropriate information about its business, including contact details of persons and services available to clients.
6. All investor grievances should be redressed in a timely and appropriate manner. A KRA shall make reasonable efforts to avoid misrepresentation and ensure that the information provided to the clients and intermediaries is not misleading.
7. A KRA shall abide by the provisions of the Act and the rules, regulations issued by the Government and SEBI, from time to time, as may be applicable. It shall not make untrue statement or suppress any material fact in any documents, reports, papers or information furnished to SEBI.
8. A KRA shall ensure that SEBI is promptly informed about any action, legal proceeding, etc., initiated against it in respect of any material breach or non-compliance by it, of any law, rules, regulations and directions of SEBI or of any other regulatory body.
9. (a) A KRA or any of his employees shall not render, directly or indirectly, any investment advice about any security in the publicly accessible media; (b) A KRA shall not make a recom-

mendation to any client who might be expected to rely thereon to acquire, dispose of or retain any securities.

10. A KRA shall ensure that any person it employs or appoints to conduct business is fit and proper and otherwise qualified to act, in the capacity so employed or appointed including having relevant professional training or experience.
11. A KRA shall have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operations, its clients from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions. The KRA shall be responsible for the acts or omissions of its employees in respect to the conduct of its business.
12. A KRA shall provide adequate freedom and powers to its compliance officer for the effective discharge of its duties.
13. A KRA shall ensure that the senior management, particularly decision makers have access to all relevant information about the business on a timely basis.
14. A KRA shall ensure that good corporate policies and corporate governance are in place.
15. A KRA should have adequately trained staff and arrangements to render fair, prompt and competence services to its clients.
16. A KRA shall develop its own internal code of conduct for governing its internal operations and laying down its standards of appropriate conduct for its employees and officers in the carrying out of their duties. Such a code may extend to the maintenance of professional excellence and standards, integrity, confidentiality, objectivity, avoidance of conflict of interests, disclosure of shareholdings and interests, etc.
17. KRA shall not be party to (a) creation of false market;(b) price rigging or manipulation;(c) passing of unpublished price sensitive information in respect of securities which are listed and proposed to be listed in any stock exchange to any person or intermediary.
18. A KRA shall maintain proper inward and outward system for all types of mail received and dispatched in all forms.
19. A KRA shall follow maker-checker concept in its activities to ensure accuracy of data.
20. A KRA shall not indulge in manipulative, fraudulent practices in the process of identification, verification and updation of a Client's KYC information with a view to distort market equilibrium or making personal gains.

10.6 Guidelines for Intermediaries, KRAs and In-person Verification

For Intermediaries:

i. Once the initial KYC of the new clients are done, the intermediary shall immediately upload the KYC information on the system of the KRA and send the KYC documents (KYC application form and supporting documents of the clients) to the KRA within 10 working days from the date of execution of documents by the client and maintain the proof of dispatch.

ii. In case a client's KYC documents which have been sent to KRA is incomplete, the same shall be communicated to the intermediary who shall forward the required information / documents promptly to KRA.

iii. While uploading the clients' data the intermediary shall ensure that there is no duplication of data in the KRA system.

iv. The intermediary shall carry out KYC when the client chooses to trade/ invest / deal through it.

v. The intermediary is also required to follow the risk based due diligence approach. Also they are required to conduct ongoing client due diligence based on risk profile and financial position of the clients as prescribed by SEBI.

vi. The intermediaries shall also maintain electronic records of KYCs of clients and keeping physical records would not be necessary. It shall promptly provide KYC related information to KRA, as and when required.

vii. The intermediary shall have adequate internal controls to ensure the security /authenticity of data uploaded by it.

For KRAs:

i. KRA system shall provide KYC information in data and image form to the intermediary.

ii. KRA shall send a letter to the client within 10 working days of the receipt of the initial/updated KYC documents from intermediary, confirming the details thereof and maintain the proof of dispatch.

iii. KRA(s) shall develop systems, in co-ordination with each other, to prevent duplication of entry of KYC details of a client and to ensure uniformity in formats of uploading / modification / downloading of KYC data by the intermediary.

iv. KRA shall maintain an audit trail of the upload / modifications / downloads made in the KYC data, by the intermediary in its system.

v. KRA shall ensure that a comprehensive audit of its systems, controls, procedures, safeguards and security of information and documents is carried out annually by an independent auditor. The Audit Report along with the steps taken to rectify the deficiencies, if any, shall be placed before its Board of Directors. Thereafter, the KRA shall send the Action Taken Report to SEBI within 3 months.

vi. KRA systems shall clearly indicate the status of clients falling under PAN exempt categories.

vii. A client can start trading/investing/dealing with the intermediary and its group/subsidiary/ holding company as soon as the initial KYC is done and other necessary information is obtained. The remaining process of KRA can still be in progress at that time.

viii. KRA is also required to follow the risk based due diligence approach. Also they are required to conduct ongoing client due diligence based on risk profile and financial position of the clients as prescribed by SEBI.

In-Person Verification (IPV):

To bring in uniformity in the KYC procedure across intermediaries, the IPV requirements for all the intermediaries have been streamlined by SEBI. Intermediaries registered with SEBI as Stock Brokers, KRAs, Depository Participants, Mutual Funds, Portfolio Managers, Venture Capital Funds and Collective Investment Schemes need to mandatorily carry out IPV for all their clients. The intermediary has to ensure that the details of the person carrying out the IPV are recorded on the KYC form at the time of IPV. The IPV carried out by one SEBI registered intermediary shall be relied upon by another intermediary. For Stock Brokers, their Sub-brokers or Authorised persons may perform the IPV.

Review Questions

1. To effectively implement the KYC guidelines, SEBI notified the _____.
   (a) SEBI (Self Regulatory Organization) Regulations, 2004
   (b) PMLA, 2002
   (c) SEBI (KYC Registration Agency) Regulations, 2011
   (d) None of the above

Ans: (c)

2. KRA shall have secure data transmission links with _____ that uploads the KYC documents on its system.
   (a) Other KRAs
   (b) Intermediaries
   (c) Exchanges
   (d) Both (a) and (b)

Ans: (d)

3. Once the initial KYC of the new clients are done, the intermediary shall immediately upload the KYC information on the system of the KRA and send the KYC.
   (a) 5 working days
   (b) 7 working days
   (c) 10 working days
   (d) 15 working days

Ans: (c)

4. KRA systems shall clearly indicate the status of clients falling under PAN exempt categories. State whether TRUE or FALSE?
   (a) True
   (b) False

Ans: (a)

Part B – Understanding Intermediary Specific Regulations

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Unit 11: SEBI (Stock Brokers and Sub Brokers) Regulations, 1992

11.1 Introduction to SEBI (Stock Brokers and Sub Brokers) Regulations, 1992

The SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992 is prescribed for anyone who wishes to register as a stock broker or its sub-broker for doing any transaction or business in the securities market. Stock brokers and sub-brokers shall ensure that they comply at all times with the various sections as given under this regulation.

11.1.1 Registration of Stock Brokers and Sub-brokers

The stock brokers shall ensure that they comply at all times with the conditions of registration under ***regulation 9*** as follows:

- the stock broker holds the membership of the stock exchange;
- the stock broker shall abide by the rules, regulations and bye-laws of the stock exchange;
- where the stock broker proposes change in control, he shall obtain prior approval of the Board for continuing to act as such after the change;
- he shall pay fees charged by the SEBI; and
- he shall take adequate steps to redress investors' grievances within 1 month of the date of receipt of the complaint and keep SEBI informed about such complaints.
- he shall at all times abide by the Code of Conduct as specified in Schedule II; and
- he shall at all times maintain the minimum networth as specified in Schedule VI.

The sub brokers shall ensure to comply at all times the conditions of registration under the ***regulation 11 and 11A*** as follows:

- No sub-broker shall act as such unless he holds a certificate granted by SEBI under these regulations.
- The application for registration shall be accompanied by a recommendation letter from a stock broker of a recognised stock exchange with whom he is to be affiliated along with two references including one from his banker.
- The application form shall be submitted to the stock exchange of which the stock broker with whom he is to be affiliated is a member.

As per ***regulation 12A***, any registration granted to a Sub-broker shall be subject to the following conditions, namely:

- he shall abide by the rules, regulations and bye-laws of the stock exchange which are applicable to him;
- he shall obtain prior approval of the SEBI when it proposes to change its status or constitution;
- he shall pay the fees charged by the SEBI in the manner as specified by the regulations;
- he shall take adequate steps to redress the grievances of the investors within one month of the date of the receipt of the complaint and keep the SEBI informed of the number, nature and other particulars of the complaints received from such investors; and
- the stock broker is authorised in writing by a stock broker being a member of a stock exchange for affiliating himself in buying, selling or dealing in securities.

It is also provided in ***regulation 15A*** that a director of a stock broker shall not act as a sub-broker to the same stock broker.

11.1.2 General Obligations and Responsibilities

The stock brokers and sub-brokers general obligations and responsibilities are elaborated under regulation 17 to 18B which are given below:
Under ***regulation 17(1),*** every stock-broker shall keep and maintain the following books of accounts, records and documents-

a) Register of transactions (Sauda Book);
b) Clients ledger;
c) General ledger;
d) Journals;
e) Cash book;
f) Bank pass book;
g) Documents register containing, inter-alia, particulars of securities received and delivered in physical form and the statement of accounts and other records relating to receipt and delivery of securities provided by the Depository Participants in respect of dematerialized securities.
h) Members' contract books showing details of all contracts entered into by it with other members of the same exchange or counterfoils or duplicates of memos of confirmation issued to such other member;
i) Counterfoils or duplicates of contract notes issued to clients;
j) Written consent of clients in respect of contracts entered into as principals;
k) Margin deposit book;
l) Registers of accounts of sub- brokers;
m) An agreement with a sub- broker specifying the scope of authority and responsibilities of the Stock-Broker and such sub- broker;
n) Client account opening form in the format as may be specified by the Board

Regulation 17(2) states that every stock-broker shall intimate to SEBI the place where the books of accounts, records and documents are maintained. Additionally, ***regulation 18***, also states that every stock broker shall preserve the books of account and other records maintained under regulation 17 for a minimum period of 5 years. Under the stock broker regulation the requirement of compliance officer is also mandated under the ***regulation 18A*** which states that every stock broker shall appoint a compliance officer who shall be responsible for monitoring the compliance of the Act, rules and regulations, notifications, guidelines instructions, etc. and for redress of investors' grievances. The compliance officer shall immediately and independently report to SEBI any non-compliance observed by him. Under ***regulation 18B***, the stock broker shall not deal with any person as a sub-broker unless such person has been granted certificate of registration by the SEBI.

SEBI has been issuing circulars and master circulars for registered trading members with respect to these regulations. These circulars include, inter alia, requirement of base minimum capital.

11.1.3 Procedure for Inspection

Regulation 19 of the SEBI (Stock Brokers and Sub-Brokers) Regulations gives the SEBI Board the right to inspect. SEBI may appoint inspecting authority to undertake inspection of the books of account, other records and documents of the stock brokers, with or without notice. The purpose of the inspection under regulation 19(1) would be to;

- Ensure that the books of account and other books are being maintained in the manner required;
- Ensure that the provisions of the Act, rules, regulations and the provisions of the SCRA and the rules made thereunder are being complied with;
- Investigate into the complaints received from the investors, other stock brokers, sub-brokers or any other person on any matter having a bearing on the activities of the stock brokers; and
- Investigate *suo-motu*, in the interest of securities business or investors' interest into the affairs of the stock broker.

Whenever any such inspection (as per Regulation 19) is initiated, the stock-broker has the following obligations under ***regulation 21***:

- It shall be the duty of every director, officer and employee of the stock-broker, to produce to the inspecting authority such books, accounts and other documents in his custody or control and furnish him with the statements and information relating to the transactions in securities market within such time as the inspecting authority may require.
- The stock-broker shall allow the inspecting authority to have reasonable access to the premises occupied by the stock- broker or by any other person on his behalf and also extend reasonable facility for examining any books, records, documents and computer data in the possession of the stock-broker or any other person and also provide copies of documents or other materials which, in the opinion of the inspecting authority are relevant.
- The inspecting authority, in the course of inspection, shall be entitled to examine or record statements of any member, director, and employee of the stock- broker.
- It shall be the duty of every director, officer and employee of the stock broker to give to the inspecting authority all assistance in connection with the inspection, which the stock broker may be reasonably expected to give.

The inspecting authority shall submit the inspection report to SEBI and based on the same, SEBI may take such action as it may deem fit and appropriate. SEBI may also appoint a qualified auditor under ***regulation 24***, to investigate into the books of account or affairs of any stock-broker. The auditor so appointed shall have the same powers of the inspecting authority and the stock broker shall have the same obligations as mentioned in the point above.

11.1.4 Action in case of Default

A stock broker or a sub-broker who contravenes any of the provisions of the Act, rules or regulations framed thereunder is liable for any one of more of the following actions –

(a) Monetary penalty

(b) Penalties as specified under the SEBI (Intermediaries) Regulations, 2008[14] including suspension or cancellation of certificate of registration as a stock broker or sub-broker
(c) Prosecution under regulation 24 of the Act.

11.1.4.1 Monetary Penalty

Under regulation 26, a stock broker shall be liable to adjudication proceedings for imposing monetary penalty in respect of following violations:

a. Failure to file any return or report with SEBI.
b. Failure to furnish any information, books or other documents within 15 days of issue of notice by SEBI.
c. Failure to maintain books of accounts or records as per the Act, rules or regulations framed thereunder.
d. Failure to redress the grievances of investors within 30 days of receipt of notice from SEBI.
e. Failure to issue contract notes in the form and manner specified by the stock exchange of which sub broker is a member.
f. Failure to deliver any security or make payment of the amount due to the investor within 48 hours of the settlement of trade unless the client has agreed in writing otherwise.
g. Charging of brokerage which is in excess of brokerage specified in the regulations or the bye-laws of the stock exchange.
h. Dealing in securities of a body corporate listed on any stock exchange on its own behalf or on behalf of any other person on the basis of any unpublished price sensitive information.
i. Procuring or communicating any unpublished price sensitive information except as required in the ordinary course of business or under any law.
j. Counseling any person to deal in securities of any body corporate on the basis of unpublished price sensitive information.
k. Indulging in fraudulent and unfair trade practices relating to securities.
l. Execution of trade without entering into agreement with the client under the Act, rules or regulations framed thereunder or failure to maintain client registration form or commission of any irregularities in maintaining the client agreement.
m. Failure to segregate his own funds or securities from the client's funds or securities or using the securities or funds of the client for his own purpose or for purpose of any other client.
n. Acting as an unregistered sub-broker or dealing with unregistered sub-brokers.
o. Failure to comply with directions issued by SEBI under the Act or the regulations framed thereunder.
p. Failure to exercise due skill, care and diligence.
q. Failure to seek prior permission of SEBI in case of any change in its status and constitution.
r. Failure to satisfy the net worth or capital adequacy norms, if any, specified by SEBI.
s. Extending use of trading terminal to any unauthorized person or place.
t. Violations for which no separate penalty has been provided under these regulations.

[14]Chapter V of the SEBI (Intermediaries) Regulations, 2008 which would be discussed in the later section of this workbook.

11.1.4.2 Action under SEBI (Intermediaries) Regulations including suspension or cancellation of certificate of registration

Under regulation 27, a stock broker is liable to enquiry proceedings under SEBI (Intermediaries) Regulations, if he –

i. ceases to be a member of a stock exchange; or
ii. has been declared defaulter by a stock exchange and has not been re-admitted as a member within a period of six months; or
iii. has been found to be not a fit and proper person by SEBI; or
iv. has been declared insolvent or order for winding up has been passed; or
v. any of the whole time director in case a broker is a company registered under the Companies Act, 1956 has been convicted by a court for an offence involving moral turpitude; or
vi. fails to pay fee as prescribed in the regulations; or
vii. fails to comply with the rules, regulations and bye-laws of the stock exchange of which it is a member; or
viii. fails to co-operate with the inspecting or investigating authority; or
ix. fails to abide by any award of the Ombudsman or decision of SEBI under the SEBI (Ombudsman) Regulations, 2003; or
x. fails to pay the penalty imposed by the Adjudicating Officer; or
xi. indulges in market manipulation of securities or index; or
xii. indulges in insider trading in violation of SEBI (Prohibition of Insider Trading) Regulations, 1992; or
xiii. violates SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003; or
xiv. commits violation of any of the provisions for which monetary penalty or other penalties could be imposed; or
xv. fails to comply with the circulars issued by SEBI; or
xvi. commits violations specified in regulation 26 which in the opinion of SEBI are of a grievous nature.

Rationalisation of process relating to surrender of registration by sub-brokers

i. The affiliating stock broker shall issue a public advertisement in a local newspaper with wide circulation where the sub-broker's place of work is situated, informing the investors/general public about the surrender of registration of his sub-broker and not to deal with such sub-broker.

ii. Further, in case of transition from sub broker to Authorized Person (AP)(where the sub broker surrenders registration while seeking approval as AP)with the same stock broker and the same stock exchange, issue of advertisement in newspaper regarding surrender of sub broker registration shall not be required. However, the affiliating stock broker shall furnish an undertaking/ confirmation to the stock exchanges at the time of surrender of sub broker registration that he has sent communication to the clients of the sub broker individually about the surrender of sub brokership and also the fact of approval as AP.

iii. The affiliating stock broker and/or stock exchange shall publish the details of sub-brokers whose registration has been surrendered or their new status as AP, as the case may be on their respective websites for the information of the investors.

11.1.4.3 Prosecution

Under regulation 28, a stock broker is liable for prosecution as per regulation 24 of the SEBI Act for any of the following violations –

a. Dealing in securities without obtaining certificate of registration from SEBI as a stock broker.
b. Dealing in securities or providing trading floor or assisting in trading outside the recognized stock exchange in violation of provisions of the SCRA or rules made or notifications issued thereunder.
c. Market manipulation of securities or index.
d. Indulging in insider trading in violation of SEBI (Prohibition of Insider Trading) Regulations, 1992.
e. Violating the SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003.
f. Failure without reasonable cause –
   - to produce to the investigating authority or any person authorized by him in this behalf, any books registers, records or other documents which are in his custody or power; or
   - to appear before the investigating authority personally or to answer any question which is put to him by the investigating authority; or
   - to sign the notes of any examination taken down by the investigating authority.
g. Failure to pay penalty imposed by the adjudicating officer or failure to comply with any of his directions or orders.

11.5.1 Code of Conduct

A stock broker or its sub broker needs to adhere to a particular code of conduct as prescribed in the schedule II of the regulations, which has been discussed herein.

Code of Conduct for Brokers

A. General

1) Integrity: A stock-broker, must maintain high standards of integrity, promptitude and fairness in the conduct of all its business.
2) Exercise of Due Skill and Care: A stock-broker, must act with due skill, care and diligence in the conduct of all its business.
3) Manipulation: A stock-broker should not indulge in manipulative, fraudulent or deceptive transactions or schemes or spread rumours with a view to distorting market equilibrium or making personal gains.
4) Malpractices: A stock-broker should not create false market either singly or in concert with others or indulge in any act detrimental to the investors' interest or which leads to interfer-

ence with the fair and smooth functioning of the market. A stock-broker should not involve itself in excessive speculative business in the market beyond reasonable levels not commensurate with its financial soundness.

5) Compliance with Statutory Requirements: A stock-broker should abide by all the provisions of the Act and the rules, regulations issued by the Government, the SEBI and the stock exchange from time to time as may be applicable to him.

B. Duty to the Investor

1) Execution of Orders: A stock-broker, in its dealings with the clients and the general investing public, should faithfully execute the orders for buying and selling of securities at the best available market price and not refuse to deal with a small investor merely on the ground of the volume of business involved. A stock-broker also should promptly inform its client about the execution or non-execution of an order, and make prompt payment in respect of securities sold and arrange for prompt delivery of securities purchased by clients.
2) Issue of Contract Note: A stock-broker should issue without delay to its client or client of the sub-broker, as the case may be a contract note for all transactions in the form as specified by the stock exchange.
3) Breach of Trust: A stock-broker should not disclose or discuss with any other person or make improper use of the details of personal investments and other information of a confidential nature of the client which it comes to know in its business relationship.
4) Business And Commission:
   a) A stock-broker should not encourage sales or purchases of securities with the sole object of generating brokerage or commission.
   b) A stock-broker should not furnish false or misleading quotations or give any other false or misleading advice or information to the clients with a view of inducing him to do business in particular securities and enabling itself to earn brokerage or commission thereby.
5) Business of Defaulting Clients: A stock-broker should not deal or transact business knowingly, directly or indirectly or execute an order for a client who has failed to carry out his commitments in relation to securities with another stock-broker.
6) Fairness to Clients: A stock-broker, when dealing with a client, must disclose whether it is acting as a principal or as an agent and should ensure at the same time that no conflict of interest arises between him and the client. In the event of a conflict of interest, he should inform the client accordingly and should not seek to gain a direct or indirect personal advantage from the situation and also not consider clients' interest inferior to his own.
7) Investment Advice: A stock-broker should not make a recommendation to any client who might be expected to rely thereon to acquire, dispose of, retain any securities unless it has reasonable grounds for believing that the recommendation is suitable for such a client upon the basis of the facts, if disclosed by such a client as to his own security holdings, financial situation and objectives of such investment. The stock-broker should seek such information from clients, wherever it feels it is appropriate to do so.

7A) Investment Advice in publicly accessible media –

(a) A stock broker or any of its employees shall not render, directly or indirectly, any investment advice about any security in the publicly accessible media, whether real time or non real-time, unless a disclosure of his interest including the interest of his dependent family members and the employer including their long or short position in the said security has been made, while rendering such advice.

(b) In case, an employee of the stock broker is rendering such advice, he shall also disclose the interest of his dependent family members and the employer including their long or short position in the said security, while rendering such advice.

8) Competence of Stock Broker: A stock-broker should have adequately trained staff and arrangements to render fair, prompt and competent services to its clients.

C. Dealing with other Stock Brokers

1) Conduct of Dealings: A stock-broker shall co-operate with the other contracting party in comparing unmatched transactions. A stock-broker should not, knowingly and wilfully deliver documents which constitute bad delivery and shall cooperate with other contracting party for prompt replacement of documents which are declared as bad delivery.
2) Protection of Clients Interests: A stock-broker shall extend fullest cooperation to other stock-brokers in protecting the interests of its clients regarding their rights to dividends, bonus shares, right shares and any other right related to such securities.
3) Transactions with Stock-Brokers: A stock-broker should carry out its transactions with other stock-brokers and shall comply with its obligations in completing the settlement of transactions with them.
4) Advertisement and Publicity: A stock-broker should not advertise its business publicly unless permitted by the stock exchange.
5) Inducement of Clients: A stock-broker should not resort to unfair means of inducing clients from other stock- brokers.
6) False or Misleading Returns: A stock-broker shall not neglect or fail or refuse to submit the required returns and not make any false or misleading statement on any returns required to be submitted to SEBI and the stock exchange.

D.

1) A stock broker should always enter into an agreement as specified by SEBI with its client.
2) A stock broker should also enter into an agreement as specified by SEBI with the client of the sub-broker.

Code of Conduct for Sub-Brokers

B. General

1. Integrity: A sub-broker should maintain high standards of integrity, promptitude and fairness in the conduct of all investment business.
2. Exercise of Due Skill and Care: A sub-broker should act with due skill, care and diligence in the conduct of all investment business.

C. Duty to the Investor

1. Execution of Orders: A sub-broker in his dealings with the clients and the general investing public must faithfully execute the orders for buying and selling of securities at the best available market price. A sub-broker shall promptly inform his client about the execution or

non-execution of an order and also assist its client in obtaining the contract note from the stock broker.

2. Breach of Trust: A sub-broker should not disclose or discuss with any other person or make improper use of the details of personal investments and other information of a confidential nature of the client which he comes to know in his business relationship.
3. Business and Commission:
   - A sub-broker shall not encourage sales or purchases of securities with the sole object of generating brokerage or commission.
   - A sub-broker shall not furnish false or misleading quotations or give any other false or misleading advice or information to the clients with a view of inducing him to do business in particular securities and enabling himself to earn brokerage or commission thereby.
   - A sub-broker shall not charge from his clients a commission more than one and one half of one percent of the value mentioned in the respective sale or purchase notes.
4. Business of Defaulting Clients: A sub-broker shall not deal or transact business knowingly, directly or indirectly or execute an order for a client who has failed to carry out his commitments in relation to securities and is in default with another broker or sub-broker.
5. Fairness to clients: A sub-broker when dealing with a client should disclose that it is acting as an agent ensuring at the same time, that no conflict of interest arises between him and the client. In the event of conflict of interest, the sub-broker should inform the client accordingly. He should not seek to gain any direct or indirect personal advantage from the situation and shall not consider client's interest inferior than his own.
6. Investment advice: A sub-broker shall not make a recommendation to any client who might be expected to rely thereon to acquire, dispose of, retain any securities unless he has reasonable grounds for believing that the recommendations is suitable for such a client upon the basis of the facts, if disclosed by such a client as to his own security holdings, financial situation and objectives of such investment.
7. Investment advice in publicly accessible media-
   (a) A sub-broker or any of his employees shall not render, directly and indirectly any investment advice about any security in the publicly accessible media, whether real time or non-real time, unless a disclosure of his interest including his long or short position in the said security has been made, while rendering such advice.
   (b) In case an employee of the sub-broker is rendering such advice, he shall disclose the interest of his independent family members and the employer including their long or short position in the said security, while rendering such advice.
8. Competence of Sub-broker: A sub-broker should have adequately trained staff and arrangements to render fair, prompt and competence services to his clients and continuous compliance with the regulatory system.

D. <u>Dealing with Stock Brokers</u>

9. Conduct of Dealings: A sub-broker shall cooperate with his broker in comparing unmatched transactions. Sub-broker shall not knowingly and wilfully deliver documents which constitute bad delivery. A sub-broker shall cooperate with other contracting party for prompt replacement of documents which are declared as bad delivery.

10. Protection of client's interest: A sub-broker shall extend fullest co-operation to his stock-broker in protecting the interests of their clients regarding their rights to dividends, right or bonus shares, or any other rights relatable to such securities.
11. Transactions with Brokers: A sub-broker should not fail to carry out his stock broking transactions with his brokers nor shall he fail to meet his business liabilities or show negligence in completing the settlement of transactions with them.
12. Agreement between sub-broker, client of the sub-broker and main broker: A sub-broker shall enter into a tripartite agreement with his client and the main stock broker indicating the rights and obligations of the stock broker, sub-broker and such client of the stock broker.
13. Advertisement and Publicity: A stock broker shall not advertise his business publicly unless permitted by the stock exchange.
14. Inducement of Clients: A stock broker shall not resort to unfair means of inducing clients from other brokers.

E. <u>Dealing with Regulatory Authorities</u>

1. General Conduct: A sub-broker shall not indulge in dishonourable, disgraceful or disorderly or improper conduct on the stock exchange nor shall he wilfully obstruct the business of the stock exchange. He shall comply with the rules, bye-laws and regulations of the stock exchange.
2. Failure to give Information: A sub-broker should not neglect or fail or refuse to submit to the SEBI or the stock exchange with which it is registered, such books, special returns, correspondence, documents and papers as may be required.
3. False or Misleading Returns: A sub-broker should not neglect or fail or refuse to submit the required returns and not make any false or misleading statement on any returns required to be submitted to the SEBI or the stock exchange
4. Manipulation: A sub-broker shall not indulge in manipulative, fraudulent or deceptive transactions or schemes or spread rumours with a view to distorting market equilibrium or making personal gains.
5. Malpractices: A sub-broker shall not create a false market either singly or in concert with others or indulge in any act detrimental to the public interest or which leads to interference with the fair and smooth functions of the market mechanism of the stock exchanges. A sub-broker should not involve himself in excessive speculative business in the market beyond reasonable levels not commensurate with his financial soundness.

11.1.6 Fees Payable by Broker and Sub-broker

Regulation 6 of the SEBI (Stock Brokers and Sub-brokers) regulation states that the brokers shall pay fees as prescribed by the regulations. The schedule III of the regulation prescribes the manner in which registration fees needs to be paid by the stock-broker, the same is given below:

a. Where the annual turnover of the broker does not exceed rupees one crore during any financial year, a sum of rupees five thousand for each financial year;
b. Where the annual turnover of the stock-broker exceeds rupees one crore during any financial year, a sum of rupees five thousand plus one hundredth of one per cent of the turnover in excess of rupees one crore for each financial year;
c. After the expiry of five financial years from the date of initial registration as stock broker; he shall pay a sum of rupees five thousand for every block of five financial years

commencing from the sixth financial year after the date of grant of initial registration to keep his registration in force.

Every remittance of fees as referred to in (a) and (b) above should be accompanies by a certificate as to the authenticity of turnover on the basis of which fees have been computed duly signed by the stock exchange of which the stock broker is a member or by a qualified auditor[15] or as defined under section 141 of the Companies Act, 2013.

Every sub-broker shall pay fees in the manner as given below:

i. Where a sub-broker has been granted certificate of registration by SEBI before August 1, 2006;
   i. He shall pay a sum of ten thousand rupees for the block of five financial years commencing from April 1, 2007; and
   ii. After the expiry of the said block of five financial years, he shall pay a sum of five thousand rupees for every subsequent block of five financial years.

ii. Where a sub-broker is granted certificate of registration by SEBI on or after August 1, 2006;
   i. He shall pay a sum of ten thousand rupees for the block of five financial years commencing from April 1, 2007; and
   ii. After the expiry of the said block of five financial years, he shall pay a sum of five thousand rupees for every subsequent block of five financial years.

11.1.7 Regulation of Transactions between Clients and Brokers

SEBI vide its notification (No. SO 855 (E), dated 29-11-1994) have prescribed regulations for transactions between clients and brokers. It shall be compulsory for all member brokers to keep money of the clients in a separate account and their own money in a separate account. No payment of transactions in which the member broker takes a position as a principal will be allowed to be made from the clients account. However, there are circumstances under which transfer from clients account to member brokers account is be allowed, the same is enumerated below:

(1)	(2)	(3)
A.	Member Broker to Keep Accounts	Every member broker shall keep such books of account, as will be necessary, to show and distinguish in connection with his business as a member – i. Moneys received from or on account of and money, paid to or on account of each of his clients, and ii. The moneys received and the moneys paid on members own account.
B.	Obligation to pay money into clients accounts	Every member broker who holds or receives money on account of a client shall forthwith pay such money to current or deposit account at bank to be kept in the name of

[15] A person shall not be qualified for appointment as auditor of a company unless he is a chartered accountant within the meaning of the Chartered Accountants Act, 1949 (38 of. 1949); *Provided* that a firm whereof all the partners practising in India are qualified for appointment as aforesaid may be appointed by its firm name to be auditor of a company, in which case any partner so practising may act in the name of the firm.

		the member in the title of which the word "clients" shall appear. Member broker may keep one consolidated clients account for all the clients or accounts in the name of each client *Provided* when a member receives a cheque or draft belonging to the client and part to the member, he shall pay the whole of such cheque or draft into the clients account and effect subsequent transfer as per prescribed guidelines.
C.	What moneys to be paid into "clients account"	No money shall be paid into clients account other than – i. Money held or received on account of clients; ii. Such money belonging to the member as may be necessary for the purpose of opening or maintaining the account; iii. Money for replacement of any sum which may by mistake or accident have been drawn from the account in contravention of point D (to be discussed below) iv. A cheque or draft received by the member representing in part money belonging to the client an in part money due to the member.
D.	What moneys to be withdrawn from "clients account"	No money shall be drawn from clients account other than- i. Money properly required for payment to or on behalf of clients or for or towards payment of a debt due to the member from clients or money drawn on clients authority, or money in respect of which there is a liability of clients to the members, provided that money so drawn shall not in any case exceed the total of the money held for the time being for such each client. ii. Such money belonging to the member as may have been paid into the client account as discussed under point C (ii) and C (iv). iii. Money which may by mistake or accident have been paid into such account in contravention of point C.

It shall also be compulsory for all member brokers to keep separate accounts for client's securities and to keep such books of account, as may be necessary, to distinguish such securities from his / their own securities. Such accounts for clients securities shall *inter alia* provide for the following:-

a. Securities received for sale or kept pending delivery in the market;
b. Securities fully 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 authorisation from client for the same shall be obtained by the member;
e. Fully paid for client's securities registered in the name of member, if any, towards margin requirement, etc.;

The member brokers need to make the payment to their clients or deliver the securities purchased within two working days of payout unless the client has requested otherwise. It is also compulsory for the member broker to issue the contract note to the client for its purchase or sale within 24 hours of the execution of the contract. We will here further discuss the other things which fall under the ambit of the client-broker relationship.

11.1.7.1 Client Agreement

Client registration documents are segregated into mandatory and non-mandatory parts. Client agreement, Know Your Client (KYC) and the Risk Disclosure Document (RDD) constitute the mandatory part. For registration of a client, along with the client application form, the client agreement also needs to be filled. The agreement should cover details of all issues that clearly define the relationship and the extent of liabilities between the client and the trading/clearing member. The following areas is necessarily needed to be included in the agreement, however additional clauses may also be inserted by the Exchange or the Broker.

- In case there in any change in the information provided by the client to the member at the time of opening the account, the client shall immediately notify the member of such change in writing.
- The agreement shall clearly specify the client's responsibility for all investment decisions and his complete understanding of the risks involved in trading of various derivatives contracts. The member shall ensure that the client has read and signed the Risk Disclosure Document.
- The agreement shall specify the nature of services provided by the broker e.g. trading facilities, clearing facilities, advisory services, portfolio management services etc.
- The agreement shall indicate the rate of brokerage/commission/fee charged by the broker in respect of various services provided by the member. The broker shall not charge brokerage more than the maximum brokerage permitted as per the rules, regulations and bye-laws of the Exchange /SEBI.
- The client's liability to pay margins as required by the trading/ clearing member or exchange or clearing corporation within the stipulated time should be clearly specified. It should also be indicated that if the broker finds it necessary, he should be authorised to levy and collect the additional margins over and above those imposed by the Exchange /Clearing Corporation and the client shall be liable to pay the margins within the stipulated time.
- The broker shall have the authority to liquidate /close out positions of the client for non-payment of margins, outstanding debts etc. Any amount of loss would be charged to the client in such an event.
- The money deposited by the client shall be kept in a separate account by the member, distinct from his own account and cannot be used by the broker for himself or for any purpose other than the purpose mentioned by the client.
- The agreement may contain any other additional provisions as considered necessary by the broker/exchanges.

11.1.7.2 Know Your Client (KYC) Form[16]

[16]SEBI circular Ref. No. MIRSD/SE/Cir-19/2009 dated December 3, 2009

SEBI has made filing of the 'Know Your Client (KYC)' form mandatory for the clients *vide* its circular. The broker is required to ensure that the client fills up the KYC, along with the 'Client Agreement and the Risk Disclosure Document'. In the KYC, the broker should ensure complete details of client information, bank and depository account details, financial details of the constituent, investment / trading experience, references, financial documents and signature of the client are provided. The photograph, proof of address and identity and the Board resolution for corporate clients permitting trading in derivative products are also required as a part of the KYC. Clients should also indicate the segments in which they would like to transact.

SEBI has issued guidelines in pursuance of the SEBI KYC Registration Agency (KRA) Regulations, 2011 and In-Person verification which have been discussed in chapter 10. The KRA system shall be applicable for all new client accounts opened from January 1, 2012.

11.1.7.3 Risk Disclosure Document (RDD)[17]

In order to familiarize the investors or the clients, the broker members are required to sign a risk disclosure document (RDD) with their clients, informing them of the various risks associated with trading in derivatives trading. The text of the RDD is provided in the regulations however, the exchanges may also prescribe any additional disclosure requirements which are considered necessary by them. RDD is mandatory for every client as per SEBI regulations.

11.1.7.4 Uniform Documentary Requirements for Trading

SEBI have prescribed the uniform formats of client registration form and broker client agreement vide its circular no. SMD/Policy/Cir/5-97 dated April 11, 1997. Additionally the format of the broker-sub-broker agreement[18] and the model format of the RDD[19] was also prescribed by SEBI vide its circulars issued from time to time. In order to bring about uniformity in documentary requirements across different segments and exchanges and also to avoid duplication and multiplicity of documents, SEBI in consultation with the exchanges has formulated uniform set of documents which are as listed below:

1. Client Registration Form: Uniform across all the segments and exchanges where the broker is trading on different segments and exchanges.
2. Member Clients Agreement: Uniform across all exchange. However, a separate agreement in the same format would be required for each of the exchanges where the broker is trading on different exchanges.
3. Model Tripartite Agreement between Broker-Sub-broker and Clients.
4. Uniform Risk Disclosure Documents
5. Broker-Sub-broker Agreement

Though the aforementioned are the model formats, the stock exchange or the stock broker may incorporate any additional clauses in the documents provided they are not in conflict with any of the clauses in the model document, as also the Rules, Regulations, Articles, Bye-laws, Circulars, Directives and Guidelines.

[17]The Risk Disclosure Document (RDD) should be read by each and every client before entering into derivatives trading and a signed copy of the same should be obtained by the broker from all its clients.
[18]SEBI circular Ref. No. SMD/Policy/Cir./11-97 dated May 21, 1997.
[19] SEBI circular Ref. No. SEBI/MRD/SE/Cir-37/2003 dated September 30, 2003.

The requirement of obtaining the client registration form may be waived for SEBI registered Foreign Institutional Investors (FIIs), Mutual Funds (MFs), Venture Capital Funds (VCFs) and Foreign Venture Capital Investors (FVCIs), Scheduled Commercial Banks (SCBs) etc .

11.1.7.5 Execution of Power of Attorney

The Power of Attorney (PoA) is a document that is executed by the client in favour of the stock broker/stock broker and depository participant to authorise the broker to operate the clients demat account and bank account to facilitate the delivery of shares and pay-in and pay-out of funds. In other words, the POA enables the stock broker to legally execute contracts on behalf of the client. Generally the POA is taken from the clients who want to avail internet based trading services. SEBI in order to standardise the norms, have prescribed guidelines to be followed by the stock brokers /depository participants while obtaining POA.

POA favouring Stock Brokers

POA executed in favour of a stock broker by the client should be limited to the following:

1. **Securities**
   - i. Transfer of securities held in the beneficial owner account(s) of the client(s) towards stock exchange related margin /delivery obligations arising out of trades executed by the client(s) on the stock exchange through the same broker.
   - ii. Pledge the securities in favour of the stock broker for the limited purpose of meeting the margin requirements of the client(s) in connection with the trades executed by the clients on the stock exchange through the same broker. Audit trail should be available with the stock broker for such transactions.
   - iii. To apply for various products like MFs, public issues etc pursuant to the instructions of the client. However necessary audit trail should be maintained by the stock broker to prove that the necessary application /act was made /done pursuant to receipt of instruction from client.
2. **Funds**
   - iv. Transfer of funds from the bank account(s) of the clients for the following:
     a. For meeting the settlement obligations of the client(s)/margin requirements of the client(s) in connection with the trades executed by the clients on the stock exchange through the same stock broker.
     b. For recovering any outstanding amount due from the client(s) arising out of clients trading activities on the stock exchanges through the same stock broker.
     c. For meeting obligations arising out of the client subscribing to such other products/facilities/services through the stock broker like MFs, public issues etc.
     d. Towards monies/fees/charges etc due to the stock broker /depository participant payable by virtue of the client using /subscribing to any of the facilities/services availed by the client at his/her instance.

All necessary audit trail should be available with the stock broker for any such transaction.

11.1.7.6 Unique Client Code (UCC)

It is mandatory for the broker to use the unique client code for all its clients. For this purpose the broker shall collect and maintain in their back office the Permanent Account Number (PAN) allotted by the Income Tax Department for all their clients. In case of other entities –

- Brokers shall verify the documents with respect to the unique code retain a copy of the document.
- The brokers shall also be required to furnish the above particulars of their clients to the stock exchanges /clearing corporations and the same would be updated on a monthly basis. Such information for a particular month should reach the exchange within 7 working days of the following month.

11.1.7.7 Contract Note

As already mentioned above, the trading member / broker have to ensure that the contract notes are issued in the prescribed format within 24 hours of execution of the trades on the exchanges. Copies of the contract and the proof of delivery/despatch is also to be maintained by the broker. The contract notes should contain the signature of the authorised person, contain the UCC and PAN details along with the trade price at which the trade was executed and the brokerage charged. The contract number should also have a running serial number. The details of the dealing office through which the deal was transacted and the PAN number of the trading member / broker should also be mentioned on the contract note.

11.1.7.8 Electronic Contract Note

The contract notes can be issued by the brokers in electronic form authenticated by means of digital signatures. All the members of the stock exchanges who are desirous of issuing Electronic Contract Notes (ECNs) to their clients shall comply with the following conditions:-

i. *Issuing ECNs when specifically consented*: The digitally signed ECNs may be sent only to those clients who have opted to receive the contract notes in an electronic form, either in the member-client agreement /tripartite agreement.
ii. *Where to send ECNs*: The usual mode of delivery of ECNs to the clients shall be through email. For this purpose, the client shall provide an appropriate email account to the member which shall be made available at all times for such receipts of ECNs.
iii. *Requirement of digital signature*: All ECNs sent through the email shall be digitally signed, encrypted, non-tamperable and shall comply with the provisions of the IT act, 2000.
iv. *Format:* The format of the issuance of the ECN is prescribed by the stock exchange and the brokers need to conform to it.

11.1.7.9 Quarterly Statement of Accounts

To avoid disputes arising between clients and brokers pertaining to payments due to / from the clients, the trading members need to adhere to the following:

- Statement of accounts for funds and securities should be sent to all the clients in such a period not exceeding 3 months (quarter) within 30 days of the expiry of such period.

- The statement should account for all the receipts and deliveries/ payments during the relevant period and not only the details of the holding as at end of the period.
- Maintain proof of despatch of such account statements.
- An error reporting clause giving 30 days time to revert back also should be incorporated in the account statement.

11.1.8 Direct Market Access

Direct Market Access (DMA) is a facility which permits the brokers to offer clients direct access to the exchange trading system through the broker's infrastructure without manual intervention by the broker. This was brought into effect vide the SEBI circular (MRD/DoP/SE/Cir-7/2008 dated April 3, 2008). Some of the advantages offered by DMA are direct control of clients over orders, faster execution of client orders, reduced risk of errors associated with manual order entry, greater transparency, increased liquidity, lower impact costs for large orders, better audit trails and better use of hedging and arbitrage opportunities through the use of decision support tools / algorithms for trading. As per the SEBI Circular, DMA facility initially is being restricted to institutional clients only.

11.1.8.1 Operational Specifications

The broker should ensure sound audit trail for all the DMA orders and trades and be able to provide identification of actual user-id for all such orders and trades. The audit trail data should also be available for at least 5 years. The DMA system shall have sufficient security features including password protection for the user ID, automatic expiry of passwords at the end of a reasonable duration and re-initialisation of access on entering fresh passwords.

11.1.8.2 Client Authorization

Brokers shall specifically authorise clients for providing DMA facility after fulfilling Know Your Client (KYC) requirements and carrying out due diligence regarding clients credit worthiness, risk taking ability, track record of compliance and financial soundness. Broker shall ensure than only those clients who are deemed fit and proper for this facility are allowed access to the DMA facility. Brokers shall maintain proper records of such due diligence. The broker shall enter into a specific agreement with the clients for whom they permit DMA facility.

11.1.8.3 Cross Trades

It is also to be noted that the brokers using DMA facility for routing client orders shall not be allowed to cross trades of their clients with each other. All orders must be offered to the market for matching.

11.1.8.4 Brokers liability

The broker shall be fully responsible and liable for all orders emanating through their DMA systems. It shall be the responsibility of the broker to ensure that only clients who fulfil the eligibility criteria are permitted to use the DMA facility.

11.1.9 Margin Requirements

SEBI circular requires the members / brokers to have a prudent system of risk management which needs to be well documented in writing and be made accessible to the clients and the exchange. The members have to ensure collection of margins and maintenance margins in the approved mode from the clients. Information related to margin applicable, utilised and required / balance in respect of each client should be furnished to the client on a daily basis.

11.2 SEBI (Alternative Investment Funds) Regulations, 2012

11.2.1 Registration as Alternative Investment Funds (AIF)

Alternative Investment Fund means any fund established or incorporated in India in the form of a trust or a company or a limited liability partnership or a body corporate which,-
(i) is a privately pooled investment vehicle which collects funds from investors, whether Indian or foreign, for investing it in accordance with a defined investment policy for the benefit of its investors; and
(ii) is not covered under the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, Securities and Exchange Board of India (Collective Investment Schemes) Regulations, 1999 or any other regulations of the Board to regulate fund management activities:
Provided that the following shall not be considered as Alternative Investment Fund for the purpose of these regulations,-
(i) family trusts set up for the benefit of relatives' as defined under Companies Act, 1956;
(ii) ESOP Trusts set up under the Securities and Exchange Board of India (Employee Stock Option Scheme and Employee Stock Purchase Scheme), Guidelines, 1999 or as permitted under Companies Act, 1956;
(iii) employee welfare trusts or gratuity trusts set up for the benefit of employees;
(iv) holding companies' within the meaning of Section 4 of the Companies Act, 1956;
(v) other special purpose vehicles not established by fund managers, including securitization trusts, regulated under a specific regulatory framework;
(vi) funds managed by securitisation company or reconstruction company which is registered with the Reserve Bank of India under Section 3 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002; and
(i) any such pool of funds which is directly regulated by any other regulator in India;

Any person wanting to commence business as an AIF should make an application to SEBI in the format as prescribed by SEBI.

Alternative Investment Funds shall seek registration in one of the categories mentioned in the Regulations and in case of Category I Alternative Investment Fund, in one of the sub-categories thereof

11.2.2 Eligibility Criteria

Further, the applicant shall also satisfy the following conditions, for SEBI to consider the application for grant of certificate:

a. the memorandum of association in case of a company; or the Trust Deed in case of a Trust; or the Partnership deed in case of a limited liability partnership permits it to carry on the activity of an Alternative Investment Fund;

b. the applicant is prohibited by its memorandum and articles of association or trust deed or partnership deed from making an invitation to the public to subscribe to its securities;

c. in case the applicant is a Trust, the instrument of trust is in the form of a deed and has been duly registered under the provisions of the Registration Act, 1908;

d. in case the applicant is a limited liability partnership, the partnership is duly incorporated and the partnership deed has been duly filed with the Registrar under the provisions of the Limited Liability Partnership Act, 2008;

e. in case the applicant is a body corporate, it is set up or established under the laws of the Central or State Legislature and is permitted to carry on the activities of an Alternative Investment Fund;

f. the applicant, Sponsor and Manager are fit and proper persons based on the criteria specified in Schedule II of the SEBI (Intermediaries) Regulations, 2008;

g. the key investment team of the Manager of Alternative Investment Fund has adequate experience, with at least one key personnel having not less than five years experience in advising or managing pools of capital or in fund or asset or wealth or portfolio management or in the business of buying, selling and dealing of securities or other financial assets and has relevant professional qualification;

h. the Manager or Sponsor has the necessary infrastructure and manpower to effectively discharge its activities;

i. the applicant has clearly described at the time of registration the investment objective, the targeted investors, proposed corpus, investment style or strategy and proposed tenure of the fund or scheme;

j. whether the applicant or any entity established by the Sponsor or Manager has earlier been refused registration by the Board.

11.2.3 Certificate Renewal and Validity

(1) The certificate granted under regulation 6 shall, inter-alia, be subject to the following conditions:-

a. The Alternative Investment Fund shall abide by the provisions of the Act and these regulations;

b. The Alternative Investment Fund shall not carry on any other activity other than permitted activities;

c. The Alternative Investment Fund shall forthwith inform the Board in writing, if any information or particulars previously submitted to the Board are found to be false or misleading in any material particular or if there is any material change in the information already submitted.

(2) An Alternative Investment Fund which has been granted registration under a particular category cannot change its category subsequent to registration, except with the approval of the Board.

11.2.4 Investment conditions and Restrictions

Investment Strategy

(1) All Alternative Investment Funds shall state investment strategy, investment purpose and its investment methodology in its placement memorandum to the investors.
(2) Any material alteration to the fund strategy shall be made with the consent of atleast two-thirds of unit holders by value of their investment in the Alternative Investment Fund.

Investment in Alternative Investment Fund

Investment in all categories of Alternative Investment Funds shall be subject to the following conditions:-

a. The Alternative Investment Fund may raise funds from any investor whether Indian, foreign or non-resident Indians by way of issue of units;

b. Each scheme of the Alternative Investment Fund shall have corpus of atleast twenty crore rupees;

c. The Alternative Investment Fund shall not accept from an investor, an investment of value less than one crore rupees. *Provided that in case of investors who are employees or directors of the Alternative Investment Fund or employees or directors of the Manager, the minimum value of investment shall be twenty five lakh rupees.*

d. The Manager or Sponsor shall have a continuing interest in the Alternative Investment Fund of not less than two and half percent of the corpus or five crore rupees, whichever is lower, in the form of investment in the Alternative Investment Fund and such interest shall not be through the waiver of management fees. *Provided that for Category III Alternative Investment Fund, the continuing interest shall be not less than five percent of the corpus or ten crore rupees, whichever is lower.*

e. The Manager or Sponsor shall disclose their investment in the Alternative Investment Fund to the investors of the Alternative Investment Fund;

f. No scheme of the Alternative Investment Fund shall have more than 1000 investors;

g. The fund shall not solicit or collect funds except by way of private placement.

Placement Memorandum

1. Alternative Investment Fund shall raise funds through private placement by issue of information memorandum or placement memorandum, by whatever name called.
2. Such information or placement memorandum as specified in point no. 1 shall contain all material information about the Alternative Investment Fund and the Manager, background of key investment team of the Manager, targeted investors, fees and all other expenses proposed to be charged, tenure of the Alternative Investment Fund or scheme, conditions or limits on redemption, investment strategy, risk management tools and parameters employed, key service providers, conflict of interest and procedures to identify and address them, disciplinary history, the terms and conditions on which the Manager offers investment services, its affiliations with other intermediaries, manner of winding up of the Alternative Investment Fund or the scheme and such other information as may be necessary for the investor to take an informed decision on whether to invest in the Alternative Investment Fund.

Schemes

1. The Alternative Investment Fund may launch schemes subject to filing of placement memorandum with the Board.
2. Such placement memorandum shall be filed with the SEBI atleast 30 days prior to launch of scheme along with the fees as specified in the regulations, provided that payment of scheme fees shall not apply in case of launch of first scheme by the Alternative Investment Fund.
3. The Board may communicate its comments, if any, to the applicant prior to launch of the scheme and the applicant shall incorporate the comments in placement memorandum prior to launch of scheme.

Tenure

1. Category I Alternative Investment Fund and Category II Alternative Investment Fund shall be close ended and the tenure of fund or scheme shall be determined at the time of application subject to sub-regulation (2) of this regulation.
2. Category I and II Alternative Investment Fund or schemes launched by such funds shall have a minimum tenure of three years.
3. Category III Alternative Investment Fund may be open ended or close ended.
4. Extension of the tenure of the close ended Alternative Investment Fund may be permitted up to two years subject to approval of two-thirds of the unit holders by value of their investment in the Alternative Investment Fund.
5. In the absence of consent of unit holders, the Alternative Investment Fund shall fully liquidate within one year following expiration of the fund tenure or extended tenure.

Listing

1. Units of close ended Alternative Investment Fund may be listed on stock exchange subject to a minimum tradable lot of one crore rupees.

2. Listing of Alternative Investment Fund units shall be permitted only after final close of the fund or scheme.

General Investment Conditions.

Investments by all categories of Alternative Investment Funds shall be subject to the following conditions:-

(a) Alternative Investment Fund may invest in securities of companies incorporated outside India subject to such conditions or guidelines that may be stipulated or issued by the Reserve Bank of India and the Board from time to time;

(b) Co-investment in an investee company by a Manager or Sponsor shall not be on terms more favourable than those offered to the Alternative Investment Fund;

(c) Category I and II Alternative Investment Funds shall invest not more than twenty five percent of the corpus in one Investee Company;

(d) Category III Alternative Investment Fund shall invest not more than ten percent of the corpus in one Investee Company

(e) Alternative Investment Fund shall not invest in associates except with the approval of seventy five percent of investors by value of their investment in the Alternative Investment Fund;

(f) Un-invested portion of the corpus may be invested in liquid mutual funds or bank deposits or other liquid assets of higher quality such as Treasury bills, CBLOs, Commercial Papers, Certificates of Deposits, etc. till deployment of funds as per the investment objective;

(g) Alternative Investment Fund may act as Nominated Investor as specified in clause (b) of sub-regulation (1) of regulation 106N of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009.

Notwithstanding the conditions as specified in sub-regulation (1), SEBI may specify additional requirements or criteria for Alternative Investment Funds or for a specific category thereof.

Conditions for Category I Alternative Investment Funds

1. The following investment conditions shall apply to all Category I Alternative Investment Funds:-

(a) Category I Alternative Investment Fund shall invest in investee companies or venture capital undertaking or in special purpose vehicles or in limited liability partnerships or in units of other Alternative Investment Funds as specified in these regulations;

(b) Fund of Category I Alternative Investment Funds may invest in units of Category I Alternative Investment Funds of same sub-category, Provided that they shall only invest in such units and shall not invest in units of other Fund of Funds.

(c) Category I Alternative Investment Funds shall not borrow funds directly or indirectly or engage in any leverage except for meeting temporary funding requirements for not more than thirty days, on not more than four occasions in a year and not more than ten percent of the corpus.

2. The following investment conditions shall apply to venture capital funds in addition to conditions laid down in sub-regulation (1):-

   (a) At least two-thirds of the corpus shall be invested in unlisted equity shares or equity linked instruments of a venture capital undertaking or in companies listed or proposed to be listed on a SME exchange or SME segment of an exchange;

   (b) Not more than one-third of the corpus shall be invested in:

   - subscription to initial public offer of a venture capital undertaking whose shares are proposed to be listed;
   - debt or debt instrument of a venture capital undertaking in which the fund has already made an investment by way of equity or contribution towards partnership interest;
   - preferential allotment, including through qualified institutional placement, of equity shares or equity linked instruments of a listed company subject to lock in period of one year;
   - the equity shares or equity linked instruments of a financially weak company[20] or a sick industrial company whose shares are listed.
   - special purpose vehicles which are created by the fund for the purpose of facilitating or promoting investment in accordance with these regulations, Provided that the investment conditions and restrictions stipulated in clause (a) and clause (b) of sub-regulation (2) shall be achieved by the fund by the end of its life cycle.

   (c) such funds may enter into an agreement with merchant banker to subscribe to the unsubscribed portion of the issue or to receive or deliver securities in the process of market making as stated in the SEBI (ICDR) Regulations, 2009 and the provisions of clause (a) and clause (b) of sub-regulation (2) shall not apply in case of acquisition or sale of securities pursuant to such subscription or market making.

   (d) such funds shall be exempt from regulation 3 and 3A of SEBI (Prohibition of Insider Trading) Regulations, 1992 in respect of investment in companies listed on SME Exchange or SME segment of an exchange pursuant to due diligence of such companies subject to the following conditions:

   - The fund shall disclose any acquisition or dealing in securities pursuant to such due-diligence, within two working days of such acquisition or dealing, to the stock exchanges where the investee company is listed;
   - Such investment shall be locked in for a period of one year from the date of investment.

3. The following conditions shall apply to SME Funds in addition to conditions laid down in sub-regulation (1):-

   (a) atleast 75 percent of the corpus shall be invested in unlisted securities or partner-ship interest of venture capital undertakings or investee companies which are SMEs or in companies listed or proposed to be listed on SME exchange or SME segment of an exchange;

[20] A financially weak company means a company, which has at the end of the previous financial year accumulated losses, which has resulted in erosion of more than fifty percent but less than hundred percent of its net worth as at the beginning of the previous financial year.

(b) such funds may enter into an agreement with merchant banker to subscribe to the unsubscribed portion of the issue or to receive or deliver securities in the process of market making under stated in the SEBI (ICDR) Regulations, 2009;

(c) such funds shall be exempt from regulation 3 and 3A of SEBI (Prohibition of Insider Trading) Regulations, 1992 in respect of investment in companies listed on SME Exchange or SME segment of an exchange pursuant to due diligence of such companies subject to the following conditions:

- The fund shall disclose any acquisition or dealing in securities pursuant to such due-diligence, within two working days of such acquisition or dealing, to the stock exchanges where the investee company is listed;
- Such investment shall be locked in for a period of one year from the date of investment.

4. The following conditions shall apply to social venture funds in addition to the conditions laid down in sub-regulation (1):-

(a) atleast seventy five percent of the corpus shall be invested in unlisted securities or partnership interest of social ventures.

(b) such funds may accept grants, provided that such utilization of such grants shall be restricted to clause (a).

(c) such funds may give grants to social ventures, provided that appropriate disclosure is made in the placement memorandum.

(d) such funds may accept muted returns for their investors i.e. they may accept returns on their investments which may be lower than prevailing returns for similar investments.

5. The following conditions shall apply to Infrastructure Funds in addition to conditions laid down in sub-regulation (1):-

(a) atleast seventy five percent of the corpus shall be invested in unlisted securities or units or partnership interest of venture capital undertaking or investee companies or special purpose vehicles, which are engaged in or formed for the purpose of operating, developing or holding infrastructure projects;

(b) notwithstanding clause (a) of sub-regulation (5), such funds may also invest in listed securitized debt instruments or listed debt securities of investee companies or special purpose vehicles, which are engaged in or formed for the purpose of operating, developing or holding infrastructure projects.

Conditions for Category II Alternative Investment Funds

The following investment conditions shall apply to Category II Alternative Investment Funds:-

a) Category II Alternative Investment Funds shall invest primarily in unlisted investee companies or in units of other Alternative Investment Funds as may be specified in the placement memorandum;

b) Fund of Category II Alternative Investment Funds may invest in units of Category I or Category II Alternative Investment Funds. Provided that they shall only invest in such units and shall not invest in units of other Fund of Funds.

c) Category II Alternative Investment Funds may not borrow funds directly or indirectly and shall not engage in leverage except for meeting temporary funding requirements for not more than thirty days, not more than four occasions in a year and not more than ten percent of the corpus;

d) Notwithstanding clause (c), Category II Alternative Investment Funds may engage in hedging, subject to guidelines as specified by the Board from time to time;

e) Category II Alternative Investment Funds may enter into an agreement with merchant banker to subscribe to the unsubscribed portion of the issue or to receive or deliver securities in the process of market making under Chapter XB of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009.

f) Category II Alternative Investment Funds shall be exempt from regulation 3 and 3A of Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992 in respect of investment in companies listed on SME Exchange or SME segment of an exchange pursuant to due diligence of such companies subject to the following conditions:

- the fund shall disclose any acquisition or dealing in securities pursuant to such due-diligence, within two working days of such acquisition or dealing, to the stock exchanges where the investee company is listed;
- such investment shall be locked in for a period of one year from the date of investment.

Conditions for Category III Alternative Investment Funds

The following investment conditions shall apply to Category III Alternative Investment Funds:-

a) Category III Alternative Investment Funds may invest in securities of listed or unlisted investee companies or derivatives or complex or structured products;

b) Fund of Category II Alternative Investment Funds may invest in units of Category I or Category II Alternative Investment Funds, Provided that they invest solely in such units and shall not invest in units of other Fund of Funds.

c) Category III Alternative Investment Funds may engage in leverage or borrow subject to consent from the investors in the fund and subject to a maximum limit, as may be specified by the Board. Provided that such funds shall disclose information regarding the overall level of leverage employed, the level of leverage arising from borrowing of cash, the level of leverage arising from position held in derivatives or in any complex product and the main source of leverage in their fund to the investors and to the Board periodically, as may be specified by the SEBI

d) Category III Alternative Investment Funds shall be regulated through issuance of directions regarding areas such as operational standards, conduct of business rules, prudential requirements, restrictions on redemption and conflict of interest as may be specified by the Board.

Other Alternative Investment Fund

The Board may lay down framework for Alternative Investment Funds other than the Funds falling in the categories specified in these regulations.

11.2.5 General Obligations of AIF

General Obligations

- All Alternative Investment Funds shall review policies and procedures, and their implementation, on a regular basis, or as a result of business developments, to ensure their continued appropriateness.
- The Sponsor or Manager of Alternative Investment Fund shall appoint a custodian registered with the Board for safekeeping of securities if the corpus of the Alternative Investment Fund is more than five hundred crore rupees. Provided that the Sponsor or Manager of a Category III Alternative Investment Fund shall appoint such custodian irrespective of the size of corpus of the Alternative Investment Fund.
- All Alternative Investment Funds shall inform the Board in case of any change in the Sponsor, Manager or designated partners or any other material change from the information provided by the Alternative Investment Fund at the time of application for registration.
- In case of change in control of the Alternative Investment Fund, Sponsor or Manager, prior approval from the Board shall be taken by the Alternative Investment Fund.
- The books of accounts of the Alternative Investment Fund shall be audited annually by a qualified auditor.

Conflict of Interest

- The Sponsor and Manager of the Alternative Investment Fund shall act in a fiduciary capacity towards its investors and shall disclose to the investors, all conflicts of interests as and when they arise or seem likely to arise.
- Manager shall establish and implement written policies and procedures to identify, monitor and appropriately mitigate conflicts of interest throughout the scope of business.
- Managers and Sponsors of Alternative Investment Fund shall abide by high level principles on avoidance of conflicts of interest with associated persons, as may be specified by the Board from time to time.

Transparency

- All Alternative Investment Funds shall ensure transparency and disclosure of information to investors on the following:
  a. financial, risk management, operational, portfolio, and transactional information regarding fund investments shall be disclosed periodically to the investors;
  b. any fees ascribed to the Manager or Sponsor; and any fees charged to the Alternative Investment Fund or any investee company by an associate of the Manager or Sponsor shall be disclosed periodically to the investors;

c. any inquiries/ legal actions by legal or regulatory bodies in any jurisdiction, as and when occurred;

d. any material liability arising during the Alternative Investment Fund's tenure shall be disclosed, as and when occurred;

e. any breach of a provision of the placement memorandum or agreement made with the investor or any other fund documents, if any, as and when occurred;

f. change in control of the Sponsor or Manager or Investee Company.

g. Alternative Investment Fund shall provide at least on an annual basis, within 180 days from the year end, reports to investors including the following information, as may be applicable to the Alternative Investment Fund:-

A. Financial information of investee companies.
B. Material risks and how they are managed which may include:
(i) concentration risk at fund level;
(ii) foreign exchange risk at fund level;
(iii)leverage risk at fund and investee company levels;
(iv) realization risk (i.e. change in exit environment) at fund and investee company levels;
(v) strategy risk (i.e. change in or divergence from business strategy) at investee company level;
(vi) reputation risk at investee company level;
(vii) extra-financial risks, including environmental, social and corporate governance risks, at fund and investee company level.

h. Category III Alternative Investment Fund shall provide quarterly reports to investors in respect of clause (g) within 60 days of end of the quarter;

i. Any significant change in the key investment team shall be intimated to all investors;

j. Alternative Investment Funds shall provide, when required by the Board, information for systemic risk purposes (including the identification, analysis and mitigation of systemic risks).

Valuation

- The Alternative Investment Fund shall provide to its investors, a description of its valuation procedure and of the methodology for valuing assets.
- Category I and Category II Alternative Investment Funds shall undertake valuation of their investments, atleast once in every six months, by an independent valuer appointed by the Alternative Investment Fund. Provided that such period may be enhanced to one year on approval of atleast seventy-five percent of the investors by value of their investment in the Alternative Investment Fund.
- Category III Alternative Investment Funds shall ensure that calculation of the net as-set value (NAV) is independent from the fund management function of the Alternative Investment Fund and such NAV shall be disclosed to the investors at intervals not longer than a quarter for close ended Funds and at intervals not longer than a month for open ended funds.

Obligation of Manager

The Manager shall be obliged to:
(a) address all investor complaints;
(b) provide to the Board any information sought by Board;
(c) maintain all records as may be specified by the Board;
(d) take all steps to address conflict of interest as specified in these regulations;
(e) ensure transparency and disclosure as specified in the regulations.

Dispute Resolution

An Alternative Investment Fund, by itself or through the Manager or Sponsor, shall lay down procedure for resolution of disputes between the investors, Alternative Invest-ment Fund, Manager or Sponsor through arbitration or any such mechanism as mutually decided between the investors and the Alternative Investment Fund.

Power to call for information

(1) The Board may at any time call for any information from an Alternative Investment Fund or its Manager or Sponsor or trustee or investor with respect to any matter relating to its activity as an Alternative Investment Fund or for the assessment of systemic risk or prevention of fraud.

(2) Where any information is called for under sub-regulation (1) it shall be furnished within the time specified by the Board.

Maintenance of Records

(1) The Manager or Sponsor shall be required to maintain following records describing:
- (a) the assets under the scheme/fund;
- (b) valuation policies and practices;
- (c) investment strategies;
- (d) particulars of investors and their contribution;
- (e) rationale for investments made.

(2) The records under sub-regulation (1) shall be maintained for a period of five years after the winding up of the fund.

Submission of reports to the Board

The Board may at any time call upon the Alternative Investment Fund to file such reports, as the Board may desire, with respect to the activities carried on by the Alternative Investment Fund.

Obligation of Alternative Investment Fund on inspection

(1) It shall be the duty of every officer of the Alternative Investment Fund in respect of whom an inspection has been ordered under regulation 30 and any other associated person who is in possession of relevant information pertaining to conduct and affairs of such Alternative Investment

Fund including Manager, if any, to produce to the Inspecting Authority such books, accounts and other documents in his custody or control and furnish him with such statements and information as the said Authority may require for the purposes of the inspection.

(2) It shall be the duty of every officer of the Alternative Investment Fund and any other associated person who is in possession of relevant information pertaining to conduct and affairs of the Alternative Investment Fund including the manager to give to the Inspecting Authority all such assistance and shall extend all such co-operation as may be required in connection with the inspection and shall furnish such information as sought by the Inspecting Authority in connection with the inspection.
(3) The Inspecting Authority shall, for the purposes of inspection, have power to examine on oath and record the statement of any employees, directors or person responsible for or connected with the activities of Alternative Investment Fund or any other associated person having relevant information pertaining to such Alternative Investment Fund.

(4) The Inspecting Authority shall, for the purposes of inspection, have power to obtain authenticated copies of documents, books, accounts of Alternative Investment Fund, from any person having control or custody of such documents, books or accounts

Review Questions

1. The application for registration by a sub-broker is required to be accompanied by a recommendation letter from_____?

   (a) Stock Exchange

   (b) Stock Broker

   (c) SEBI

   (d) None of the above

Ans: (b)

2. Is the Stock broker required to pre-intimate SEBI about shifting the location where it keeps its books of accounts. State Yes or No?

   (a) Yes

   (b) No

Ans: (b)

3. A stock Broker when dealing with a client must disclose whether it is acting as a Principal /agent. State whether True or False?

   (a) True

   (b) False

Ans: (a)

4. Category I and II Alternative Investment Funds shall invest what portion of the corpus in one Investee Company?

   (a) Not more than 50%

   (b) Not more than 45%

   (c) Maximum 10%

   (d) Not more than 25%

Ans: (d)

Unit 12: SEBI (Merchant Bankers) Regulations 1992, SEBI (Delisting of Equity Shares) Regulations, 2009, SEBI (Substantial Acquisition of Shares & Takeovers) Regulations, 2011 & SEBI (BuyBack of Securities) Regulations, 1998

12.1 Introduction

The primary activity of Merchant Banks is to provide fee-based advice to corporations and governments on the issue of securities. Merchant banks these days however perform a variety of other activities such as financing foreign trade, underwriting of equity issues, portfolio management and undertaking foreign security business as well as foreign loan business, project appraisal etc.

Since the functions are very similar to those of Investment Bankers, they are often thought to be the same. The term 'Investment Banking' has a much wider connotation and is gradually becoming more of an inclusive term to refer to all types of capital market activity, both fund-based and non-fund based. Besides the above, the investment banks also provide a host of specialized corporate advisory services in the areas of project advisory, business and financial advisory and mergers and acquisitions[21].

In this chapter we will also discuss briefly the role of merchant banker and the compliances so required in case of takeovers and buy-backs of securities as given in the SEBI (Substantial Acquisition of Shares & Takeovers) Regulations, 1997 and SEBI (BuyBack of Securities) Regulations, 1998 respectively and in the Delisting of securities from stock exchanges as per provisions given under the SEBI (Delisting of Equity Shares) Regulations, 2009 and the certain compliances as given in the Model Listing Agreement.

12.2 SEBI (Merchant Bankers) Regulations, 1992

The SEBI (Merchant Bankers) Regulations, 1992 lists out the different provisions as given under its various Regulations for an intermediary who wants to get registered as a merchant banker with SEBI. The Merchant Banking function though long existent was first regulated by the introduction of the SEBI (Merchant Bankers) Regulation, 1992.

12.2.1 Definition of a Merchant Banker

Merchant Banker as defined in the Regulation means "*any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager, consultant, adviser or rendering corporate advisory service in relation to such issue management"*.

12.2.2 Registration as a Merchant Banker

An application for the grant of certificate as merchant bankers needs to be submitted to SEBI as per the provisions of the SEBI (Merchant Bankers) Regulations. The regulation states that an ap-

[21] *Reference*: Investment Banking – An Odyssey in High Finance by Pratap Subramanyam.

plication for registration made under this regulation shall be accompanied by a non-refundable application fee of Rs. 25,000/- and can be made only for Category I Merchant Banker.

"(a) Category I, that is—

(i) to carry on any activity of the issue management, which will, inter alia, consist of preparation of prospectus and other information relating to the issue, determining financial structure, tie up of financiers and final allotment and refund of the subscriptions; and

(ii) to act as adviser, consultant, manager, underwriter, portfolio manager;

However, an applicant can carry on the activity as portfolio manager only if he obtains separate certificate of registration under the SEBI (Portfolio Manager) Regulations, 1993.

12.2.3 Eligibility Criteria for Grant of Certificate

An applicant seeking registration as Merchant Banker shall comply with the requirements such as the Capital Adequacy Requirements, Registration Fees, and Criteria for fit and proper person etc. which would be discussed in the following sections.

12.2.3.1 Consideration of Application

As per Regulation 6 of the regulation, SEBI shall consider grant of a certificate of merchant banker to an applicant who complies with the following requirements as mentioned below:

(a) An applicant shall be a body corporate other than NBFC, *provided* that the merchant banker who has been granted registration by the RBI to act as Primary or Satellite Dealer may carry on such activity subject to the condition that it shall not accept or hold public deposit.
(b) The applicant should have the necessary infrastructure like adequate office space, equipments and manpower to effectively discharge his activities.
(c) The applicant should have in his employment minimum of two persons who have the experience to conduct the business of merchant banker.
(d) A person directly or indirectly connected with the applicant has not been granted registration by SEBI.
(e) The applicant, his partner, director or principal officer are not involved in any litigation connected with the securities market which has an adverse bearing on the business of the applicant;
(f) The applicant, his director, partner or principal officer have not been at any time been convicted for any offence involving moral turpitude or has been found guilty of any economic offence;
(g) The applicant has the professional qualification from an institution recognized by the Government in finance, law or business management;
(h) Grant of certificate to the applicant is in the interest of investors;
(i) The applicant satisfies the capital adequacy requirements and is Fit and proper person.

12.2.3.2 Capital Adequacy Requirements

The regulation 7 of the SEBI MB Regulations specifies the capital adequacy requirements for applicants seeking registration as Merchant Bankers. It states that applicants shall have a net

worth of not less than five crore rupees. Net worth here means the paid-up capital and free reserves of the applicant at the time of making application.

12.2.3.3 Fit and Proper Person

Regulation 6A of the SEBI (Merchant Bankers) Regulations states that for purpose of granting registration to an applicant, SEBI takes into account the "Criteria for fit and proper person" as given under the SEBI (Intermediaries) Regulations 2008.

"*For the purpose of determining as to whether an applicant or the intermediary is a 'fit and proper person' the Board may take into account any consideration it deems fit, including but not limited to the following criteria in relation to the applicant or the intermediary, the principal officer and the key management persons by whatever name called –*

a) Integrity, reputation and character;

b) Absence of convictions and restraint orders;

c) *Competence including financial solvency and net worth*"

12.2.3.4 Furnishing of Information, Clarification and Personal Representation

The section 5 of SEBI (Merchant Bankers) regulations state

1) SEBI may require the applicant to furnish further information or clarification regarding matters relevant to the activity of a merchant banker for the purpose of disposal of the application.
2) The applicant or its principal officer shall, if so required, appear before SEBI for personal representation.

12.2.4 Registration, Renewal Fees & Validity

SEBI, on being satisfied that the applicant is eligible for registration as a merchant banker, shall grant the certificate. On being intimated of the grant of this certificate the merchant banker now has to pay the requisite fees within 15 days of receipt of such intimation from SEBI.

Every Merchant Banker is required to pay an initial fee of Rs. 10 lakhs as registration fees and to keep the registration in force subsequent renewal fees of Rs. 5 lakhs every three years from the fourth year from the date of initial registration. The renewal fee has to pay to SEBI within 15 days of the receipt of such information from SEBI.

The certificate of registration and the renewal granted under the SEBI MB regulations shall be valid for a period of 3 years from the date of its issue to the applicant.

12.2.5 Renewal of Certificate

When a merchant banker is granted the certificate of registration, the certificate has to be renewed every three years from the fourth year from the date of the initial registration, as per regulation 9 of the SEBI (Merchant Bankers) Regulation. If the merchant banker desires to apply for renewal of registration he has to do the same three months prior to the expiry of the registration by paying the applicable fees.

The application for renewal is treated by SEBI in the same manner as if it were a fresh application and shall be accompanied by a non-refundable application fee of Rs. 25,000. SEBI on being satisfied about the eligibility of the applicant for renewal of certificate shall grant the certificate of registration to the merchant banker.

12.2.6 Conditions of Registration

Any certificate which has been granted to the merchant banker or renewal granted under the SEBI (Merchant Bankers) Regulation shall be subject to the following conditions as mentioned below:

a) Where the merchant banker proposes to change its status or constitution, it shall obtain prior approval of SEBI for continuing to act as such after the change;

b) The merchant banker shall pay the fees for registration or renewal, as the case may be, in the manner as provided in these regulations;

c) The merchant banker shall take adequate steps for redress of investor grievances within one month of the date of the receipt of the complaint and keep SEBI informed about the number, nature and other particulars of the complaints received;

d) It shall maintain capital adequacy requirements at all times during the period of the certificate or renewal thereof;

e) It shall abide by the regulations made under the SEBI Act, 1992 in respect of the activities carried on by it as merchant banker.

12.2.7 Refusal to Grant Certificate

SEBI can refuse to grant the certificate of registration or renewal of the certificate to an applicant as per Regulation 10 of the SEBI (Merchant Bankers) Regulation:

i. Where an application for grant of a certificate or for renewal of certificate does not satisfy the conditions as laid down in the Regulation 6 of this Regulation, SEBI may reject the application after giving an opportunity of being heard.

ii. SEBI should communicate the refusal to grant registration within thirty days of such refusal to the applicant stating therein the grounds on which the application has been rejected.

iii. Applicant who is aggrieved by the decision of SEBI to not grant or renew registration may apply to SEBI, within a period of thirty days from the date of receipt of such intimation from SEBI, for reconsideration of its decision.

iv. SEBI shall reconsider an application made as per the provisions laid down in the SEBI (Merchant Bankers) Regulations and communicate its decision as soon as possible in writing to the applicant.

Regulation 11 states that any merchant banker whose application for a certificate has been refused by SEBI shall on and from the date of the receipt of the communication from SEBI should cease to carry on any activity as merchant banker.

12.2.8 Suspension of Certificate

As per Regulation 12, the merchant banker who has been granted certificate of registration has to pay the prescribed fees as given in the Regulations[22]. When the merchant banker fails to pay the prescribed annual fees, SEBI may suspend the registration certificate, upon which the merchant banker will not be allowed to carry on with its business till the time he remains suspended.

12.2.9 General Obligations and Responsibilities

12.2.9.1Code of Conduct

The regulation 13 provides that each merchant banker registered with SEBI should follow the prescribed code of conduct as given under the schedule III of the SEBI (Merchant Bankers), Regulation. The code of conduct impresses heavily the importance of integrity, honesty and ethical behaviour expected from merchant bankers. As a client and investor driven business, merchant bankers are expected to keep in mind the interests of the investors at all times and redress any grievances immediately while keeping SEBI informed of the same. The code of conduct prescribes that a merchant banker shall:

1. make all efforts to protect the interests of investors.

2. maintain high standards of integrity, dignity and fairness in the conduct of its business.

3. fulfill its obligations in a prompt, ethical, and professional manner.

4. at all times exercise due diligence, ensure proper care and exercise independent professional judgment.

5. endeavour to ensure that (a) Inquiries from investors are adequately dealt with; (b) Grievances of investors are redressed in a timely and appropriate manner; (c) Where a complaint is not remedied promptly, the investor is advised of any further steps which may be available to the investor under the regulatory system.

6. ensure that adequate disclosures are made to the investors in a timely manner in accordance with the applicable regulations and guidelines so as to enable them to make a balanced and informed decision.

7. endeavour to ensure that the investors are provided with true and adequate information without making any misleading or exaggerated claims or any misrepresentation and are made aware of the attendant risks before taking any investment decision.

[22]Refer to section 11.2.4 of this chapter OR Schedule II of the SEBI (Merchant Banking) Regulations, 1992.

8. endeavour to ensure that copies of the prospectus, offer document, letter of offer or any other related literature is made available to the investors at the time of issue or the offer.

9. not discriminate amongst its clients, save and except on ethical and commercial considerations.

10. not make any statement, either oral or written, which would misrepresent the services that the merchant banker is capable of performing for any client or has rendered to any client.

11. avoid conflict of interest and make adequate disclosure of its interest.

12. put in place a mechanism to resolve any conflict of interest situation that may arise in the conduct of its business or where any conflict of interest arises, shall take reasonable steps to resolve the same in an equitable manner.

13. make appropriate disclosure to the client of its possible source or potential areas of conflict of duties and interest while acting as merchant banker which would impair its ability to render fair, objective and unbiased services.

14. always endeavour to render the best possible advice to the clients having regard to their needs.

15. not divulge to anybody either orally or in writing, directly or indirectly, any confidential information about its clients which has come to its knowledge, without taking prior permission of its clients, except where such disclosures are required to be made in compliance with any law for the time being in force.

16. ensure that any change in registration status/any penal action taken by SEBI or any material change in the merchant banker's financial status, which may adversely affect the interests of clients/investors is promptly informed to the clients and any business remaining outstanding is transferred to another registered intermediary in accordance with any instructions of the affected clients.

17. shall not indulge in any unfair competition, such as weaning away the clients on assurance of higher premium or advantageous offer price or which is likely to harm the interests of other merchant bankers or investors or is likely to place such other merchant bankers in a disadvantageous position while competing for or executing any assignment.

18. maintain arms length relationship between its merchant banking activity and any other activity.

19. have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operations, its clients, investors and other registered entities from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions.

20. not make untrue statement or suppress any material fact in any documents, reports or information furnished to SEBI.

21. maintain an appropriate level of knowledge and competence and abide by the provisions of the Act, regulations made there under, circulars and guidelines, which may be applicable and relevant to the activities carried on by it. The merchant banker shall also comply with the award of the Ombudsman passed under the SEBI (Ombudsman) Regulations, 2003.

22. ensure that SEBI is promptly informed about any action, legal proceedings, etc., initiated against it in respect of material breach or non-compliance by it, of any law, rules, regulations, and directions of SEBI or of any other regulatory body.

23. (a) A merchant banker or any of its employees shall not render, directly or indirectly, any investment advice about any security in any publicly accessible media, whether real-time or non-real-time, unless a disclosure of his interest including a long or short position, in the said security has been made, while rendering such advice.
(b) In the event of an employee of the merchant banker rendering such advice, the merchant banker shall ensure that such employee shall also disclose the interests, if any, of himself, his dependent family members and the employer merchant banker, including their long or short position in the said security, while rendering such advice.

24. demarcate the responsibilities of the various intermediaries appointed by it clearly so as to avoid any conflict or confusion in their job description.

25. provide adequate freedom and powers to its compliance officer for the effective discharge of the compliance officer's duties.

26. develop its own internal code of conduct for governing its internal operations and laying down its standards of appropriate conduct for its employees and officers in carrying out their duties. Such a code may extend to the maintenance of professional excellence and standards, integrity, confidentiality, objectivity, avoidance or resolution of conflict of interests, disclosure of shareholdings and interests, etc.

27. ensure that good corporate policies and corporate governance are in place.

28. ensure that any person it employs or appoints to conduct business is fit and proper and otherwise qualified to act in the capacity so employed or appointed (including having relevant professional training or experience).

29. ensure that it has adequate resources to supervise diligently and does supervise diligently persons employed or appointed by it in the conduct of its business, in respect of dealings in securities market.

30. be responsible for the acts or omissions of its employees and agents in respect of the conduct of its business.

12.2.9.2 Restriction on Business

The SEBI (Merchant Bankers) Regulations restricts the association of merchant bankers with any business other that of the securities market. The regulation 13A of the SEBI (Merchant Bankers) Regulations states:

"No merchant banker, other than a bank or a public financial institution, who has been granted a certificate of registration under these regulations, shall after June 30th, 1998 carry on any business other than that in the securities market.

However, notwithstanding anything contained above, a merchant banker who prior to the date of notification of the SEBI (Merchant Bankers) Amendment Regulations, 1997, has entered into a contract in respect of a business other than that of the securities market may, if so desires discharge his obligations under such contract.

Provided that a merchant banker who has been granted certificate of registration to act as primary or satellite dealer by Reserve Bank of India, may carry on such business as may be permitted by Reserve Bank of India.

Provided further that a merchant banker, who has been granted certificate of registration under these regulations, may ensure market making in accordance with SEBI (ICDR) Regulations, 2009.

12.2.9.3 Maintenance of books of account, records etc

The solvency and financial stability of merchant banks is of prime importance to the merchant banking business. Keeping this in mind, SEBI has prescribed the following under regulation 14 which a merchant banker shall comply with:

(1) Every merchant banker is required to keep and maintain the following books of account, records and documents namely:—

(a) a copy of balance sheet as at the end of the each accounting period;
(b) a copy of profit and loss account for that period;
(c) a copy of the auditor's report on the accounts for that period;
(d) a statement of financial position.

(2) Every merchant banker shall intimate to SEBI the place where the books of account, records and documents are maintained.

(3) Every merchant banker shall also after the end of each accounting period furnish to SEBI copies of the balance sheet, profit and loss account and such other documents for any other preceding five accounting years when required by SEBI.

The above documents need to be maintained for a period of 5 years (regulation 16) and if required by SEBI, a merchant banker must furnish unaudited half-yearly results (regulation 15).

12.2.10 Responsibilities as Lead Merchant Banker

As given in regulation 20, when a merchant banker is appointed the lead manager for any issue, he shall agree to manage or be associated with the issue, only when his responsibilities relating to the issue i.e. of disclosures, allotment and refund are clearly defined, allocated and determined. A statement specifying the responsibilities of the lead manager should be furnished to SEBI, one month prior to opening of the issue for subscription.

In cases, where there are more than one lead merchant banker's to the issue, the responsibilities of each of such lead merchant bankers shall be furnished to SEBI, atleast one month prior to opening of the issue for subscription.

A merchant banker as per regulation 21and 21A, should not be associated with any issue, if a merchant banker who is not holding a certificate of registration is associated with the issue. It

shall further not lead or manage any issue or be associated with any activity undertaken under any regulations made by SEBI, if the merchant banker is himself the promoter or a director or an associate of the issuer of securities or of any person making the offer to sell or purchase securities in terms of any regulations made by SEBI.

The merchant banker shall under regulation 27, submit to SEBI complete particulars of any transaction for acquisition of securities of any corporate whose issue is being managed by that `merchant banker within 15 days from the date of entering into such transaction. Further the complete particulars of any transaction for acquisition of securities made in pursuance of underwriting or market making obligations in accordance with the provisions as mentioned in the SEBI ICDR Regulations, 2009 also should be submitted to SEBI on quarterly basis.

12.2.11 Disclosures to SEBI

A merchant banker shall disclose to SEBI, as and when SEBI requires the following information:

i. The merchant banker's responsibilities with regard to the management of the issuer;

ii. Any change in the information or particulars previously furnished, which have a bearing on the certificate granted to it;

iii. The names of the body corporate whose issues the merchant banker has managed or has been associated with;

iv. The particulars relating to the breach of the capital adequacy requirements as mentioned in the regulation;

v. Any information relating to the merchant banker's activities as a manager, underwriter, consultant or adviser to an issue.

The merchant banker is required to submit a periodic report in such manner as may be specified by SEBI from time to time. SEBI has prescribed the following:

The Boards of Merchant Bankers are required to review the report and record its observations on (i) the deficiencies and non-compliances, (ii) corrective measures initiated to avoid such instances in future, (iii) pre-issue and post-issue due diligence process followed and whether they are satisfied and (iv) track record of past issues managed. The Compliance Officer of the Merchant Banker is required to send a report in the revised format to SEBI on a half yearly basis within 3 months of the expiry of the half year.

12.2.12 Obligations of merchant banker on inspection by SEBI

SEBI holds the right to inspection of the intermediaries who are registered with it as per provisions given under regulation 31 of the SEBI (Merchant Bankers) Regulation. During inspection, it shall:

i. Be the duty of every director, proprietor, partner, officer and employee of the merchant banker, who is being inspected, to produce to the inspecting authority such books, accounts and other documents in his custody or control. They shall also furnish with the statements and information relating to his activities as a merchant banker as the inspecting authority may seek.

ii. The merchant banker should also allow the inspecting authority to have reasonable access to the premises occupied by such merchant banker or by any other person on his behalf. It also shall extend reasonable facility for examining any books, records, documents and computer data in the possession of the merchant banker or any such other person. Further, it should also provide copies of documents or other materials which, in opinion of the inspecting authority are relevant for the purposes of the inspection.

iii. The merchant banker shall render to the inspecting authority any kind of assistance that may be required in the course of inspection.

12.2.13 Compliance Officer

As per Regulation 28, the merchant banker is required to appoint a compliance officer who shall be responsible for monitoring the compliance of the SEBI Act, rules and regulations, notifications, guidelines, instructions, etc., issued by the SEBI or the Central Government and for redressed of investors' grievances. The roles of the compliance officer have been discussed in detail in chapter 3 of this workbook.

12.3 SEBI (Substantial Acquisition of Shares & Takeovers) Regulations, 2011

In this section, we are going to discuss very briefly about the specific role of Merchant Banker and the compliances required to be adhered to as per the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011.

The acquirer[23] company is required to appoint a SEBI registered Merchant Banker, as a manager to the open offer before making the public announcement. The merchant banker however, should not be an associate of or group of the acquirer or the target company.

The public announcement shall be made by the merchant banker not later than 4 working days of entering into an agreement for acquisition of shares or voting rights or deciding to acquire shares or voting rights. The copy of the public announcement made shall be submitted to SEBI through the Merchant Banker. Further, within 14 days from the date of public announcement, the merchant banker shall help the acquirer company file the draft of the letter of offer with SEBI.

12.3.1 General Obligations of the Merchant Banker

The merchant banker shall-

1. Ensure the following before the public announcement of the offer is made-
   - Acquirer is able to implement the offer;
   - Provisions relating to escrow account has been made;
   - Firm arrangements for funds and money for payment through verifiable means to fulfil the obligations under the offer are in place;
   - Public announcement of offer is made in terms of the regulations;
   - Merchant banker's shareholding, if any in the target company should be disclosed in the public announcement and the letter of offer.

[23] Acquirer means any person who, directly or indirectly, acquirer or agrees to acquire shares or voting rights in the target company, or acquires or agrees to acquire control over the target company, either by himself or with any person acting in concert with the acquirer.

2. Furnish to SEBI a due diligence certificate which shall be attached to the draft letter of offer.
3. Ensure that the public announcement and the letter of offer is filed with SEBI, target company and also sent to all the stock exchanges on which the shares of the target company are listed in accordance with the regulations.
4. Ensure that the contents of the public announcement of offer as well as the letter of offer are true, fair and adequate and based on reliable sources, quoting the source wherever necessary.
5. Ensure compliance of the regulations and any other laws or rules as may be applicable in this regard.
6. Not deal in the shares of the target company during the period commencing from the date of his appointment till the expiry of the 15 days from the date of closure of the offer.
7. Make sure that upon the fulfilment of all obligations by the acquirer, the bank with whom the escrow amount has been deposited, releases the balance amount to the acquirers.
8. Send a final report to the SEBI within 45 days from the date of closure of the offer.

12.4 SEBI (Delisting of Equity Shares) Regulations, 2009

The SEBI (Delisting of Equity Shares) Regulations, 2009 applies to delisting of equity shares of a company from the exchanges where they are listed provided the public shareholders holding equity shares of that company are given an exit opportunity.

The promoters of the company after receiving the in-principle approval for delisting from the recognised stock exchange shall make a public announcement in English and Hindi national dailies each which has a wide circulation. Before making the public announcement, however, the promoter has to appoint a merchant banker registered with SEBI and such other intermediaries as is considered necessary. The promoter shall ensure that no person is appointed as a merchant banker if he is an associate of the promoter.

The appointed merchant banker and the promoter have to ensure compliance of the provisions as is discussed hereunder:

Escrow Account

- Before making the public announcement, the promoter shall open an escrow account and deposit therein the total estimated amount of consideration calculated on basis of floor price and number of equity shares outstanding with public shareholders.

- The escrow account shall consist of either cash deposited with a scheduled commercial bank, or a bank guarantee in favour of the merchant banker, or a combination of both.

- Where the escrow account consists of deposit with a scheduled commercial bank, the promoter shall, while opening the account, empower the merchant banker to instruct the bank to issue banker's cheques or demand drafts for the amount lying to the credit of the escrow account, and the amount in such deposit (if any) after payment of consideration for equity shares tendered in the offer.

Rights of Shareholders to Participate in the Book Building Process

- The merchant banker shall take necessary steps to ensure compliance to the fact that a promoter or a person acting in concert with any of the promoters shall not make a bid in the offer.

- Any holder of depository receipts issued on the basis of underlying shares held by a custodian and any such custodian shall not be entitled to participate in the offer.

Offer Price and Book Building Process

- The offer price shall be determined through book building after the floor price has been fixed and the same shall be disclosed in the public announcement and the letter of offer.

- The shareholders holding securities in demat form and desirous of availing the exit opportunity should deposit the equity shares in respect of which bids have been made, with the special depositories account opened by the merchant banker for the purpose prior to placement of orders or, alternately, may mark a pledge for the same to the merchant banker in favour of the said account.

- The merchant banker shall ensure that the equity shares in the said special depositories account are not transferred to the account of the promoter unless the bids in respect thereof are accepted and payments made.

- The investor holding the physical equity shares shall send the bidding form together with the share certificate and transfer deed to the trading member appointed for the purpose, who shall after entering the bids into the system send them to the company or the share transfer agent for confirming their genuineness. The certificates which are found genuine shall then be delivered to the merchant banker. The merchant banker will make it over to the promoter after the bids in respect of those certificates have been accepted and payment made.

Bidding Period

The date of the opening of the offer should not be later than 45 days from the date of the public announcement. The offer shall remain open for a minimum period of 3 working days and a maximum period of 5 working days, during which the public shareholders have to tender their bids.

12.5 Obligations under the SEBI (Buyback of Securities) Regulations, 1998

The SEBI (Buyback of Securities) Regulations, 1998 is applicable to buy-back of shares or other specified securities of a company listed on a stock exchange. A company desiring to buyback its shares, shall make a public announcement and within 5 working days of the public announcement file the draft letter of offer containing disclosures to SEBI through a Merchant Banker who should not be associated with the company.

The merchant banker shall ensure that–

a. The company is able to implement the offer;
b. The provision relating to escrow account has been made;
c. Firm arrangements for monies for payment to fulfil the obligations under the offer are in place;
d. The public announcement of buy-back is made in terms of the regulations;
e. The letter of offer has been filed in terms of the regulations;
f. Due diligence certificate is attached with the draft letter of offer while filing with SEBI;
g. Contents of the public announcements of offer as well as the letter of offer are true, fair and adequate and quoting the source wherever necessary;
h. Compliance requirements as given under section 68 of the Companies Act, and any other laws or rules as may be applicable in this regard have been met with;
i. Upon fulfilment of all obligations by the company under the regulations, the merchant banker informs the bank with whom the escrow or special amount has been deposited to release the balance amount to the company;
j. Final report to SEBI is sent within 15 days from the date of closure of the buy-back offer.
k. Along with the company, it submits the information regarding the shares or other specified securities bought-back, to the stock exchange on a daily basis and publish the said information in a national daily on a fortnightly basis and also every time when an additional five per cent of the buy-back is completed.
l. Along with the company, the buy-back price is determined based on the acceptances received.
m. Separate norms are provided for buy-back of physical shares or other specified securities under Regulation 15A

The appointed merchant banker also has to ensure compliance of the provisions as in discussed hereunder:

Escrow Account

a) The company on or before opening the offer, shall deposit in an escrow account some portion of the payable amount which shall depend upon the total consideration.
b) The escrow account shall consists of (i) cash deposited with a scheduled commercial bank, or (ii) bank guarantee in favour of the merchant banker by any scheduled commercial bank,.
c) For such part of the escrow account as is in the form of a cash deposit with a scheduled commercial bank, the company shall while opening the account, empower the merchant banker to instruct the bank to make payment of the amounts lying to the credit of the escrow account, to meet the obligations arising out of the buy-back.
d) For such part of the escrow account as is in the form of a bank guarantee:

   (a) the same shall be in favour of the merchant banker and shall be kept valid for a period of thirty days after the closure of the offer or till the completion of all obligations under these regulations, whichever is later.

   (b) the same shall not be returned by the merchant banker till completion of all obligations under the regulations.

e) The escrow amount may be released for making payment to the shareholders subject to atleast 2.5% of the amount earmarked for buy-back as specified in the resolutions referred to in regulation 5 or regulation 5A remaining in the escrow account at all points of time.

f) On fulfilling the obligation specified at sub regulation (3) of Regulation 14, the amount and the guarantee remaining in the escrow account, if any, shall be released to the company.

Extinguishing Certificates

The company shall complete the verification of acceptances within fifteen days of the payout.
The company shall extinguish and physically destroy the security certificates so bought back during the month in the presence of a Merchant Banker and the Statutory Auditor, on or before the fifteenth day of the succeeding month. Provided that the company shall ensure that all the securities bought-back are extinguished within seven days of the last date of completion of buy-back.
The shares held with the depository in dematerialised mode shall be extinguished in the manner as given in the SEBI (Depositories and Participants) Regulations, 1996.

Review Questions

1. The SEBI (Merchant Banking) Regulations, 1992 provide for _____.

   (a) Registration of merchant bankers

   (b) General obligations of merchant bankers

   (c) General responsibilities of merchant bankers

   (d) All of the above

Ans: (d)

2. The applicant for merchant banker should have necessary infrastructure like _____.

   (a) Office space as per SEBI criteria

   (b) Equipments in place

   (c) Skilled and relevant manpower

   (d) All of the above

Ans: (d)

3. The applicant for merchant banker should necessarily fulfil the capital adequacy requirement as specified in the SEBI (Merchant Bankers) Regulation. State whether True or False?

   (a) True

   (b) False

Ans: (a)

4. In case of buy-back, the company shall ensure that all the securities bought back are extinguished within ____ days of the last date of completion of buy-back.

   (a) 4

   (b) 7

   (c) 10

   (d) 15

Ans: (b)

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Unit 13: SEBI (Issue of Capital and Disclosure Requirements) Regulations 2009

13.1 Introduction

SEBI (Issue of Capital and Disclosure Requirements) Regulations 2009 hereinafter referred as ICDR Regulations were notified in August 2009, in place of the SEBI (Disclosure and Investor Protection) Guidelines, 2000.

The ICDR Regulations, lays down general conditions for capital market issuances like public and rights issuances; eligibility requirements; general obligations of the issuer and intermediaries in public and rights issuances; regulations governing preferential issues, qualified institutional placements and bonus issues by listed companies; Issue of IDRs. ICDR regulations also have detailed requirements laid out with respect to disclosure and process requirements for capital market transactions by listed and unlisted companies.

While the eligibility and disclosure obligations are applicable to the Issuer, in capital market transactions, the role of the merchant banker/ lead manager/ book runner is extremely important since they perform the role of agents in capital market transactions and are registered entities with SEBI. In fact, SEBI holds the merchant banker responsible and accountable for any deficiencies/ lapses in such capital market transactions. The various compliances which are required to be adhered to and are of high importance from regulatory perspective are discussed in the subsequent sections

13.2 Allocation of Responsibilities

The lead merchant bankers are required to make inter-se allocation of responsibilities pertaining to the activities or sub-activities to be carried out under these regulations and disclose the same in the offer document. These are notified under ***Schedule I of the ICDR regulations*** which is as given below:

(a) The merchant banker (lead) shall delineate the activity-wise allocation of responsibilities and intimate SEBI about the name of the lead merchant banker responsible for each set of the activities or sub-activities at the time of filing the draft offer document with SEBI. This intimation is required to be signed by all the lead merchant bankers to the issue.
(b) Where the circumstances warrant joint and several responsibilities of the lead merchant bankers for any particular activity, a coordinator designated from among the lead merchant bankers shall furnish to SEBI, when called for any information, report, comments etc on matters relating to such activity.
(c) The activities or sub-activities can be grouped on the following lines:
    i. Capital structuring with the relative components and formalities such as composition of debt and equity, type of instruments, etc.
    ii. Drafting and design of the offer document and of the advertisement or publicity material including newspaper advertisement and brochure or memorandum containing salient features of the offer document.

iii. Selection of various agencies connected with issue, such as registrars to the issue, printers, advertising agencies, etc.

iv. Marketing of the issue, which shall cover, inter alia, formulating marketing strategies, preparation of publicity budget, arrangements for selection of (i) admedia, (ii) centres for holding conferences of stock brokers, investors, etc., (iii) bankers to the issue, (iv) collection centres as per schedule III, (v) brokers to the issue, and (vi) underwriters and underwriting arrangement, distribution of publicity and issue material including application form, prospectus and brochure and deciding upon the quantum of issue material.

v. Post-issue activities, which shall involve essential follow-up steps including follow-up with bankers to the issue and Self Certified Syndicate Banks to get quick estimates of collection and advising the issuer about the closure of the issue, based on correct figures, finalisation of the basis of allotment or weeding out of multiple applications, listing of instruments, despatch of certificates or demat credit and refunds and coordination with various agencies connected with the post-issue activity such as registrars to the issue, bankers to the issue, Self Certified Syndicate Banks, etc.

f) The co-ordinator designated from among the lead merchant shall be responsible for ensuring compliance with these regulations and other requirements and formalities specified by the RoC, SEBI, recognised stock exchanges where specified securities being offered are proposed to be listed.

In cases, where the post-issue activities are handled by other intermediaries, the designated lead merchant banker responsible for ensuring that these intermediaries fulfil their functions and enable him to discharge this responsibility through suitable agreement with the issuer.

In case of issues which are under-subscribed, the lead merchant banker responsible for underwriting arrangements shall be responsible for invoking underwriting obligations and ensuring that the notice for devolvement containing the obligation of the underwriters is issued in terms of these regulations. The underwriting obligations will be discussed in section 13.5.

13.3 Role as Advisors

The merchant banker(s) advises the Issuer Company on all matters related to the public issue, including but not limited to the activities mentioned in the inter-se allocation of responsibilities. It is the responsibility of the issuer company to appoint one or more merchant bankers, at least one of whom is the lead merchant banker and also appoint other intermediaries in consultation with the lead merchant banker, to carry out the obligations relating to the issue.

13.3.1 Drafting of the Offer Document, abridged prospectus etc

The merchant banker is responsible for carrying out due diligence on the issuer company and ensure that the disclosures made in the offer document are true, fair, accurate and complete. The merchant banker(s) also files due diligence certificates with SEBI at various stages during the issue process to confirm that due diligence has been carried out by the merchant banker(s) on the issuer company, its promoters, directors, group entities and relates to all aspects including business, legal and financial diligence. The formats of the due diligence certificates at each stage

are given as Forms in the regulations[24]. Some of the key activities, where the merchant banker has to exercise its due diligence are listed below:

- Provide the Issuer Company with a detailed due diligence checklist based on ICDR requirements and information that is important for investors to receive through the prospectus (using his own judgement and also as required by the SEBI ICDR Regulations). It includes inputs from the legal counsels and other experts, if any, assisting in the process of diligence. It also includes formats of certificates that the merchant banker(s) seeks from the Company, formats of consents from all intermediaries involved, details from group and associate companies, promoters, directors etc. The due disclosure requirements in the offer document, abridged prospectus and abridged letter of offer are given in the Schedule VIII of the ICDR.
- The merchant banker(s) is also required to keep a tab on the public communications, publicity materials, advertisements and any research report by the issuer company. Any issuer company intending to come out with a public issue needs to adhere to the publicity restrictions as given under Regulation 60 of the ICDR and the merchant banker to the issue has to confirm that the same has been adhered to. All publicity material, public communications etc need to be approved by the lead merchant banker responsible for marketing of the issue. The idea is that all advertisements should be truthful and fair and should not be manipulative or deceptive or distorted and should not contain any statement, promise or forecast which is untrue or misleading. There should be no "conditioning" of the market. All advertising by the issuer company should be consistent with past practices.
- As an integral part of the financial due diligence, the merchant banker(s) meet with the auditors of the issuer company and discuss information required to be disclosed in the offering document. In accordance with requirements under Regulations 68 and note IX under Schedule VIII of the ICDR, the information required includes audited consolidated or unconsolidated financial statements prepared in accordance with Indian GAAP standards:
    - Standalone financial statements for Issuer company [Audited and restated] for last 5 years and stub period (not older than six months from the date of the offering document)
    - Standalone financial statements for each of subsidiaries; associate companies/ JVs [Audited and restated] for the last 5 years and stub period (not older than six months from the date of the offering document)
    - Consolidated financial statements for the Issuer company, subsidiaries and associate companies [Audited and restated], for the applicable period.
    - Other Requirements include statement of tax benefit; significant accounting policies; changes in accounting policies in the last five years and effect to be reflected as if a uniform accounting policy has been followed; notes to accounts; qualifications to accounts, if any; break up of significant transactions with the promoter/ promoter group/ group companies of promoters; break up of other income giving the recurring and non-recurring other income separately; accounting ratios; capitalization statement; taxation statement; break up of loans and advances; related party transactions, statement of dividend paid; Basis on Issue Price and any other financial information re-

[24] Schedule VI of the SEBI (ICDR) Regulations, 2009 gives the format of the form.

quired while providing description of the business of the Company/ RBI related disclosures etc.

- A site visit, if relevant, is also generally undertaken by the merchant banker(s) at the beginning of the diligence process. The objectives of the site visit are to get an appreciation of the business of the company, the manufacturing process, machinery and equipment, plant layout, environment issues etc.
- Based on the documents compiled by the Issuer and perusal of key documents such as board minutes, shareholder meeting minutes, land and property agreements, forms 29 and 32 of the directors, loan documents, agreements with shareholders, agreements with customers, litigation related documents, documents filed with the ROC etc; discussions with the promoters and management, the drafting of the draft Prospectus is undertaken.

As per SEBI circular CIR/MIRSD/1/2012 dated January 10, 2012, the merchant bankers shall disclose the track record of the performance of the public issues managed by them. The track record shall be disclosed for a period of three financial years from the date of listing for each public issue managed by the merchant banker. This information should be made available on the website and a reference to the same should be made in the offer document.

SEBI has vide Circular CIR/MRD/DP/18/2012 dated July 18, 2012, comprehensive guidelines on offer for sale of shares by promoters through Stock Exchange mechanism.

SEBI has issued a General Order – SEBI (Framework for rejection of Draft Offer Documents) Order), 2012 vide Circular No. CIR/CFD/DIL/15/2012 dated October 15, 2012 notifying the broad framework followed by SEBI for rejection of Offer Documents. It is necessary for Merchant Bankers to take note of the same and take due care before filing the draft offer document with SEBI.

13.4 Due Diligence and Compliances

13.4.1 Documents to be submitted before the opening of the issue

In order to maintain maximum possible transparency in the issue process and to safeguard the interests of the investors, SEBI requires the lead merchant banker to submit documents regarding the issue process and the issuer's financial health.

Regulation 8 of the SEBI ICDR Regulations provides the details of the documents which are required to be submitted to SEBI before the opening of the issue. The lead merchant banker shall submit the following to SEBI along with the draft offer document:

- Copy of the agreement entered into between the issuer and the lead merchant bankers;
- Copy of inter-se allocation of responsibilities of each merchant banker, in case the issue is managed by more than one merchant banker;
- Due diligence certificate as per the format prescribed in the SEBI ICDR Regulation;
- Due diligence certificate from the debenture trustee in case of an issue of convertible debt instruments as per the prescribed format provided in the Regulations.
- Certificate confirming compliance of the conditions mentioned therein as format specified in the Regulations.

Once SEBI has made its observations on the draft offer document or even after the expiry of the stipulated period, if SEBI has not issued any observation, the lead merchant banker is required to submit the following documents to SEBI:

- Statement certifying that all changes, suggestions and observations made by SEBI have been incorporated in the offer document;
- Due diligence certificate at the time of registering the prospectus with the Registrar of Companies;
- Copy of the resolution passed by the board of directors of the issuer for allotting specified securities to promoters towards amount received against promoters' contribution, before opening of the issue;
- Certificate from a Chartered Accountant, before opening of the issue, certifying that promoters' contribution has been received in accordance with these regulations, accompanying therewith the names and addresses of the promoters who have contributed to the promoters' contribution and the amount paid by each of them towards such contribution;
- Due diligence certificate as per the prescribed format immediately before the opening of the issue, certifying that necessary corrective action, if any, has been taken;
- Due diligence certificate as per format provided in the Regulation after the issue has opened but before it closes for subscription.

The issuer while filing draft offer document with the recognized stock exchange where the specified securities are proposed to be listed, submit the Permanent Account Number (PAN), bank account number and passport number of its promoters to such stock exchange.

The post issue merchant banker shall be responsible for the post issue activities till the subscribers have received the securities certificates, credit to their demat account / refund of the application money and till the listing agreement is entered into by the issuer with the stock exchange and the listing / trading permission is obtained.

The responsibility of the lead merchant banker shall continue even after the completion of the issue process. The issuer is required to appoint a compliance officer, who shall in addition to the compliance officer of the merchant banker be responsible for monitoring the compliance of the securities law and investor grievances redressal.

13.4.2 Draft offer document to be made public

The draft offer document submitted to SEBI has to be made public, for comments if any, by hosting it on the website of SEBI, the recognized Stock Exchanges on which the issue is to be listed and the website of the merchant bankers associated with the issue for at least 21 days from the date of the filing.

The lead merchant bankers shall, after expiry of the stipulated period, file with SEBI a statement giving information of the comments received by them or the issuer on the draft offer document during that period and the consequential changes, if any, to be made in the draft offer document.

13.4.3 Dispatch of Issue Material

The lead merchant bankers are responsible for the dispatch of the issue material to all the parties concerned. This involves the dispatch of the offer document and other material like forms for ASBA (Application Supported by Blocked Amount) to the designated stock exchanges, syndicate members, underwriters, bankers to the issue, investors' associations and Self Certified Syndicate Banks in advance

13.5 Role as an Underwriter[25]

One of the most important roles of the merchant banks involved in the process of issue management is that of underwriting of the issue. Underwriting is an agreement with or without conditions to subscribe to the securities of an issuer when the existing shareholders of such issuer or the public do not subscribe to the securities offered to them and Underwriters are person who engages in the business of underwriting of an issue of securities of a body corporate. When the issuer makes a public issue (other than through the book building process) or rights issue, and desires to have the issue underwritten, it has to appoint the underwriters in accordance with SEBI (Underwriters) Regulations, 1993. In case the issuer makes a public issue through the book building process, such issue shall be underwritten by book runners or syndicate members, provided that seventy five per cent of the net offer to public proposed to be compulsorily allotted to qualified institutional buyers (QIBs) for the purpose of compliance of the eligibility conditions as specified in the Regulation cannot be underwritten.

The issuer company shall enter into underwriting agreement with the book runner, who in turn shall enter into underwriting agreement with the syndicate members, indicating therein the number of specified securities which they shall subscribe to at the predetermined price in the event of under-subscription in the issue. In case where the syndicate member fails to fulfill its underwriting obligation, the lead book runner shall fulfill the underwriting obligations. The book runners and syndicate members shall not subscribe to the issue in any manner except for fulfilling their underwriting obligations.

A copy of the syndicate agreement is required to be filed with SEBI before the opening of bids.

In case of every underwritten issue, the lead merchant banker or the lead book runner shall undertake minimum underwriting obligations as specified in the Securities and Exchange Board of India (Merchant Bankers) Regulations, 1992. Where hundred per cent of the offer through offer document is underwritten, the underwriting obligations shall be for the entire hundred per cent of the offer through offer document and shall not be restricted up to the minimum subscription level.

13.5.1 Minimum Subscription

In order to prevent any wrong doing in the issue of securities and to safeguard the interests of the investors SEBI ICDR has issued some minimum subscription limits for every issue as per Regulation 14.

[25] The SEBI (Underwriters) Regulations, 1993 have been discussed in Unit 17 of this workbook.

(1) The minimum subscription to be received in an issue shall not be less than ninety per cent of the offer through offer document. The minimum subscription to be received in terms of minimum number of specified securities is required to be as per SCRR 1957. (2) In the event of non-receipt of minimum subscription as referred to in above, all application moneys received shall be refunded to the applicants forthwith, but not later than:

(a) fifteen days of the closure of the issue, in case of a non-underwritten issue; and

(b) seventy days of the closure of the issue, in the case of an underwritten issue where minimum subscription including devolvement obligations paid by the underwriters is not received within sixty days of the closure of the issue.

The offer document must contain adequate disclosures regarding minimum subscription as specified the SEBI ICDR Regulations. The above mentioned Regulation 14 provisions shall not apply to the sale of specified securities except the requirement related to allotment of minimum number of specified securities.

The Regulation 15 of the SEBI ICDR states that the issuer company cannot make allotment in excess of the specified securities offered through the offer document. However, in case of over-subscription, an allotment of not more than 10% of the net offer to the public can be made for the purpose of making allotment in minimum lots.

13.6 General Obligations of Merchant Bankers with respect to Public and Rights Issue

ICDR Regulations prescribes general obligations of Issuers and other intermediaries who are related with the process of issue management. However, we will here only discuss those obligations which are pertaining to Merchant Bankers only.

1. **Prohibition of payment of incentives:** No person connected with the issue shall offer any incentive, whether direct or indirect, in any manner, whether in cash or kind or services or otherwise to any person for making an application for allotment of specified securities.

2. **Public Communications / Research reports:** Any intermediary concerned with the issue shall not issue any public communication including advertisement, research report and publicity material which contains projections, estimates, conjectures etc or any matter extraneous to the contents of the offer document. Any advertisement or research report issued by an issuer, any intermediary concerned with the issue or their associates shall comply with the following:

(a) It shall be truthful, fair and shall not be manipulative or deceptive or distorted and it shall not contain any statement, promise or forecast which is untrue or misleading.

(b) Reproduction of information given in the offer document should be done in such a manner that all information and relevant facts are disclosed in clear, concise and understandable language and not restricted to select extracts relating to that information.

(c) Slogans and brand names for the issue should not be used except the normal commercial name of the issuer or commercial brand names of its products already in use.

(d) In cases where the financial data is used, the data should be for last three years and shall also include the particulars relating to sales, gross profit, net profit, share capital, reserves, earning per share, dividends and the book values.

(e) Advertisements shall not use extensive technical, legal terminology or complex language and excessive details which may distract the investors. Also the advertisements shall not contain statements which promise or guarantee rapid increase in profits.

(f) Advertisements of issues shall not display models, celebrities, fictional characters, landmarks or caricatures or the likes. It shall not contain slogans, expletives or non-factual and unsubstantiated titles.

(g) The advertisements shall not appear in the form of crawlers on television. The risk factors pertaining to the issues in case of advertisements of issues on television screens should not be scrolled but viewers should be advised to refer to the red herring prospectus or other offer document for details.

(h) The advertisement regarding any issue on billboards should not contain information other than what is specified in the SEBI ICDR Regulations.

No advertisement shall be issued giving any impression that the issue has been fully subscribed or oversubscribed during the period the issue is open for subscription. An announcement regarding the closure of issue should be made only after the lead merchant banker is satisfied that atleast 90% of the offer through the offer document have been subscribed and a certificate regarding that have been obtained from the registrar to the issue. However, such announcement should not be made before the issue closure date.

3. **Publicly available documents:** The lead merchant banker along with the issuer shall ensure that the contents of offer documents hosted on the websites as required in the Regulation is same as that of the printed copies filed with the RoC, SEBI and the stock exchanges. As and when required by any investor, the lead merchant and the stock exchange should furnish a copy of the draft offer document. However, a reasonable sum of money can be charged by the merchant banker or the stock exchange for the same.

4. **Investor Grievances:** The post-issue lead merchant bankers should look into the post-issue activities such as allotment, refund, dispatch and giving instructions to the syndicate members, Self-Certified Syndicate Banks and other intermediaries. The lead merchant banker is required to also look into and monitor the redress of the investor grievances if any.

5. **Post-issue Reports:** The lead merchant banker is required to submit the post-issue reports to SEBI as specified in the Regulations. The initial post-issue report shall be submitted within 3 days of closure of the issue in specified formats and the final post issue reports within 15 days of the date of finalization of basis of allotment or within 15 days of refund of money in case of fail-

ure of issue. The lead merchant banker has to submit a due diligence certificate as per format specified in the Regulations along with the post-issue report.

6. **Post-issue Advertisements:** The merchant banker related to the post-issue activities shall ensure that advertisements giving details relating to over subscription, basis of allotment, number, value and percentage of all applications, number, value and percentage of successful allottees for all applications, date of completion of dispatch of refund orders or instructions to Self-Certified Syndicate Banks by the Registrar, date of dispatch of certificates and date of filing of listing applications, etc is released within ten days from the date of completion of the various activities in atleast one English national daily newspaper and one Hindi national daily newspaper at a place where the issuer company has its registered office.

It is the responsibility of the post-issue merchant banker to ensure that the issuer company, advisors, brokers or any other entity connected with the issue does not publish any advertisements which state that issue has been over-subscribed. The advertisement should also not indicate the investor's response to the issue, during the period when the public issue is open for subscription by the public.

8. **Co-ordination with other Intermediaries:** The post-issue merchant banker has to maintain close coordination with the registrars to the issue and arrange to depute its officers to the offices of various intermediaries at regular intervals after the closure of the issue. This would enable the post-issue merchant banker to monitor (a) the flow of application from collecting bank branches; (b) processing of the applications including the application form for ASBA; (c) other related matters till the basis of allotment is finalized; (d) dispatch of security certificates and refund orders are completed and securities are listed.

In cases, where there is a devolvement on underwriters, the merchant banker has to ensure that the notice for devolvement containing the obligation of the underwriters is issued within a period of ten days from the date of closure of the issue. It is also the responsibility of the post-issue merchant banker to confirm to the bankers to issue that all formalities in connection with the issue have been completed and that the banker is free to release the money to the issuer or release the money for refund in case of failure of the issue.

9. **Miscellaneous responsibilities:** The merchant banker has to ensure that all the information contained in the offer document and the particulars as per the audited financial statements in the offer document are not more than 6 months old from the issue opening date. The post-issue merchant banker has to:

- Ensure that the dispatch of refund orders, allotment letters and share certificates are done by way of registered post or certificate of posting, whichever is applicable.
- Ensure payment of interest to the applicants for delayed dispatch of allotment letters, refund orders, etc as per the disclosures made in the offer document.

Review Questions

1. Post issue activities, generally co-ordinated by Lead Merchant Banker, include which of the following?

   (a) Deciding on centres for holding conferences of stock brokers, investors, etc.

   (b) Processing rematerialisation requests

   (c) Finalisation of the basis of allotment

   (d) All of the above

Ans: (c)

2. As per SEBI (ICDR) Regulation, only audited and consolidated financial statements need to be prepared in accordance to GAAP. State whether True or False.

   (a) True

   (b) False

Ans: (b)

3. As per SEBI (ICDR) Regulations, the minimum subscription to be received in an issue must be atleast _____ of the offer through offer document.

   (a) 65%

   (b) 75%

   (c) 80%

   (d) 90%

Ans: (d)

4. As per SEBI (ICDR) Regulation, an advertisement may be issued giving any impression that the issue has been fully subscribed or oversubscribed during the period the issue is open for subscription, with prior intimation to SEBI. State whether the above statement is true or false?

   (a) True

   (b) False

   Ans: (b)

Unit 14: Depositories Act 1996

14.1 Introduction

The Depositories Act, 1996 provides for the establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security by (a) making securities freely transferable subject to certain exceptions; (b) dematerialization of the securities in the depository mode; and (c) providing for maintenance of ownership records in a book entry form. In order to streamline the settlement process, the Act envisages transfer of ownership of securities electronically by book entry. The Act has made the securities of all companies freely transferable in the depository mode, restricting the company's right to use discretion in effecting the transfer of securities. The other procedural and the transfer deed requirements stated in the Companies Act have also been dispensed with.

14.2 Rights and Obligations of Depositories

- An entity intending to act as a depository participant should enter into an agreement with Depository in the prescribed format.
- Every depository shall on receipt of intimation from a participant, register the transfer of security in the name of the transferee. If the beneficial owner or a transferee of any security seeks to have custody of such security the depository shall inform the issuer accordingly.
- Every person subscribing to securities shall have the option either to receive or hold securities certificates with a depository and if the person opts to hold with a depository, the issuer shall intimate depository the details of allotment and on receipt of such information the depository shall enter the name of allottee as the beneficial owner of security.
- All securities held by a depository shall be dematerialized and shall be in fungible form.
- The register and index of beneficial owners maintained by a depository under Section 11 of the Depositories Act, 1996 shall be deemed to be the corresponding register and index under the Companies Act, 2013
- Depositor shall inform the issuer about the transfer of securities in the name of beneficial owners at such intervals and as prescribed by bye-laws.
- If a beneficial owner seeks to opt out of a depository in case of any security, he shall inform the depository accordingly and then depository shall make entry accordingly in its records and inform the issuer accordingly. The issuer on fulfillment of all conditions as per the regulations by the depository shall issue new certificates to the beneficial owner within thirty days of the receipt of information from depository.
- When any loss is caused to the beneficial owner due to negligence of the depository or the participant, the depository shall indemnify the beneficial owner. Where such loss is indemnified by the depository, it can recover the same from participant where such loss is due to negligence of the participant.
- Where any loss due to the negligence of the participant is indemnified by the depository, the depository can recover the same from such participant.

14.3 Enquiry and Inspection

SEBI may call upon any issuer, depository, depository participant or beneficial owner to furnish in writing such information relating to the securities held in a depository as it may require or it may authorize any person to make an enquiry or inspection in relation to the affairs of the issuer, beneficial owner, depository participant who shall submit a report of such enquiry or inspection to it within such period. Every director, partner, manager, officer, employee or secretary of the depository or beneficial owner or issuer or participant shall produce all information and documents as per the requirement of the person conducting the enquiry or inspection. After making or causing to be made an enquiry, SEBI can issue appropriate directions to the depository participant as may be appropriate in the interest of investors or securities market. It is hereby declared that the power to issue directions under this section shall include and always be deemed to have been included the power to direct any person, who made profit or averted loss by indulging in any transaction or activity in contravention of the provisions of this Act or regulations made thereunder, to disgorge an amount equivalent to the wrongful gain made or loss averted by such contravention.

14.3.1 Penalties

Section 19A of the Depositories Act lays down the penalties to be imposed for failure to furnish information, return etc. by any person who is required under this Act or any rules or regulation or bye-laws made thereunder;

1. Failure in furnishing any information, document, books, returns or report to SEBI or filing any return within the time specified thereof, shall make him liable to a penalty of one lakh rupees for each day during which such failure continue or one crore rupees which is less for each such failure.
2. For failure to maintain books of account or records – Rs.1 crore or Rs.1 lakh for each day of default, whichever is less;
3. For failure to enter into agreement either by intermediary or any issuer – Rs. 1 crore or Rs.1 lakh for each day of default, whichever is less;
4. For failure to redress investors' grievances after having been called upon to do so by SEBI within the specified time period– Rs. 1 crore or Rs.1 lakh for each day of default, whichever is less;
5. For delay in dematerialization or issue of certificate of securities – Rs. 1 crore or Rs.1 lakh for each day of default, whichever is less;
6. For failure by any person to comply as per the directions of section 19 issued by SEBI within specified time - Rs. 1 crore or Rs.1 lakh for each day during such failure, whichever is less;

Without prejudice to the above penalties by adjudicating officer, if any person contravenes or attempts to contravene or abets the contravention of the Depositories Act or rules or regulations or bye-laws made thereunder or fails to pay the penalty imposed by the adjudicating officer or to comply with any of his directions or orders, then such person shall be punishable with imprisonment up to 10 years, or with fine up to Rs. 25 crores, or with both.

14.4 Miscellaneous Issues

14.4.1 Composition of Certain Offences

Notwithstanding anything contained in the Code of Criminal Procedures, any offence punishable under this Act, not being an offence punishable with imprisonment only, or with imprisonment and also with fine, may either before or after the institution of any proceeding, be compounded by the Securities Appellate Tribunal (SAT) or a court before which such proceedings are pending.

14.4.2 Power to Grant Immunity

Central Government may, on recommendation by SEBI and if satisfied, grant immunity from prosecution or penalty to a person, who is alleged to have violated Depositories Act or the rules or regulations made thereunder, if such person has made full and true disclosure of such alleged violation. This is provided that no such immunity may be granted where the prosecution proceedings have already been initiated before the receipt of application for grant of immunity. The recommendation of board under this sub-section is not binding upon the Central Government.
The government may also withdraw immunity given to a person if it is satisfied that such person had given false evidence and hence may be tried for the offence.

14.4.3 Appeals

Any person aggrieved by an order of the SEBI made under this Act or the regulations made thereunder may prefer an appeal to the Central Government within such time as may be prescribed.

Appeal to Securities Appellate Tribunal (SAT):

- Any person aggrieved by an order of the SEBI or Adjudicating Officer (AO) may prefer an appeal to the SAT. However, no appeal shall lie to the SAT from an order made by the SEBI or by an AO with the consent of the parties.
- Every appeal shall be filed within a period of 45 days from the date on which a copy of the order made by SEBI or AO is received by the aggrieved party.
- Provided that the SAT may entertain an appeal after the expiry of the said period of 45 days if it is satisfied that there was sufficient cause for not filing it within that period.
- On receipt of an appeal, the SAT may, after giving the parties to the appeal, an opportunity of being heard, pass such orders thereon as it thinks fit, confirming, modifying or setting aside the order appealed against.
- The SAT shall send a copy of every order made by it to the SEBI, the parties to the appeal and to the concerned AO.
- The appellant may either appear in person or authorize one or more chartered accountants or company secretaries or cost accountants or legal practitioners or any of its officers to present his or its case before the SAT.

Appeal to the Supreme Court:

Any person aggrieved by any decision or order of the SAT may file an appeal to the Supreme Court within 60 days from the date of communication of the SAT order to him on any question of law arising out of such order. Provided that the Supreme Court may, if it is satisfied, allow the appeal to be filed within a further period not exceeding 60 days.

Review Questions

1. Which Act provides for the establishment of depositories in securities?

   (a) SEBI Act

   (b) Companies Act

   (c) Depositories Act

   (d) Securities Contracts (Regulation) Act

Ans: (c)

2. The immunity can be granted by the Central Government on recommendation of SEBI, under Depositories Act only if the person has made full disclosure of the violation. State whether True or False?

   (a) True

   (b) False

Ans: (a)

3. An entity intending to act as a depository participant should enter into an agreement with _____in the prescribed format.

   (a) Bank

   (b) Issuer

   (c) Depository

   (d) Broker

Ans: (c)

4. As per the Depositories Act, failure to furnish information or books or documents or reports by the depository or the depository participant of their functioning will carry a fine of Rs.one lakhs for each day of failure or Rs._____, whichever is less.

   (a) Rs. One Crore

   (b) Rs. Two Crore

   (c) Rs. Three Crore

   (d) Rs. Four Crores

Ans: (a)

Unit 15: SEBI (Depositories and Participants) Regulations 1996

The relationship between the Depository Participants (DPs) and the depository is governed by an agreement made between the two under the Depositories Act, 1996, SEBI [Depositories and Participants] Regulations, 1996 and the Bye laws of the Depository. Before commencing business as a depository participant, it has to get registered with the SEBI as a Depository Participant. The commencement, rights and obligations of the participants, issuers etc are prescribed in the SEBI (Depositories and Participants) Regulations 1996. In this Unit, we try to give insights into this regulation; however it is advised to refer to the regulation in detail.

15.1 Registration of a Depository Participant

- Depository Participants are required to be registered with SEBI. The application for registration should be routed through the Depository concerned. The certificate of registration is valid for 5 years and has to be renewed thereafter.
- A SEBI registered stock broker can become a depository participant provided the stock broker has a minimum net worth of Rs.50 lakhs (to be complied with separately for each such depository of which it seeks to act as a participant). Provided further, that the aggregate value of the portfolio of securities of clients held in dematerialized form through it should not exceed 100 times the net worth of the stock broker. However, if the stock broker seeking to act as a depository participant has a minimum net worth of Rs.10 crores, the limit on aggregate value of portfolio is not applicable.
- Depository participant shall always comply with the conditions of registration.
- Depository participant shall always comply with the Code of Conduct.

15.2 Rights and Obligations

- A Depository Participant should enter into an agreement in the prescribed format (as specified in the Depository's Bye-laws) with a beneficial owner before acting as a depository participant on his behalf.
- With effect from August 27, 2012, it has been made mandatory for all depository participants to make available a 'Basic Services Demat Account' with limited services as per the terms specified to retail individual investors.
- A separate account should be maintained for each beneficial owner and the securities of each beneficial owner should be segregated.
- Transfer to and from the accounts of the client should be made only on the basis of a duly authorised order, instruction, direction or mandate and adequate audit trail should be maintained of such authorization.
- Client should be allowed to withdraw or transfer securities from its account in a manner as specified in the agreement with the client.
- A statement of account should be provided to the client once in a month or at shorter intervals, if agreed with the client; if there are no transactions in the account the statement should be furnished once in a quarter. Transaction statements and other documents can be provided under digital signature. Depository Participant should maintain continuous connectivity with each depository for which it is a participant.
- Adequate mechanism for the purposes of reviewing, monitoring and evaluating the internal accounting controls should be in place.
- Depository Participant should submit periodic returns to SEBI and to Depository in the specified format.

- Depository Participant should not delegate its functions to any other person without prior approval of the Depository.
- In case of a request for dematerialization, Depository Participant should, within 7 days of receipt of security certificate, furnish the same to the Issuer, who then within 15 days shall cancel the security certificate and substitute in its records the name of the Depository as the registered owner and shall send the details of the same to the Depository and to every stock exchange where the security is listed.
- A Depository Participant, on receiving the request for pledge or hypothecation from a beneficial owner/client, shall after satisfaction that the securities are available for pledge or hypothecation, forward the application to the Depository after necessary notings.

15.2.1 Record of Services

- Depository participant should maintain the following records:
  - Records of all transactions entered into with the Depository and with clients (beneficial owners).
  - Details of securities dematerialized and rematerialized on behalf of clients with whom it has entered into an agreement;
  - Records of instructions received from clients and statements of account provided to clients;
  - Records of approval, notice, entry and cancellation of pledge or hypothecation, as the case may be.
- Records and documents should be:
  - Preserved by the Depository Participant for a minimum of 5 years. However, if any enforcement agency has taken copy of any documents and records, then the originals of such records (whether electronic or physical) should be maintained for such period till the trial or investigation proceedings are over.
  - Maintained separately for each Depository, if a Depository Participant enters into an agreement with more than one Depository.
  - Reconciled by the Depository Participant with the Depository on a daily basis.
- The location of the records and documents should be intimated to SEBI.
- Where records are kept electronically, the depository participant should ensure that the integrity of the data processing systems is maintained and take adequate precautions against the records being lost, destroyed or tampered with and in the event of loss or destruction, ensure the availability of sufficient back up of records at all times at a different place.
- A depository participant should make available all records to the depository for inspection matters relating to transfer of securities, maintenance of records of holders, handling of physical securities.

15.2.2 Redress of Investor Grievances

Depository Participant should redress the grievances of the investors within 30 days of the receipt of complaint and keep the depository informed about the number and nature of grievances redressed by it and number of grievances pending before it.

15.2.3 Investment Advice

A depository participant or any of its employees shall not render directly or indirectly, any investment advice about any security in the publicly accessible media, whether real-time or non-

real-time, unless a disclosure of his interest including long or short position in the said security has been made, while rendering such advice.
In case the depository participant is rendering such advice, he shall also disclose the interest of his dependent family members and the employer including their long or short position in the said security, while rendering such advice.

15.2.4 Appointment of Compliance Officer

A depository participant shall appoint a compliance officer, who shall be responsible for monitoring the compliance of the Act, rules and regulations, notifications, guidelines, instructions etc issued by SEBI or the central government and for redress of investor grievances. The Compliance Officer should immediately and independently report to SEBI any non-compliance observed by him.

15.2.5 Inspection

It shall be the duty of the depository participant whose affairs are being inspected or investigated to produce to the inspecting authority such books, accounts, securities, records and other documents in its custody or control and furnish him with such statements and information relating to his activities within a specified time period as the inspecting officer may specify.

15.3 Action in case of Default

A depository or a depository participant who –
- contravenes any of the provisions of the SEBI Act, the Depositories Act, the bye-laws, agreements or SEBI (Depositories and Participants) Regulations;
- fails to furnish any information relating to its activity as a depository or participant as required under these regulations;
- does not furnish the information called for by SEBI under the Depositories Act or furnishes false or misleading information;
- does not co-operate in any inspection or investigation or enquiry conducted by SEBI;
- fails to comply with any direction of SEBI issued under regulation 18 of the Depositories Act;
- fails to pay the annual fee;

shall be dealt with in the manner provided under Chapter V of the SEBI (Intermediaries) Regulations, 2008[26].

15.4 Code of Conduct for Participants

The Regulation 20AA read with the third schedule of the SEBI (Depositories and Participants) Regulations 1996 prescribes the Code of Conduct for Participants which are as given below:
- A Participant shall make all efforts to protect the interests of investors.
- A Participant shall always endeavour to -
  - render the best possible advice to the clients having regard to the clients' needs and the environments and his own professional skills;
  - ensure that all professional dealings are affected in a prompt, effective and efficient manner;
  - inquiries from investors are adequately dealt with;

[26]See section 7.4, Unit 7 of this workbook or refer to the regulation for more details.

  - grievances of investors are redressed without any delay.
- A Participant shall maintain high standards of integrity in all its dealings with its clients and other intermediaries, in the conduct of its business.
- A Participant shall be prompt and diligent in opening of a beneficial owner account, dispatch of the Dematerialization Request Form (DRF), Rematerialisation Request Form (RRF) and execution of Debit Instruction Slip and in all the other activities undertaken by him on behalf of the beneficial owners.
- A Participant shall endeavor to resolve all the complaints against it or in respect of the activities carried out by it as quickly as possible, and not later than one month of receipt.
- A Participant shall not increase charges / fees for the services rendered without proper advance notice to the Beneficial Owners.
- A Participant shall not indulge in any unfair competition, which is likely to harm the interests of other Participants or investors or is likely to place such other Participants in a disadvantageous position while competing for or executing any assignment.
- A Participant shall not make any exaggerated statement whether oral or written to the clients either about its qualifications or capability to render certain services or about its achievements in regard to services rendered to other clients.
- A Participant shall not divulge to other clients, press or any other person any information about its clients which has come to its knowledge except with the approval / authorization of the clients or when it is required to disclose the information under the requirements of any Act, Rules or Regulations.
- A Participant shall co-operate with SEBI as and when required.
- A Participant shall maintain the required level of knowledge and competency and abide by the provisions of the Act, Rules, Regulations and circulars and directions issued by SEBI. The Participant shall also comply with the award of the Ombudsman passed under SEBI (Ombudsman) Regulations, 2003.
- A Participant shall not make any untrue statement or suppress any material fact in any documents, reports, papers or information furnished to SEBI.
- A Participant shall not neglect or fail or refuse to submit to SEBI or other agencies with which it is registered, such books, documents, correspondence, and papers or any part thereof as may be demanded / requested from time to time.
- A Participant shall ensure that SEBI is promptly informed about any action, legal proceedings etc., initiated against it in respect of material breach or non compliance by it, of any law, rules, regulations, directions of SEBI or of any other regulatory body.
- A Participant shall maintain proper inward system for all types of mail received in all forms.
- A Participant shall follow the *maker-checker* concept in all of its activities to ensure the accuracy of the data and as a mechanism to check unauthorized transaction.
- A Participant shall take adequate and necessary steps to ensure that continuity in data and record keeping is maintained and that the data or records are not lost or destroyed. It shall also ensure that for electronic records and data, up-to-date back up is always available with it.
- A Participant shall provide adequate freedom and powers to its compliance officer for the effective discharge of his duties.
- A Participant shall ensure that it has satisfactory internal control procedures in place as well as adequate financial and operational capabilities which can be reasonably expected to take care of any losses arising due to theft, fraud and other dishonest acts, professional misconduct or omissions.

- A Participant shall be responsible for the acts or omissions of its employees and agents in respect of the conduct of its business.
- A Participant shall ensure that the senior management, particularly decision makers have access to all relevant information about the business on a timely basis.
- A Participant shall ensure that good corporate policies and corporate governance are in place.

Review Questions

1. For an entity to function as a Depository Participant, it is mandatory for it to be registered with SEBI as a Depository Participant. State True or False?

   (a) True

   (b) False

Ans: (a)

2. Every Depository Participant should put in place an adequate mechanism for _____ the internal accounting controls.

   (a) Reviewing

   (b) Monitoring

   (c) Evaluating

   (d) All of the above

Ans: (d)

3. As per the SEBI (Depositories and Participants) Regulations, the records and documents should be reconciled by the Depository Participant with each depository on a _____ basis.

   (a) Daily

   (b) Two-day

   (c) Weekly

   (d) Fortnightly

Ans: (a)

4. As per the SEBI (Depositories and Participants) Regulations, a Depository Participant shall not increase charges / fees for the services rendered without proper advance notice to the Beneficial Owners. State whether True or False?

   (a) True

   (b) False

Ans: (a)

Unit 16: SEBI (Bankers to an Issue) Regulations 1994

Bankers to an Issue mean a scheduled bank which carries out all or any of the following activities, namely:

- Acceptance of application and application monies;
- Acceptance of allotment or call monies;
- Refund of application monies;
- Payment of dividend or interest warrants.

16.1 Registration as Banker to an Issue

A scheduled bank making an application to SEBI for grant of certificate as Banker to an Issue needs to do the same in the format as specified in the Regulations and grant of certificate by SEBI would be subject to fulfilment of the following requirements:

(a) The applicant has the necessary infrastructure, communication and data processing facilities and manpower to effectively discharge its activities;
(b) The applicant or any of its directors is not involved in any litigation connected with the securities market and which has an adverse bearing on the business of the applicant or has not been convicted of any economic offence;
(c) The applicant is a fit and proper person;
(d) Grant of certificate to the applicant is in the interest of investors.

Once the certificate of registration as Banker to an Issue is granted, it is valid for a period of 3 years. Every Banker to an Issue is required to pay a sum of Rs. 10 lakh as registration fees at the time of the grant of certificate by SEBI. Application for renewal should be given three months before the expiry of the period of certificate, alongwith the non-refundable application fee of Rs. Twenty Five Thousand. To keep the registration in force, the renewal fee is Rs. 5 lakhs every three years from the date of initial registration.

16.2 General Obligations and Responsibilities of Banker to an Issue

16.2.1 Maintenance of books of account, records and the documents

Every banker to an issue shall maintain the following records for a minimum period of 3 years:

a. the number of applications received, the names of the investors, the dates on which the applications were received and the amount so received from the investors;
b. the time within which the applications received from the investors were forwarded to the body corporate or registrar to an issue, as the case may be;
c. dates and amount of refund monies paid to the investors;
d. dates, names and amount of dividend/interest warrant paid to the investors.

Each banker to an issue shall also keep SEBI informed about the place where the records and documents mentioned above are kept.

16.2.2 Furnishing of Information to SEBI

Every banker to an issue shall furnish to the SEBI the following information when the same is sought from them, namely:

a. the number of issues for which he was engaged as a banker to an issue;
b. the number of applications and details of the application monies received by the banker to an issue;
c. the dates on which the applications received from the investors were forwarded to the body corporate or registrar to an issue;
d. the dates on which and the amount refunded to the investors;
e. the payment or dividend/or interest warrants to the investors.

The Board of Directors of the Bankers to an Issue are required to review the periodic report to be submitted to SEBI and record its observations on the deficiencies and non-compliances and corrective measures initiated to avoid such instances in future. The Compliance Officer of the Bankers to an Issue is required to send the report in the prescribed format on a half yearly basis within 3 months of the expiry of the half year.

16.2.3 Agreement with body corporate

Every banker to an issue shall enter into an agreement with the body corporate for which it is acting as banker to an issue. The agreement shall contain the following:

a. The number of centres at which the applications and application monies of an issue of a body corporate will be collected from the investors;
b. The time within which the statement regarding the applications and application monies received from the investors investing in an issue of a body corporate will be forwarded to the registrar to an issue or the body corporate, as the case may be;
c. That a daily statement will be sent by the designated controlling branch of the bankers to the issue to the registrar to an issue indicating the number of applications received on that date from the investors investing in the issue of a body corporate, and the amount of application money received.

16.3 Code of Conduct for Bankers to an Issue

SEBI regulations have prescribed certain code of conduct for bankers to an issue. Each banker to an issue shall:

- Make all efforts to protect the interests of investors;
- Observe high standards of integrity and fairness in the conduct of its business;
- Fulfil its obligations in a prompt, ethical and professional manner.
- At all times exercise due diligence, ensure proper care and exercise independent professional judgment.
- Not at any time act in collusion with other intermediaries or the issuer in a manner that is detrimental to the investor.
- Endeavour to ensure that (a) inquiries from investors are adequately dealt with;(b) grievances of investors are redressed in a timely and appropriate manner;(c) where a complaint is not remedied promptly, the investor is advised of any further steps which may be available to the investor under the regulatory system.

- Not (a) allow blank application forms bearing brokers stamp to be kept at the bank premises or peddled anywhere near the entrance of the premises;(b) accept applications after office hours or after the date of closure of the issue or on bank holidays;(c) after the closure of the public issue accept any instruments such as cheques/demand drafts/stock invests from any other source other than the designated Registrar to the Issue;(d) part with the issue proceeds until listing permission is granted by the stock exchange to the body corporate;(e) delay in issuing the final certificate pertaining to the collection figures to the Registrar to the Issue, the lead manager and the body corporate and such figures should be submitted within seven working days from the issue closure date.
- Be prompt in disbursing dividends, interests, or any such accrual income received or collected by him on behalf of his clients.
- Not make any exaggerated statement, whether oral or written to the client, either about its qualification or capability to render certain services or its achievements in regard to services rendered to other clients.
- Always endeavour to render the best possible advice to the clients having regard to the clients' needs and the environments and his own professional skill.
- Not divulge to anybody either orally or in writing, directly or indirectly, any confidential information about its clients which has come toots knowledge, without taking prior permission of its clients except where such disclosures are required to be made in compliance with any law for the time being in force.
- Avoid conflict of interest and make adequate disclosure of his interest.
- Put in place a mechanism to resolve any conflict of interest situation that may arise in the conduct of its business or where any conflict of interest arises, shall take reasonable steps to resolve the same in an equitable manner.
- Make appropriate disclosure to the client of its possible source or potential areas of conflict of duties and interest while acting as a banker to an issue which would impair its ability to render fair, objective and unbiased services.
- Not indulge in any unfair competition, which is likely to harm the interests of other bankers to an issue or investors or is likely to place such other bankers to an issue in a disadvantageous position while competing for or executing any assignment.
- Not discriminate amongst its clients, save and exception ethical and commercial considerations.
- Ensure that any change in registration status/any penal action taken by SEBI or any material change in financials which may adversely affect the interests of clients/investors is promptly informed to the clients and any business remaining outstanding is transferred to another registered person in accordance with any instructions of the affected clients/investors.
- Maintain an appropriate level of knowledge and competency and abide by the provisions of the Act, regulations, circulars and guidelines of SEBI. The banker to an issue shall also comply with the award of the Ombudsman passed under the Securities and Exchange Board of India (Ombudsman) Regulations, 2003.
- Ensure that SEBI is promptly informed about any action, legal proceedings, etc., initiated against it in respect of any material breach or non-compliance by it, of any law, rules, regulations, and directions of SEBI or of any other regulatory body.
- Not make any untrue statement or suppress any material fact in any documents, reports, papers or information furnished to SEBI.

- Not neglect or fail or refuse to submit to SEBI or other agencies with which it is registered, such books, documents, correspondence, and papers or any part thereof as may be demanded/requested from time to time.
- Abide by the provisions of such acts and rules, regulations, guidelines, resolutions, notifications, directions, circulars and instructions as may be issued from time to time by the Central Government, the Reserve Bank of India, the Indian Banks Association or SEBI and as may be applicable and relevant to the activities carried on by the banker to an issue.
- Not render, directly or indirectly, any investment advice about any security in the publicly accessible media, whether real-time or non-real-time, unless a disclosure of its interest including longer short position in the said security has been made, while rendering such advice, (b) In case, an employee of the banker to an issue is rendering such advice, the banker to an issue shall ensure that he discloses his interest, the interest of his dependent family members and that of the employer including employer's long or short position in the said security, while rendering such advice.
- A banker to an issue or any of its directors, or employee having the management of the whole or substantially the whole of affairs of the business, shall not, either through its account or their respective accounts or through their family members, relatives or friends indulge in any insider trading.
- Have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operations, its clients, investors and other registered entities from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions.
- Provide adequate freedom and powers to its compliance officer for the effective discharge of its duties.
- Develop its own internal code of conduct for governing its internal operations and laying down its standards of appropriate conduct for its employees and officers in the carrying out of their duties as a banker to an issue and as a part of the industry. Such a code may extend to the maintenance of professional excellence and standards, integrity, confidentiality, objectivity, avoidance of conflict of interests, disclosure of shareholdings and interests, etc.
- Ensure that any person it employs or appoints to conduct a business is fit and proper and otherwise qualified to act in the capacity so employed or appointed (including having relevant professional training or experience).
- Ensure that it has adequate resources to supervise diligently and does supervise diligently persons employed or appointed by it to conduct business on its behalf.
- Be responsible for the acts or omissions of its employees and agents in respect to the conduct of its business.
- Ensure that the senior management, particularly decision makers have access to all relevant information about the business on timely basis.
- If the banker to an issue is registered with SEBI in other capacity shall endeavour to ensure that arms-length relationship is maintained in terms of both manpower and infrastructure between the activities carried out as banker to an issue and other permitted activities.
- Not be a party to or instrumental for (a) creation of false market;(b) price rigging or manipulation; or(c) passing of unpublished price sensitive information in respect of securities which are listed and proposed to be listed in any stock exchange to any person or intermediary.

16.4 Obligations of Banker to an Issue in case of inspection by RBI

On inspection by RBI, it shall be the duty of every director, proprietor, partner, officer and employee of the banker to an issue, to produce such books, accounts and other documents and information relating to its activities as a banker to an issue within such time as the Reserve Bank may require.

The banker to an issue shall allow the inspecting authority to have reasonable access to the premises occupied by it or by any other person on his behalf and also extend reasonable facility for examining any books, records, documents and computer data in the possession of the banker to an issue or any such other person and also provide copies of documents or other materials which, in the opinion of the Reserve Bank of India are relevant for the purposes of the inspection.

It shall be the duty of every director, proprietor, partner, officer or employee of the banker to an issue to give to the inspecting authority all assistance in connection with the inspection which the banker to an issue may reasonably be expected to give.

Review Questions

1. Which of the following is NOT the activity performed by Bankers to an Issue??
   (a) Acceptance of application monies
   (b) Collection of securities transaction tax
   (c) Acceptance of call monies
   (d) Payment of dividend or interest warrant

Ans: (b)

2. A Banker to an Issue has allowed blank application forms bearing brokers' stamp to be kept at the bank premises. Has the Banker violated the Code of Conduct prescribed by SEBI?
   (a) Yes
   (b) No

Ans: (a)

3. Apart from SEBI regulations, Bankers to an Issue shall abide by the relevant rules and regulations of _____.
   (a) Central Government
   (b) RBI
   (c) Indian Banks Association
   (d) All of the above

Ans: (d)

4. Under the Code of Conduct, SEBI prescribes Bankers to an Issue against their participation in _____.
   (a) Creation of false market
   (b) Price rigging or manipulation
   (c) Passing of unpublished price sensitive information
   (d) All of the above

Ans: (d)

Unit 17: SEBI (Underwriters) Regulations, 1993

17.1 Registration as Underwriter

Underwriter is a person who engages in the business of underwriting of an issue of securities of a body corporate. Amongst other intermediaries merchant bankers generally register themselves as Underwriters with SEBI. The role of merchant banker as underwriter has been discussed in the earlier section 13.5.

SEBI while considering the grant of certificate as an underwriter, looks into the following, namely:

- The applicant should have the necessary infrastructure like adequate office space, equipments, and manpower to effectively discharge his activities;
- Applicant should have past experience in underwriting or has in his employment minimum two persons who had the experience in underwriting;
- Any person, directly or indirectly connected with the applicant should not have been granted registration by the SEBI under the SEBI Act;
- The applicant should have fulfilled the capital adequacy requirements as specified in the regulations;
- Any director, partner or principal officer should not have been convicted for any offence involving moral turpitude or should have been found guilty of any economic offence.
- The applicant should be a fit and proper person as defined in the SEBI (Intermediaries) Regulations, 2008.

The certificate of registration so granted and its renewal is valid for a period of 3 years from the date of its issue to the applicant. An underwriter shall apply for renewal of registration three months prior to the expiry of the period of the certificate along with the appropriate fees as provided by in the regulations.

Every underwriter shall pay Rs. Ten lakh as registration fees at the time of grant of certificate and renewal fee of Rs. 5 lakh every three years from the fourth year from the date of initial registration

17.1.1 Capital Adequacy Requirements

The capital adequacy requirement should not be less than the networth of Rs. 20 lakh. A stock broker who acts as an underwriter shall also fulfil the capital adequacy requirements as specified by the stock exchange of which he is a member.

17.2 General Obligations and Responsibilities

The underwriters as registered with SEBI need to follow general obligations and are entrusted with certain responsibilities as per the SEBI (Underwriters) Regulations, 1993. The underwriter shall not obtain any direct or indirect benefit from undertaking the issue, other than the commission or brokerage payable under an agreement for underwriting. Every underwriter, in the event of being called upon to subscribe for securities issued by body corporate shall subscribe to such securities within 45 days of the receipt of such intimation from such body corporate.

17.2.1 Agreement with clients

Every underwriter shall enter into an agreement with each body corporate on whose behalf the he would be acting as an underwriter. The agreement amongst other things should mention the following:

i. The period for which the agreement shall be in force;
ii. The allocation of duties and responsibilities between the underwriter and the client;
iii. The amount of underwriting obligations;
iv. The period within which the underwriter has to subscribe to the issue after being intimated by or on behalf of such body corporate;
v. The amount of commission or brokerage payable to the underwriter;
vi. Details of the arrangement, if any, made by the underwriter for fulfilling the underwriting obligations.

17.2.2 Maintenance of books of account and records, etc

Subject to provisions as given under any other law, every underwriter shall keep and maintain the following books of account and documents, namely-

A. In relation to underwriter being a body corporate-

- A copy of the balance sheet and profit and loss account as specified in 129 of the Companies Act, 2013;
- A copy of the auditor's report referred to in section 143 of the Companies Act, 2013.

B. In relation to an underwriter not being a body corporate-

- Records in respect of all sums of money received and expended by them and the matters in respect of which the receipt and expenditure take place; and
- Their asset and liabilities.

Without prejudice to anything as mentioned in "A" and "B" above, the underwriter shall after the close of each financial year, provide to SEBI, if so required, the copies of balance sheet, profit and loss account, statement of capital adequacy requirement and such other documents as may be required by SEBI. These may be made available to SEBI within 6 months from the close of the said period.

The underwriters also need to maintain the following records with respect to –
(i) Details of agreements entered into with the corporates;
(ii) Total amount of securities subscribed of each body corporate;
(iii) Statement of capital adequacy requirements;
(iv) Such other records as may be specified by SEBI for underwriting.

The underwriter should also inform SEBI about the place where the books of account, records and documents are maintained. These documents, books of account and other records shall be preserved for a minimum period of 5 years as in provided in the SEBI (Underwriters) Regulations, 1993.

17.3 Code of Conduct

SEBI regulations prescribe for certain code of conduct for all its intermediaries. The following are the Code of conduct as given under Regulation 13 of the SEBI (Underwriters) Regulations, 1993. An underwriter shall:

- Make all efforts to protect the interests of its clients.
- Maintain high standards of integrity, dignity and fairness in the conduct of its business.
- Ensure that he and his personnel will act in an ethical manner in all his dealings with a body corporate making an issue of securities.
- Render high standards of service, exercise due diligence, ensure proper care and exercise independent professional judgement.
- Endeavour to ensure all professional dealings are effected in a prompt, efficient and effective manner.
- Not make any statement, either oral or written, which would misrepresent the services that the underwriter is capable of performing for its client, or has rendered to any other issuer company, or his underwriting commitment.
- Avoid conflict of interest and make adequate disclosure of his interest.
- Put in place a mechanism to resolve any conflict of interest that may have arisen in the conduct of its business or when such situations crops up, take adequate steps to resolve the same in equitable manner.
- Make appropriate disclosures to the client of its possible source or potential areas of conflict of duties and interest while acting as underwriter which would impair its ability to render fair, objective and unbiased services.
- Not divulge to other Issuer, Press or any party any confidential information about his Issuer Company, which has come to his knowledge and deal in securities of any Issuer Company without making disclosure to SEBI as required under the regulations and also to the Board of Directors of the Issuer Company.
- Not discriminate amongst its clients, save and except on ethical and commercial considerations.
- Ensure that any change in registration status/any penal action taken by SEBI or any material change in the financials which may adversely affect the interests of the clients should be informed to the investors without any delay. If instructed by the clients/investors, business outstanding should also be transferred to another registered person.
- Maintain appropriate level of knowledge and competency and abide by the provisions as stated in the SEBI Act, regulations, circulars and guidelines issued by SEBI.
- Ensure that any action taken by any other regulatory body or under any law be informed to SEBI.
- Not make any untrue statement or suppress any material fact in any documents, reports, papers or information furnished to SEBI.
- Not render, directly or indirectly any investment advice about any security in the publicly accessible media, whether real-time or non-real-time, unless a disclosure of his interest including his long or short position in the said security has been made, while rendering such advice. In case, an employee of the underwriter is rendering such advice, he shall also disclose the interest of his dependent family members and the employer including their long or short position in the said security, while rendering such advice.

- Not indulge in any unfair competition, which is likely to be harmful to the interest of other underwriters carrying on the business of underwriting or likely to place such other underwriters in a disadvantageous position in relation to the underwriter while competing for, or carrying out any assignment.
- Have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operations, its clients and other registered entities from financial loss arising from theft, fraud and other dishonest acts, professional misconduct or omissions.
- Provide adequate freedom and powers to its compliance officer for effective discharge of his duties.
- Develop its own internal code of conduct for governing its internal operations and laying down its standards of appropriate conduct for its employees and officers in the carrying out of their duties. Such code may help maintain professional excellence and standards, integrity, confidentiality, objectivity, avoidance of conflict of interest, disclosure of shareholdings and interest etc.
- Ensure good corporate policies and corporate governance is in place.
- Ensure that it has resources to supervise diligently and does supervise diligently persons or appointed by it to conduct business on its behalf.
- Be responsible for the acts or omissions of its employees and agents in respect to the conduct of its business.
- Not be a party to or instrumental for (i) creation of false market; (ii) price rigging or manipulation; (iii) passing of unpublished price sensitive information in respect of securities which are listed and proposed to be listed in any stock exchange to any person or intermediary.

Review Questions

1. The certificate of registration as Underwriter is valid for a period of _____ years.

   (a) 1

   (b) 2

   (c) 3

   (d) 4

Ans: (c)

2. A firm has applied to SEBI for grant of certificate as an underwriter. The firm does not have past experience in underwriting. As per the SEBI guidelines, a minimum of how many employees of the firm shall have experience in underwriting?

   (a) 1

   (b) 2

   (c) 3

   (d) 4

Ans: (b)

3. The documents, books of accounts and other records relating to its underwriting activities should be preserved for a minimum period of _____ years by the Underwriter.

   (a) 3

   (b) 5

   (c) 7

   (d) 10

Ans: (b)

4. SEBI regulations prescribe that underwriters should inform SEBI of any action taken by other regulators on such underwriter.

   (a) True

   (b) False

Ans: (a)

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Unit 18: SEBI (Debenture Trustees) Regulations, 1993

18.1 Registration as Debenture Trustee

Debenture trustee means a trustee of a trust deed for securing any issue of debentures of a body corporate. An application by a debenture trustee for grant of certificate shall be made to SEBI as per the prescribed format. No person shall be entitled to act as a debenture trustee unless he is either –

a) a scheduled bank carrying on commercial activity; or
b) a public financial institution within the meaning of section 2(72) of the Companies Act, 2013; or
c) an insurance company; or
d) body corporate.

SEBI shall take into account the following while considering the application of grant of registration to Debenture Trustees. The debenture trustee should-

- have the necessary infrastructure like adequate office space, equipment's and manpower to effectively discharge his activities;
- have any past experience as a debenture trustee or has in his employment minimum two persons who had the experience in matters which are relevant to a debenture trustee;
- not have any person who is directly or indirectly is connected with the applicant who has already been granted registration by SEBI;
- have in his employment atleast one person who possesses the professional qualification in law from an institution recognised by the Government;
- not have any of its director or principal officer convicted for any offence involving moral turpitude or have been found guilty of any economic offence;
- be fit and proper person as defined in the SEBI (Intermediaries) Regulations, 2008;
- fulfil the capital adequacy requirements.

The certificate of registration and its renewal shall be valid for a period of three years from the date of its issue. The debenture trustee if so desires can make an application for renewal of certificate before three months of the expiry of the period of certificate.

Every debenture trustee shall pay a sum of Rs. 10 lakhs as registration fees at the time of the grant of certificate by SEBI and shall pay renewal fee of Rs. 5 lakh every three years from the fourth year from the date of initial registration. The renewal fee shall be paid within 15 days of being intimated by SEBI.

18.2 Capital Adequacy Requirements

The capital adequacy requirement shall not be less than the networth of one crore rupees, provided that a debenture trustee holding certificate of registration as on the date of commencement of the SEBI (Debenture trustees) (Amendment) Regulations, 2003 shall fulfil the networth requirements within two years from the date of such commencement.

18.3 Responsibilities and Obligations of Debenture Trustees

18.3.1 Obligations before appointment as Debenture Trustees

No debenture trustee shall act as such in respect of each issue of debenture unless –

a. he enters into a written agreement with the body corporate before the opening of the subscription list for issue of debentures;

b. the agreement shall contain (i) that the debenture trustee has agreed to act as such under the trust deed for securing an issue of debentures for the body corporate; (ii) the time limit within which the security for the debentures shall be created.

18.3.2 Debenture Trustee not to act for an associate

No debenture trustee shall act as such for any issue of debentures in case—
(a) it is an associate of the body corporate, or
(b) it has lent and the loan is not yet fully repaid or is proposing to lend money to the body corporate ***provided*** that this requirement shall not be applicable in respect of debentures issued prior to the commencement of the Companies (Amendment) Act, 2000, where—
(i) recovery proceedings in respect of the assets charged against security has been initiated, or
(ii) the body corporate has been referred to Board for Industrial and Financial Reconstruction under the Sick Industrial Companies (Special Provisions) Act, 1985,prior to commencement of SEBI (Debenture Trustees) Regulations, 2003.

18.3.3 Obligation of the Debenture Trustees towards content of the trust deed

Every debenture trustee shall ensure that the trust deed executed between a body corporate and debenture trustee shall amongst other things provide for the following matters namely-

1. *Preamble:* shall state the rights of the debenture holders and the manner in which these rights are vested in the trustee.
2. *Description of Instruments:* shall state the purpose of raising finance and the details of the debentures eg, tenure, interest/coupon, periodicity of payment etc.
3. *Details of Charged Securities (existing or future):* shall contain the details with reference to Nature of charge, rank of charge of assets, charging of future assets, time limit within which the future security for the issue of debentures shall be created, enforceability of securities, circumstances when the security will become enforceable etc.
4. *Events of Defaults:* shall define the event of default which if occurs shall invite the actions by debenture trustee.
5. *Rights of Debenture Trustees*
6. *Obligations of body corporate*
7. *Miscellaneous issues* such as procedure for appointment and removal of trustee including appointment of new trustees, provision that the debenture trustee shall not relinquish from its assignment unless another debenture trustee has been appointed etc .

18.3.4 Duties of the Debenture Trustees

It shall be the duty of every debenture trustee to—

(a) Call for periodical reports from the body corporate;

(b) Take possession of trust property in accordance with the provisions of the trust deed;

(c) Supervise the implementation of the conditions regarding creation of security for the debentures and debenture redemption reserve, wherever applicable;

(d) Enforce security in the interest of the debenture holders;

(e) Do such acts as are necessary in the event the security becomes enforceable;

(f) Carry out such acts as are necessary for the protection of the debenture holders and to do all things necessary in order to resolve the grievances of the debenture holders;

(g) Ascertain and satisfy itself that; (i) in case where the allotment letter has been issued and debenture certificate is to be issued after registration of charge, the debenture certificates have been despatched by the body corporate to the debenture holders within 30 days of the registration of the charge with the Registrar of Companies; (ii) debenture certificates have been despatched to the debenture holders in accordance with the provisions of the Companies Act; (iii) interest warrants for interest due on the debentures have been despatched to the debenture holders on or before the due dates; (iv) debenture holders have been paid the monies due to them on the date of redemption of the debentures;

(h) Ensure on a continuous basis that the property charged to the debentures is available and adequate at all times to discharge the interest and principal amount payable in respect of the debentures and that such property is free from any other encumbrances save and except those which are specifically agreed to by the debenture trustee;

(i) Exercise due diligence to ensure compliance by the body corporate, with the provisions of the Companies Act, the listing agreement of the stock exchange or the trust deed;

(j) To take appropriate measures for protecting the interest of the debenture holders as soon as any breach of the trust deed or law comes to his notice;

(k) To ascertain that the debentures have been converted or redeemed in accordance with the provisions and conditions under which they are offered to the debenture holders;

(l) Inform SEBI immediately of any breach of trust deed or provision of any law;

(m) Appoint a nominee director on the Board of the body corporate in the event of: (i) two consecutive defaults in payment of interest to the debenture holders; or (ii) default in creation of security for debentures; or (iii) default in redemption of debentures;

(n) communicate to the debenture holders on half yearly basis the compliance of the terms of the issue by the body corporate, defaults, if any, in payment of interest or redemption of debentures and action taken thereof.

The debenture trustee shall:

(a) obtain reports from the lead bank regarding progress of the project;
(b) monitor utilisation of funds raised in the issue;

(c) obtain a certificate from the issuer's auditors with respect to (i) utilisation of funds during the implementation period of the project; and(ii) cases of debentures issued for financing working capital, at the end of each accounting year.

A debenture trustee shall call or cause to be called by the body corporate a meeting of all the debenture holders on—

(a) a requisition in writing signed by at least one-tenth of the debenture holders in value for the time being outstanding;

(b) the happening of any event, which constitutes a default or which in the opinion of the debenture trustees affects the interest of the debenture holders.

No debenture trustee shall relinquish its assignments as debenture trustee in respect of the debenture issue of any body corporate, unless and until another debenture trustee is appointed in its place by the body corporate.

A debenture trustee may inspect books of account, records, registers of the body corporate and the trust property to the extent necessary for discharging its obligations.

18.3.5 Maintenance of books of account, records, documents etc.

Every debenture trustee shall keep and maintain proper books of account, records and documents, relating to the trusteeship functions for a period of not less than five financial years preceding the current financial year. Every debenture trustee shall intimate to SEBI, the place where the books of account, records and documents are maintained.

18.4 Code of Conduct for the Debenture Trustees

Regulation 16 of the SEBI (Debenture Trustees) Regulations, 1993 read alongwith Schedule III details the code of conduct for the debenture trustees. A debenture trustee shall:

1. Make all efforts to protect the interest of debenture holders.
2. Maintain high standards of integrity, dignity and fairness in the conduct of its business.
3. Fulfil its obligations in a prompt, ethical and professional manner.
4. At all times exercise due diligence, ensure proper care and exercise independent professional judgment.
5. Take all reasonable steps to establish the true and full identity of each of its clients, and of each client's financial situation and maintain record of the same.
6. Ensure that any change in registration status/any penal action taken by SEBI or any material change in financial position which may adversely affect the interests of clients/debenture holders is promptly informed to the clients and any business remaining outstanding is transferred to another registered intermediary in accordance with any instructions of the affected clients.
7. Avoid conflict of interest and make adequate disclosure of its interest.
8. Not divulge to anybody either orally or in writing, directly or indirectly, any confidential information about its clients which has come to its knowledge, without taking prior permis-

sion of its clients, except where such disclosures are required to be made in compliance with any law for the time being in force.

9. Put in place a mechanism to resolve any conflict of interest situation that may arise in the conduct of its business or where any conflict of interest arises, shall take reasonable steps to resolve the same in an equitable manner.
10. Make appropriate disclosure to the client of its possible source or potential areas of conflict of duties and interest while acting as debenture trustee which would impair its ability to render fair, objective and unbiased services.
11. Not indulge in any unfair competition, which is likely to harm the interests of other trustees or debenture holders or is likely to place such other debenture trustees in a disadvantageous position while competing for or executing any assignment nor shall it wean away the clients of another trustee on assurance of lower fees.
12. Not discriminate among its clients, except and save on ethical and commercial considerations.
13. Share information available with it regarding client companies, with registered credit rating agencies.
14. Provide clients and debenture holders with adequate and appropriate information about its business, including contact details, services available to clients, and the identity and status of employees and others acting on its behalf with whom the client may have to contact.
15. Ensure that adequate disclosures are made to the debenture holders, in a comprehensible and timely manner so as to enable them to make a balanced and informed decision.
16. Endeavour to ensure that (a) inquiries from debenture holders are adequately dealt with; (b) grievances of debenture holders are redressed in a timely and appropriate manner;(c) where a complaint is not redressed promptly, the debenture holder is advised of any further steps which may be available to the debenture holder under the regulatory system.
17. Make reasonable efforts to avoid misrepresentation and ensure that the information provided to the debenture holders is not misleading.
18. Maintain required level of knowledge and competency and abide by the provisions of the Act, regulations and circulars and guidelines. The debenture trustee shall also comply with the award of the Ombudsman passed under the Securities and Exchange Board of India (Ombudsman) Regulations, 2003.
19. Not make untrue statement or suppress any material fact in any documents, reports, papers or information furnished to SEBI.
20. A Debenture Trustee or any of its directors, partners or manager having the management of the whole or substantially the whole of affairs of the business, shall not either through its account or their respective accounts or through their associates or family members, relatives or friends indulge in any insider trading.
21. Ensure that SEBI is promptly informed about any action, legal proceeding, etc., initiated against it in respect of any material breach or non-compliance by it, of any law, rules, regulations, directions of SEBI or of any other regulatory body.
22. Not render, directly or indirectly, any investment advice about any security in the publicly accessible media, whether real-time or non-real-time unless a disclosure of his interest in-

cluding long or short position in the said security has been made, while rendering such advice; (b) In case, an employee of the Debenture Trustee is rendering such advice, the debenture trustee shall ensure that he discloses his interest, the interest of his dependent family members and that of the employer, including their long or short position in the said security, while rendering such advice.

23. Ensure that any person it employs or appoints to conduct business is fit and proper and otherwise qualified to act in the capacity so employed or appointed (including having relevant professional training or experience.
24. Ensure that it has adequate resources to supervise diligently and does supervise diligently persons employed or appointed by it to conduct business on its behalf.
25. Have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operations, its clients, debenture holders and other registered entities from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions.
26. Be responsible for the acts or omissions of its employees and agents in respect to the conduct of its business.
27. Provide adequate freedom and powers to its compliance officer for the effective discharge of its duties.
28. Ensure that the senior management, particularly decision makers have access to all relevant information about the business on a timely basis.
29. Ensure that good corporate policies and corporate governance is in place.
30. Develop its own internal code of conduct for governing its internal operations and laying down its standards of appropriate conduct for its employees and officers in the carrying out of their duties. Such a code may extend to the maintenance of professional excellence and standards, integrity, confidentiality, objectivity, avoidance of conflict of interests, disclosure of shareholdings and interests, etc.
31. Not be party to (i) creation of false market;(ii) price rigging or manipulation;(iii) passing of unpublished price sensitive information in respect of securities which are listed and proposed to be listed in any stock exchange to any person or intermediary.

18.5 Dissemination of Information

Debenture trustees shall disclose the information to the investors and the general public by issuing a press release in any of the following events:

- Default by issuer company to pay interest on debentures or redemption amount;
- Failure to create a charge on the assets;
- Revision of rating assigned to the debentures.

The aforementioned information need to be placed on the website of the debenture trustee. Further all information/reports on debentures issued including compliance reports filed by the

companies and the debenture trustees shall be made public by disseminating on the websites of the companies and the debenture trustees.

Review Questions

1. As per SEBI (Debenture Trustees) Regulations, which of the following can apply to register a Debenture Trustee?

   (a) Scheduled Bank

   (b) Public Finance Institution

   (c) Insurance Company

   (d) All of the above

Ans: (d)

2. As per the SEBI (Debenture Trustee) Regulations, the certificate of registration as Debenture Trustee is valid for a period of _____ years.

   (a) 1

   (b) 2

   (c) 3

   (d) 4

Ans: (c)

3. As per the SEBI (Debenture Trustees) Regulations, debenture trustee shall communicate to the debenture holders on _____ basis regarding compliance, defaults, etc and the action taken by it.

   (a) Monthly

   (b) Quarterly

   (c) Half yearly

   (d) Annually

Ans: (c)

4. The debenture trustee shall comply with the award of Ombudsman passed under the Securities and Exchange Board of India(Ombudsman) Regulations, 2003. State whether True or False?

   (a) True

   (b) False

Ans: (a)

Unit 19: SEBI (Credit Rating Agencies) Regulations, 1999

19.1 Registration as a Credit Rating Agency

Credit rating agencies are body corporate which is engaged in, or proposes to be engaged in, the business of rating of securities offered by way of public or rights issue. Any person wanting to commence business as a credit rating agency should make an application to SEBI in the format as prescribed by SEBI.

Promoter of Credit Rating Agency

SEBI shall not consider the application, unless the applicant is promoted by a person belonging to any one of the following categories, namely:

(a) a public financial institution, as defined in section 2(72) of the Companies Act, 2013;
(b) a scheduled commercial bank included for the time being in the second schedule to the Reserve Bank of India Act, 1934;
(c) a foreign bank operating in India with the approval of the Reserve Bank of India;
(d) a foreign credit rating agency recognised by or under any law for the time being in force in the country of its incorporation, having at least 5 years of experience in rating securities;
(e) any company or a body corporate, having continuous net worth of minimum Rs.one hundred crores as per its audited annual accounts for the previous five years prior to filing of the application with SEBI for the grant of certificate under these regulations.

19.1.1 Eligibility Criteria

Further, the applicant shall also satisfy the following conditions, for SEBI to consider the application for grant of certificate:

a) the applicant is set up and registered as a company under the Companies Act, 1956;
b) the applicant has, in its Memorandum of Association, specified rating activity as one of its main objects;
c) the applicant has a minimum net worth of Rs.5 crores, ***provided*** that a credit rating agency existing at the commencement of these regulations, with a net worth of less than Rs. 5 crores, shall be deemed to have satisfied this condition, if it increases its net worth tithe said minimum within a period of three years of such commencement.
d) the applicant has adequate infrastructure, to enable it to provide rating services in accordance with the provisions of the Act and these regulations;
e) the applicant and the promoters of the applicant, have professional competence, financial soundness and general reputation of fairness and integrity in business transactions, to the satisfaction of SEBI;
f) neither the applicant, nor its promoter, nor any director of the applicant or its promoter, is involved in any legal proceeding connected with the securities market, which may have an adverse impact on the interests of the investors;

g) neither the applicant, nor its promoters, nor any director, of its promoter has at any time in the past been convicted of any offence involving moral turpitude or any economic offence;
h) the applicant has, in its employment, persons having adequate professional and other relevant experience to the satisfaction of SEBI;
i) neither the applicant, nor any person directly or indirectly connected with theapplicant has in the past been (i) refused by SEBI a certificate under these regulations or (ii) subjected to any proceedings for a contravention of the Act or of any rules or regulations made under the Act.
j) the applicant, in all other respects, is a fit and proper person for the grant of a certificate;
k) grant of certificate to the applicant is in the interest of investors and the securities market.

19.1.2 Certificate Renewal and Validity

The period of validity of the certificate granted to the Credit Rating Agency is three years. The Credit Rating Agency on being granted the registration certificate shall pay to SEBI the registration fee of Rs. 20 lakh. Application for renewal can be made to SEBI three months prior to the expiry of the certificate accompanied with the renewal fees. The renewal fee is Rs. 10 lakh.

19.2 General Obligations of Credit Rating Agencies

19.2.1 Agreement with client

Every credit rating agency shall enter into a written agreement with each client whose securities it proposes to rate, and every such agreement shall include the following provisions, namely:-

a) Rights and liabilities of each party in respect of the rating of securities;
b) Fees which shall be charged by the credit rating agency;
c) That the client shall agree to a periodic review of the rating by the credit rating agency during the tenure of the rated instrument;
d) That the client shall agree to co-operate with the credit rating agency in order to enable the latter to arrive at, and maintain, a true and accurate rating of the clients securities and shall in particular provide to the latter, true, adequate and timely information for the purpose;
e) The credit rating agency shall disclose to the client the rating assigned to the securities of the latter through regular methods of dissemination, irrespective of whether the rating is or is not accepted by the client;
f) The client shall agree to disclose, in the offer document (i) the rating assigned to the client's listed securities by any credit rating agency during the last three years; and(ii) any rating given in respect of the client's securities by any other credit rating agency, which has not been accepted by the client;
g) The client shall agree to obtain a rating from at least two different rating agencies for any issue of debt securities whose size is equal to or exceedsRs.100 crores.

19.2.2 Monitoring of Ratings

Every credit rating agency shall, during the lifetime of securities rated by it continuously monitor the rating of such securities. The credit rating agencies shall also disseminate information regarding newly assigned ratings, and changes in earlier rating promptly through press releases and websites. In the case of securities issued by listed companies, such information shall also be

provided simultaneously to the concerned regional stock exchange and to all the stock exchanges where the said securities are listed.

19.2.3 Procedure for review of Rating

Every credit rating agency shall carry out periodic reviews of all published ratings during the lifetime of the securities. In case where the client does not co-operate with the credit rating agency so as to enable the credit rating agency to comply with its obligations of monitoring of ratings, the credit rating agency shall carry out the review on the basis of the best available information ***provided*** that they disclose to the investors that owing to such lack of co-operation, a rating has been based on the best available information.

A credit rating agency shall not withdraw a rating so long as the obligations under the security rated by it are outstanding, except where the company whose security is rated is wound up or merged or amalgamated with another company.

19.2.4 Internal procedures to be framed

Every credit rating agency shall frame appropriate procedures and systems for monitoring the trading of securities by its employees in the securities of its clients, in order to prevent contravention of;
(a) The Securities and Exchange Board of India (Insider Trading) Regulations,1992;
(b) The Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to the Securities Market) Regulations,1995; and
(c) Other laws relevant to trading of securities.

19.2.5 Disclosure of Rating Definitions and Rationale

Every credit rating agency shall:
a) make the definitions of the concerned rating, along with the symbolavailable in the public domain. They shall also make available to the general public information relating to the rationale of the ratings, which shall cover an analysis of the various factors justifying a favourable assessment, as well as factors constituting a risk.
b) state that the ratings do not constitute recommendations to buy, hold or sell any securities.

19.2.6 Submission of information to SEBI

Every credit rating agency shall comply with such guidelines, directives, circulars and instructions as may be issued by SEBI from time to time, on the subject of credit rating. The credit rating agency shall furnish information as sought by SEBI–

(a) within a period specified by SEBI or
(b) if no such period is specified, then within a reasonable time.

Every credit rating agency shall, at the close of each accounting period, furnish to SEBI copies of its balance sheet and profit and loss account.

19.2.7 Maintenance of Books of Accounts, records, etc.

Regulation 21 of the SEBI (Credit Rating Agencies), 1999 provides that every credit rating agency shall keep and maintain, for a minimum period of five years, the following books of accounts, records and documents, namely:

- copy of its balance sheet, as on the end of each accounting period;
- copy of its profit and loss account for each accounting period;
- copy of the auditor's report on its accounts for each accounting period.
- copy of the agreement entered into, with each client;
- information supplied by each of the clients;
- correspondence with each client;
- ratings assigned to various securities including up-gradation and down-gradation (if any) of the ratings so assigned.
- rating notes considered by the rating committee;
- record of decisions of the rating committee;
- letter assigning rating;
- particulars of fees charged for rating and such other records as SEBI may specify from time to time.

The credit rating agency shall also intimate to SEBI the place where the books of account, records and documents as required under the regulations are kept.

19.2.8 Steps on auditor's report

Every credit rating agency shall, within two month's from the date of the auditor's report, take steps to rectify the deficiencies if any, made out in the auditor's report.

19.2.9 Confidentiality

Every credit rating agency shall treat, as confidential, information supplied to it by the client and no credit rating agency shall disclose the same to any other person, except where such disclosure is required or permitted by under or any law for the time being in force.

19.2.10 Rating process

Every credit rating agency shall specify the rating process and file a copy of the same and any modifications or additions made therein from time to time with SEBI for record. The credit rating agency shall, in all cases, follow a proper rating process. They should have professional rating committees, comprising members who are adequately qualified and knowledgeable to assign a rating.

All rating decisions, including the decisions regarding changes in rating, shall be taken by the rating committee. Every credit rating agency shall have qualified analysts to carry out a rating assignment. Every credit rating agency shall inform SEBI about new rating instruments or symbols introduced by it.

Every credit rating agency, shall, while rating a security, exercise due diligence in order to ensure that the rating given by the credit rating agency is fair and appropriate. A credit rating agency shall not rate securities issued by it.

Rating definition, as well as the structure for a particular rating product, shall not be changed by a credit rating agency, without prior information to SEBI.A credit rating agency shall disclose to the concerned stock exchange through press release and websites for general investors, the rating assigned to the securities of a client, after periodic review, including changes in rating, if any.

19.3 Restrictions on Rating of Securities issues by Promoters

Securities Issues by Promoter

No credit rating agency shall rate a security issued by its promoters. Where the promoter is a leading institution, its Chairman, director or employee shall not be a Chairman, director or employee of the credit rating agency or its rating committee.

Securities Issues by Entities connected with Promoter etc.

The credit rating agency shall not rate a security issued by an entity, which is a borrower of its promoter, or a subsidiary of its promoter, or an associate of its promoter if there are common Chairman, Directors between credit rating agency and these entities, there are common employees, there are common chairman, Directors, Employees on the rating Committee.

No credit rating agency shall rate a security issued by its associate or subsidiary, if the credit rating agency or its rating committee has a Chairman, director or employee who is also a Chairman, director or employee of any such entity.

19.4 Code of conduct of the Credit Rating Agencies

Regulation 13 of the SEBI (Credit Rating Agencies) detail out the code of conduct to be followed by the Credit Rating Agencies. A credit rating agency shall:

1. Make all efforts to protect the interests of investors.
2. In the conduct of its business, shall observe high standards of integrity, dignity and fairness in the conduct of its business.
3. Fulfil its obligations in a prompt, ethical and professional manner.
4. At all times exercise due diligence, ensure proper care and exercise independent professional judgment in order to achieve and maintain objectivity and independence in the rating process.
5. A credit rating agency shall have a reasonable and adequate basis for performing rating evaluations, with the support of appropriate and in-depth rating researches. It shall also maintain records to support its decisions.
6. Have in place a rating process that reflects consistent and international rating standards.

7. Not indulge in any unfair competition nor shall it wean away the clients of any other rating agency on assurance of higher rating.
8. Keep track of all important changes relating to the client companies and shall develop efficient and responsive systems to yield timely and accurate ratings. Further a credit rating agency shall also monitor closely all relevant factors that might affect the creditworthiness of the issuers.
9. Disclose its rating methodology to clients, users and the public.
10. Disclose to the clients, possible sources of conflict of duties and interests, which could impair its ability to make fair, objective and unbiased ratings. Further it shall ensure that no conflict of interest exists between any member of its rating committee participating in the rating analysis, and that of its client.
11. Not make any exaggerated statement, whether oral or written, to the client either about its qualification or its capability to render certain services or its achievements with regard to the services rendered to other clients.
12. Not make any untrue statement, suppress any material fact or make any misrepresentation in any documents, reports, papers or information furnished to SEBI, stock exchange or public at large.
13. Ensure that SEBI is promptly informed about any action, legal proceedings etc., initiated against it alleging any material breach or non-compliance by it, of any law, rules, regulations and directions of SEBI or of any other regulatory body.
14. Maintain an appropriate level of knowledge and competence and abide by the provisions of the Act, regulations and circulars, which may be applicable and relevant to the activities carried on by the credit rating agency. The credit rating agency shall also comply with award of the Ombudsman passed under the Securities and Exchange Board of India (Ombudsman) Regulations, 2003.
15. Ensure that there is no misuse of any privileged information including prior knowledge of rating decisions or changes.
16. Not render, directly or indirectly any investment advice about any security in the publicly accessible media. They shall not offer fee-based services to the rated entities, beyond credit ratings and research.
17. Ensure that any change in registration status/any penal action taken by SEBI or any material change in financials which may adversely affect the interests of clients/investors is promptly informed to the clients and any business remaining outstanding is transferred to another registered person in accordance with any instructions of the affected clients/investors.
18. Maintain an arm's length relationship between its credit rating activity and any other activity.
19. Develop its own internal code of conduct for governing its internal operations and laying down its standards of appropriate conduct for its employees and officers in the carrying out of their duties within the credit rating agency and as a part of the industry. Such a code may
20. Extend to the maintenance of professional excellence and standards, integrity, confidentiality, objectivity, avoidance of conflict of interests, disclosure of shareholdings and interests, etc. Such a code shall also provide for procedures and guidelines in relation to the estab-

lishment and conduct of rating committees and duties of the officers and employees serving on such committees.

21. Provide adequate freedom and powers to its compliance officer for the effective discharge of his duties.
22. Ensure that the senior management, particularly decision makers have access to all relevant information about the business on a timely basis.
23. Ensure that good corporate policies and corporate governance are in place.
24. Not generally and particularly in respect of issue of securities rated by it, be party to or instrumental for (a) creation of false market;(b) price rigging or manipulation; or (c) dissemination of any unpublished price sensitive information in respect of securities which are listed and proposed to be listed in any stock exchange, unless required, as part of rationale for the rating accorded

19.5 Guidelines for Credit Rating Agencies

SEBI vide its circular Ref. No. MIRSD/CRA/6/2010, dated 3-5-2010 have prescribed certain transparency and disclosure norms for the Credit Rating Agencies with respect to its Rating process, Dealings with Conflict of Interest, Obligations in respect of Rating of Structured Finance Products, Unsolicited Credit Ratings, Disclosures to be made on their websites etc.

SEBI has issued further guidelines for Credit Rating Agencies on 1st March, 2012. As per this guideline, according to SEBI (Credit Rating Agencies) Regulations, 1999 (the Regulations), a credit rating agency (CRA) has been defined as a body corporate which is engaged in the business of rating of securities offered by way of public or rights issues. The term "securities" has been defined in Clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956. The CRAs registered with SEBI also carry out rating of other securities / instruments and loans / facilities provided by banks which are not regulated by SEBI. Such ratings are being used by the other regulators or their regulated entities for the specified purposes. Therefore, all ratings have now been brought within the purview of the CRA Regulations irrespective of whether it is within the meaning of the term 'securities' or otherwise.

Review Questions

1. For SEBI to consider the application of registration as a credit rating agency of an entity promoted by a company, the promoter shall have a continuous networth of minimum _____ for the previous five year.

   (a) Rs. 1 crore

   (b) Rs. 10 crore

   (c) Rs. 100 crore

   (d) Rs. 1000 crore

Ans: (c)

2. As per the SEBI (Credit Rating Agencies) Regulations, the certificate of registration as credit rating agency is valid for a period of _____ years.

   (a) 1

   (b) 2

   (c) 3

   (d) 4

Ans: (c)

3. What is the renewal fee to keep the registration in force as credit rating agency?

   (a) Rs. 10 lakh

   (b) Rs. 50 lakh

   (c) Rs. 20 lakh

   (d) Rs. 25 lakh

Ans: (a)

4. A credit rating agency encouraged its client-facing employees to assure a higher rating to the clients than the competitors. Is it a violation as per the SEBI code of conduct of credit rating agencies?

   (a) Yes

   (b) No

Ans: (a)

Unit 20: SEBI (Custodian of Securities) Regulations, 1996

20.1 Custodian and Custodial Services

A “Custodian of Securities" is any person who carries on or proposes to carry on the business of providing custodial services. Custodial services in relation to securities of a client or gold or gold related instruments held by a mutual fund or title deeds of real estate assets held by a real estate mutual fund scheme in accordance with the SEBI (Mutual Funds) Regulations, 1996 means, safekeeping of such securities or gold or gold related instruments or title deeds of real estate assets and providing services incidental thereto, and includes—

i. maintaining accounts of securities or gold or gold related instruments or title deeds of real estate assets of a client;

ii. undertaking activities as a Domestic Depository in terms of the Companies (Issue of Indian Depository Receipts) Rules, 2004;

iii. collecting the benefits or rights accruing to the client in respect of securities or gold or gold related instruments or title deeds of real estate assets;

iv. keeping the client informed of the actions taken or to be taken by the issuer of securities, having a bearing on the benefits or rights accruing to the client; and

v. maintaining and reconciling records of the services as have been referred to in the above points(i) to (iii).

20.2 Registration and Eligibility

Any person proposing to act as a custodian of securities need to get himself registered with SEBI. As stated in Regulation 6 of the SEBI (Custodian of Securities) Regulations, 1996, SEBI will consider the application for grant of certificate after looking into the following:

a. the applicant should fulfil the capital requirement in accordance with regulation;
b. the applicant should have the necessary infrastructure, including adequate office space, vaults for safe custody of securities and computer systems capability, required to effectively discharge his activities as custodian of securities;
c. the applicant should have the requisite approvals under any law for the time being in force, in connection with providing custodial services in respect of gold or gold related instruments of a mutual fund or the title deeds of a real estate assets held by a real estate mutual funds scheme , where applicable;
d. the applicant should have employed adequate and competent persons who have the experience, capacity and ability of managing the business of the custodian of securities;
e. the applicant should have prepared a complete manual, setting out the systems and procedures to be followed by him for the effective and efficient discharge of his functions and the arms length relationships to be maintained with the other businesses, if any, of the applicant;
f. whether the applicant is a person who has been refused a certificate by SEBI or whose certificate has been cancelled by SEBI;

g. whether the applicant, his director, his principal officer or any of his employees is involved in any litigation connected with the securities market;
h. the grant of certificate should be in the interest of investors;
i. the applicant should be fit and proper person as defined in the SEBI (Intermediaries) Regulations, 2008.

Capital Adequacy Requirements

An applicant for the Custodian of Securities should have a networth of minimum of Rs. 50 crores.

Period of Validity of Certificate

Every certificate grated to the applicant as a Custodian of Securities shall be valid for a period of three years from the date of registration or its renewal. Application of renewal shall be made to SEBI atleast three months prior to the expiry of its certificate.

On being granted the certificate of registration, the Custodian of securities need to pay registration fee of Rs. 15 lakh to SEBI, and an annual fee of Rs. 10 lakh or 0.00025% of the 'assets under custody' of the custodian of securities, whichever is higher. The annual fee shall be payable with reference to each financial year, within one month of completion of the financial year.

20.3 General Obligations and Responsibilities of Custodians

20.3.1 Segregation of Activities

In cases where the custodian of securities is carrying on any activity besides that of acting as custodian of securities, then, he should ensure that the activities relating to his business as custodian of securities is separate and segregated from all other activities. Further the officers and employees engaged in providing custodial services shall not be engaged in any other activity carried on by him.

20.3.2 Monitoring, Review evaluating and inspecting systems and controls

Every custodian of securities shall have in place adequate mechanisms for the purposes of reviewing, monitoring and evaluating the custodian's controls, systems, procedures and safeguards. The custodian of securities shall have the mechanisms inspected annually by an expert and shall forward the inspection report to SEBI within three months from the date of inspection.

20.3.3 Prohibition of assignment

Custodian of securities shall not assign or delegate its functions as a custodian of securities to any other person unless such person is a custodian of securities ***provided*** that a custodian of securities may engage the services of a person not being a custodian, for the purpose of physical safekeeping of gold belonging to its client being a mutual fund having a gold exchange traded fund scheme. However, this would be subject to the following conditions—

- the custodian of securities shall remain responsible in all respects to its client for safekeeping of the gold kept with such other person, including any associated risks;
- all books, documents and other records relating to the gold so kept with the other person shall be maintained in the premises of the custodian or if they are not so maintained, they shall be made available therein, if so required by SEBI;
- the custodian of securities shall continue to fulfil all duties to the clients relating to the gold so kept with the other person, except for its physical safekeeping.

20.3.4 Separate custody account

Every custodian of securities shall open a separate custody account for each client, in the name of the client whose securities are in its custody and the assets of one client shall not be mixed with those of another client.

20.3.5 Agreement with the client

Every custodian of securities shall enter into an agreement with each client on whose behalf it is acting as custodian of securities and every such agreement shall provide for the following matters:

- the circumstances under which the custodian of securities will accept or release securities assets or documents from the custody account;
- the circumstances under which the custodian of securities will accept or release monies from the custody account;
- the circumstances under which the custodian of securities will receive rights or entitlements on the securities of the client;
- the circumstances and the manner of registration of securities in respect of each client; &
- details of the insurance, if any, to be provided for by the custodian of securities.

20.3.6 Internal controls

Every custodian of securities shall have adequate internal controls to prevent any manipulation of records and documents including audits for securities and rights or entitlements arising from the securities held by it on behalf of its client. Every custodian of securities shall have appropriate safekeeping measures to ensure that such securities, assets or documents are protected from theft and natural hazard.

20.3.7 Maintenance of records and documents and furnishing of information

Without prejudice to the provisions of any other law for the time being in force every custodian of securities shall maintain the following records and documents for a minimum period of five years:

a. records containing details of securities, assets or documents received and released on behalf of each client;

b. records containing details of monies received and released on behalf ofeach client;

c. records containing details of rights or entitlements of each client arising from the securities held on behalf of the client;

d. records containing details of registration of securities in respect of each client;

e. ledger for each client;

f. records containing details of instructions received from and sent to clients; and

g. records of all reports submitted to SEBI.

Further the custodian of securities shall also inform SEBI the place where the records and documents as mentioned above are maintained.

20.4 Code of Conduct

SEBI (Custodian of Securities) Regulations, 1996 prescribes the Code of Conduct for the Custodian of Securities which we discuss below. The Custodian of Securities shall:

1. Maintain the highest standard of integrity, fairness and professionalism in the discharge of his duties.
2. Be prompt in distributing dividends, interest or any such accruals of income received or collected by him on behalf of his clients on the securities held in custody.
3. Be continuously accountable for the movement of securities in and out of custody account, deposit, and withdrawal of cash from the client's account and shall provide complete audit trail, whenever called for by the client or SEBI.
4. Establish and maintain adequate infrastructural facility to be able to discharge custodial services to the satisfaction of clients, and the operating procedures and systems of the custodian of securities shall be well documented and backed by operations manuals.
5. Maintain client confidentiality in respect of the client's affairs. Where custodian records are kept electronically, the custodian of securities has to take necessary precautions to ensure that continuity in record keeping is not lost or destroyed and that sufficient back up of records is available.
6. Create and maintain the records of securities held in custody in such manner that the tracing of securities or obtaining duplicate title documents is facilitated, in the event of loss of original records for any reason.
7. Extend to other custodial entities, depositories and clearing organizations all such cooperation that is necessary for the conduct of business in the areas of inter custodial settlements, transfer of securities and transfer of funds.
8. Ensure that an arms length relationship is maintained, both in terms of staff and systems, from his other businesses.
9. Exercise due diligence in safe-keeping and administration of the assets of his clients in his custody for which he is acting as custodian of securities.
10. Not render, directly or indirectly any investment advice about any security in the publicly accessible media, whether real-time or non-real-time, unless a disclosure of his interest including long or short position in the said security has been made, while rendering such advice. In case an employee of the custodian of securities is rendering such advice, he shall

also disclose the interest of his dependent family members and employer including their long or short position in the said security, while rendering such advice.

Review Questions

1. A person who carries on or proposed to carry on the business of providing custodial services is called _____.

   (a) Depository

   (b) Custodian

   (c) Debenture trustee

   (d) Underwriter

Ans: (b)

2. The certificate of registration as custodian is valid for a period of _____ years as per the SEBI (Custodian of Securities) Regulations.

   (a) 1

   (b) 2

   (c) 3

   (d) 4

Ans: (c)

3. The custodian should segregate his custodial activities from his other activities. State whether True or False?

   (a) True

   (b) False

Ans: (a)

4. As per the SEBI (Custodian of Securities) Regulations, every custodian shall maintain the records and documents for a minimum period of _____ years.

   (a) 3

   (b) 5

   (c) 7

   (d) 10

Ans: (b)

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