Before the

MEMBER AND CORE SETTLEMENT GUARANTEE FUND COMMITTEE

Of

NSE Clearing Limited

Exchange Plaza, Bandra Kurla Complex, Bandra East, Mumbai – 400051

Held on February 12, 2020

In the matter of Clearing Member

M/s Edelweiss Custodial Services Ltd

CORAM:

Mrs Bhagyam Ramani (through Video conference)	- Chairperson of the Committee
Mr. N.K.Maini	- Committee Member
Mr Harun R Khan	- Committee Member
Mr. Vikram Kothari	- Committee Member

Also Present:

Mr. Dhawal Shah - Head - Compliance

Ms Jinal Shah - Sr. Manager

BACKGROUND

1. Edelweiss Custodial Services Limited (hereinafter referred as the "**Noticee**"), having its office at Edelweiss House, 14th floor, Off CST Road, Kalina, Mumbai 400098, is registered as a professional clearing member with the NSE Clearing Limited ("**NCL**") (SEBI Registration No. INZ000177437).

2. NCL received an email dated November 13, 2019 from the Noticee (which was jointly addressed to the National Stock Exchange ("**NSE**") and NCL) in respect of Vrise Securities Private Limited (a trading member with NSE which has been clearing trades in the futures and options ("**F&O**") segment of NSE through the Noticee as the Clearing Member) ("**VRISE**") stating, *inter alia*, as under:

a. As on November 13, 2019, there were outstanding dues of around Rs 19.46 crore towards the settlement obligations of VRISE ("**Unpaid Dues**") and against such Unpaid Dues, the Noticee held collaterals to the tune of approximately Rs 36 crores.
b. The securities received by the Noticee as collateral have been received from the demat account of VRISE. VRISE has also confirmed that these securities belong to it and are free from encumbrances.
c. The Unpaid Dues had been outstanding since November 07, 2019. The Noticee had called for the settlement of the Unpaid Dues *vide* its letters dated November 11, 2019 and November 13, 2019.

d. Since November 11, 2019, the Noticee had received mails from 7 clients of VRISE seeking release of their securities/ funds.

e. VRISE vide its email dated November 08, 2019 had mentioned about collateral offered by it belonging to some clients. Such intimation was after VRISE had defaulted in payment to the Noticee.

f. There seemed to be client related issues at VRISE's end.

g. Considering the investor concerns, the Noticee was seeking guidance from the NSE and the NCL on how to deal with surplus collaterals after recovery of their dues.

3. In response to the Noticee's abovementioned email dated November 13, 2019 seeking guidance from NSE and NCL, on November 14, 2019, NSE addressed an email to the Noticee (copying NCL therein) expressly stating that "*in accordance with the rules and regulations of SEBI/ Exchange / CC and the TM/CM Agreement, you are advised to ensure that client securities are **not** utilized for meeting the TM's proprietary account obligations / dues*".

(Emphasis Supplied)

4. In response, on November 22, 2019, the Noticee addressed its letter sent by email to NSE and NCL, narrating certain matters including that it had received mails from a few clients of VRISE requesting for release of their (i.e. the clients') securities; acknowledging that these clients were registered with VRISE; stating that the Noticee had not received any securities directly from the clients' accounts; acknowledging that effective August 1, 2019 as per NSE's circular, the Trading Member (VRISE in this case) was to report client holdings to the Clearing Member (the Noticee in this case) – which

VRISE as Trading Member had done; expressing a view that the collateral placed by VRISE with it can be used by it for recovery of VRISE's dues to it as they are not client securities as per the Noticee's records. In conclusion, the Noticee stated that it trusted that NSE and NCL were in concurrence with its view; and that the Noticee would be grateful if NSE and NCL could guide the Noticee on the manner of dealing with surplus collateral that may lie with them post recovery of their dues.

5. In response to the Noticee's above email / letter, NSE again wrote to the Noticee (with copy to NCL) *vide* its email of November 24, 2019 expressly stating that "*we again reiterate that, in accordance with the rules and regulations of SEBI/ Exchange / CC and the TM/CM Agreement, you are advised to ensure that client securities are not utilized for meeting the TM's proprietary account obligations / dues. You are therefore requested to maintain status quo in the matter".*

(Emphasis Supplied)

6. By another email of December 2, 2019 to the Noticee (with copy to NCL), NSE informed the Noticee that it had not given the clarification that the Noticee, by its letter of November 22, 2019, was seeking to say that NSE had given at point 9 of NSE's email dated August 19, 2019. By this email, NSE also pointed out to the Noticee that as per SEBI's circular dated April 17, 2008, brokers are to have adequate systems and procedures in place to ensure that client collateral is not used for any purposes other than meeting the respective client's margin requirements / pay ins; and that the said circular was also forwarded to all the clearing members for compliance vide circular dated April 21, 2008.

7. Thereafter, as NSE noticed a reduction in the value of securities reported by the Noticee for VRISE and uploaded by the Noticee to NCL through inspection database of NSE, NSE addressed an email dated December 13, 2019 to the Noticee pointing out the same; and also observing that the Noticee had been uploading client-wise security balances of VRISE since August 19, 2019 onwards; and that the Noticee had allowed proprietary trading to VRISE in the derivatives segment even after August 19, 2019 based on client securities. By this email, NSE called upon the Noticee to release the securities of clients which have not been utilized for client obligations at the earliest and also explain the reduction in the securities as reported by the Noticee and whether any client securities have been sold to meet the open obligations of VRISE.

8. By its email of December 18, 2019 to NSE and NCL, the Noticee responded that as VRISE had outstanding obligations, the Noticee had applied the collateral placed by VRISE with the Noticee towards satisfaction of VRISE's obligations.

9. Thereafter, by its email dated December 20, 2019 to the NSE and the NCL, the Noticee acknowledged that it had received end-client complaints for approximately Rs.3.1 crore but stated that it had no source to validate the information; that the end clients had not traded since April 2019 with VRISE in the F&O Segment and that the gross value of securities sold for the said clients was approx. Rs.10.84 cr.

10. In view of the above, NCL sent an email to the Noticee on January 02, 2020 stating that it was observed that the Noticee was aware that the securities (which had been sold by it) belonged to the clients of VRISE, particularly as the Noticee had been uploading client wise securities details to NCL since August 19, 2019. An explanation was sought from the Noticee for disregarding express directions not to deal with client securities and also

why suitable action should not be initiated against the Noticee for not adhering to the rules, byelaws and regulations of NCL.

11. In response to the above email, the Noticee submitted its reply vide letter dated January 06, 2020, *inter alia*, stating that it had not violated any legally binding regulatory directions or any Rules, Bye-laws or Regulations of NCL.

12. In light of the liquidation of collateral informed by the Noticee to the NSE (copy marked to NCL) by its email dated December 20, 2019, NCL conducted a limited purpose inspection of the Noticee's books, registers, records and other relevant documents in the F&O segment during the month of January 2020 covering the period from October 01, 2019 to December 31, 2019 (hereinafter referred to as the "**LPI**"). Following the LPI, the list of violations observed in the LPI were communicated by NCL to the Noticee by its letter dated January 08, 2020.

13. The following is a summary of the findings and details of violations by the Noticee, as observed in the LPI report dated January 08, 2020:

i. The Noticee had dealt with securities that were not belonging to VRISE and has wrongly appropriated the same towards the proprietary obligations of VRISE despite being fully aware that the securities belong to the clients. Accordingly, it has misused the securities of the clients of VRISE and, therefore, violated the directives of SEBI/ NSE and the Rules/ Bye-laws/ Regulations of the NCL as under:

(i) SEBI circular no. CIR/HO/MIRSD/DOP/CIR/P/2019/75 dated June 20, 2019 regarding handling of clients' securities by Trading Members/ Clearing Members ("**2019 SEBI Circular**");

(ii) SEBI circular no. MRD/DOP/SE/Cir-11/2008 dated April 17, 2008 ("**2008 SEBI Circular**') and NSE circular no. NSE/INSP/2008/66 dated April 21, 2008 ("**2008 NSE Circular**"); and

(iii) Regulation 10.2.4 of the NCL F&O Regulations ("**NCL Regulations**").

ii. The Noticee had reported to NCL that it has collected all margins for proprietary obligations of VRISE in the MG12 Report. However, on inspection, it was observed that some of the collateral which was collected by the Noticee towards proprietary obligations actually included securities which were declared as client securities by VRISE. Since client securities cannot be utilized for proprietary obligations, in effect, margins for the proprietary obligations of the TM were not collected by the Noticee. Therefore, the Noticee had violated Regulation 4.5.1 of the NCL Regulations i.e., the F&O CMs shall demand from its constituents the margin monies which the CM has to provide under these Regulations in respect of dealings done by the F&O CMs for such constituents.

iii. The Noticee had sought guidance from NSE/ NCL in the matter of the securities deposited by VRISE, a Trading Member of NSE. In the email communications dated November 14, 2019, November 24, 2019 and December 13, 2019, NSE had directed the Noticee that: (a) client securities not to be utilized for meeting the Trading Member's proprietary account obligations/ dues; (b) maintain status quo in the matter; and (c) release the securities of clients which have not been utilized for client

obligations. However, the Noticee disregarded the directions of NSE and disposed client securities. Therefore, it was observed that the Noticee had acted in haste and wilfully disregarded the guidance/ directives of NSE which the Clearing Member itself had sought from NSE. This manner of conducting its business is improper and, hence is in violation of Clause 1 and Clause 2 read with Clause 3(1)(b) and Clause 3(1)(c) of Chapter V of NCL Rules.

14 A show cause notice dated January 08, 2020 ("**SCN**") was issued to the Noticee calling upon the Noticee to show cause as to why appropriate disciplinary action in terms of Rule 1 and Rule 2 of Chapter V of Rules of NCL (F&O) should not be initiated against the Noticee for the non-compliances, as mentioned in the SCN. The non compliances contained in the SCN were as under :

A. **Misuse of Client Securities (Violation of SEBI Circular No MRD/DoP/SE/Cir-11/2008 dated April 17, 2008, NSE Circular No NSE/INSP/2008/66 dated April 21, 2008 and Regulation 10.2.4 of NCL FO Regulations).**

B. **Violation of NCL F&O Regulation 4.5.1 "The F&O Clearing Members shall demand from its constituents the margin monies which the clearing member has to provide under these Regulations in respect of dealings done by the F&O Clearing Members for such constituents."**

C. **Non adherence to NSE directives (Violation of Clause 1 and Clause 2 read with Clause 3(1)(b) and Clause 3(1)(c) of Chapter V of NCL Rules) with respect to directions of NSE to the Noticee that (a) client securities not to be utilized for meeting the Trading Member's proprietary account obligations/ dues; (b) maintain status quo in the matter; and (c) release the securities of clients which have not been utilized for client obligations.**

In terms of the SCN, the Noticee was also provided an opportunity of personal hearing before the Membership Selection Committee of NCL ("**MCSGFC/ Committee**") on January 13, 2020. The Noticee furnished its reply, *vide* its letter dated January 10, 2020 to the SCN ("**Reply**"). Further, the Noticee, through its authorized representatives, appeared for the personal hearing before the MCSGFC on January 13, 2020. Thereafter, at the Noticee's request, the Noticee was also given an opportunity to file written submissions covering the oral submissions before the Committee and accordingly, the Noticee has filed additional written submissions dated January 16, 2020 ("**Additional Submissions**").

Submissions made by the Noticee

15. The Noticee submitted its reply dated January 10, 2020. At the personal hearing before the MCSGFC in its meeting held on January 13, 2020, the Noticee was represented by Mr. Dipesh Shah – Director, Mrs. Kamala K – Group Compliance and Governing Officer, Mr. Prashant Mody – EVP, Mr. Atul Bapna – SVP and Mr. Ashish Ahuja, Mr. Sameer Pandit and Ms. Krina Gandhi from their Advocate's Office. The Noticee also submitted its Additional Submissions dated January 16, 2020.

16. The following is a brief summary of the oral submissions made by the Noticee before MCSGFCand the written submissions and Additional Submissions made by the Noticee :

i. The Noticee has denied all the allegations contained in the SCN.

ii. The Noticee has stated that NCL has acted in haste in not giving adequate time in the matter and without considering any of the submissions made by the Noticee in the Noticee's letter dated January 06, 2020.

iii. The Noticee has described the sequence of events of default of VRISE in November 2019 and has stated that guidance was sought from NSE/ NCL only for surplus collaterals of VRISE.

iv. The Noticee has stated that it is not required to bifurcate the Trading Member's limits between the Trading Member's proprietary or client trades or get into the ownership trail of the collateral placed with it so long as the same was originated from the concerned Trading Member and stood in the name of the Trading Member.

v. The Noticee has stated that it had raised a specific query with NSE by its email dated August 14, 2019 (copy marked to NCL), and inquired whether data reporting will have any impact on margin reporting. This was responded to by NSE on August 19, 2019 (copy marked to NCL) who confirmed that both are not linked.

vi. In response to query from the Committee members regarding client complaints, the Noticee has responded that they had received complaints directly from the end clients of VRISE, even before the selling of the securities on November 15, 2019.

vii. The Noticee has submitted that Clearing Members are akin to Clearing Corporations in terms of dealing with collaterals.

viii. The Noticee has submitted that the collateral placed with the Noticee had stood in the name of VRISE and that VRISE was the beneficial owner of such securities as per the provisions of the Depositories Act and the Noticee was entitled to presume that it had all rights to deal with such securities under Section 10 of the Depositories Act.

ix. The Noticee has submitted that the Noticee has not violated any SEBI/ NSE circulars/ Regulations relating to monitoring / utilisation of client securities.

x. The Noticee has submitted that it had also obtained written undertakings from VRISE on two occasions whereby VRISE had confirmed to the Noticee that the shares placed with it as collateral were with due authority.

xi. The Noticee has submitted that only after committing a default and failing to meet its pay-in obligations, VRISE began to claim that the securities placed with the Noticee were actually client securities.

xii. The Noticee has submitted that the Clearing Member is only a pass through agency which submits information that has been provided to it by the Trading Member. The Clearing Member does not have any independent mechanism of verifying the correctness or accuracy of the data submitted by the Trading Member.

xiii. The Noticee has submitted that the SEBI circular dated April 17, 2008 circular referred to brokers, whereas Brokers and Clearing Members are distinctly defined by SEBI and, therefore, the circular is not applicable to the Noticee.

xiv. The Noticee has stated that in the matter of Allied Financial Services Private Limited, SEBI clarified that the injunction/restriction against a broker was not intended to put any embargo on the collaterals deposited by Allied Financial Services Pvt Ltd with the CM to meet its margin obligations.

xv. The Noticee has submitted that in the matter of BRH Wealth Kreators Limited, the broker had misutilised client securities by pledging them to banks and financial institutions. The broker sought to raise a defence that it had informed the stock exchanges to freeze its account and also informed the banks that the securities pledged with them were client securities. However, SEBI rejected this defence and held that it was the responsibility of the broker to comply with the regulations

relating to client securities at the first opportunity and the broker cannot take refuge under intimations that it may have given to exchanges or lenders.

xvi. Further, the Noticee has referred to the case of JRY Investments Private Limited, wherein, Bombay High Court has recognised that dematerialised shares have no individual identity and are in a fungible form and the Depositories Act has been enacted for the purpose of recording accurately the transfers and pledges of shares including those in a dematerialised form and that the Depositories Act is a self-contained code and that ownership and transfer of shares governed by the Act must be in accordance with the provisions of the Depositories Act.

xvii. The order passed by SEBI in the matter of Karvy Stock Broking Limited is on materially different facts and deals with issues that are not relevant to the present case.

xviii. Emails from NSE cannot be considered a "direction" by NSE to the Noticee. The guidance issued by NSE on dealing with any client securities so far as it relates to Trading Member's obligation to CM was concerned was beyond its regulatory purview and the Noticee was not bound by the guidance.

Details of violations alleged and MCSGFC's findings:

17. The MCSGFC has considered in detail the oral submissions made by the Noticee and the written submissions made by the Noticee in its letter dated January 06, 2020, Reply and Additional Submissions. In the following paragraphs, the MCSGFC deals with each specific violation alleged against the Noticee as contained in the SCN, the submissions made by the Noticee and the MCSGFC's findings *in seriatim.*

17.1 Misuse of securities of clients of VRISE leading to the violation of circulars / directives of SEBI/ NSE and the Regulations of NCL

17.1.1 Details of violation

As mentioned in the SCN and hereinabove, for recovering outstanding dues of VRISE to the Noticee on account of VRISE's proprietary trades, the Noticee has sold securities which did not belong to VRISE, and actually belonged to the clients of VRISE.

17.1.2 MCSGFC's observations on the violation

(1) The main issue in the present case is the misuse of clients' securities by brokers. There are several circulars, regulations, etc. which make it abundantly clear that brokers are prohibited from carrying on any proprietary trading by using clients securities as collateral or margin. This is evident, *inter alia,* from the following:

(i) SEBI's Circular No. MRD/DoP/SE/Cir-11/2008 dated April 17, 2008 (**"2008 SEBI Circular"**) states *inter alia* as under:

"... in order to reiterate the need for brokers to maintain proper records of client collateral and to prevent misuse of client collateral, it is advised that :-

2.1 Brokers should have adequate systems and procedures in place to ensure that the client collateral is not used for any purposes other than meeting the respective client's margin requirements/ pay-ins....."

Emphasis Supplied

(ii) Following the 2008 SEBI Circular, NSE had issued circular no. NSE/INSP/2008/66 dated April 21, 2008 ("**the 2008 NSE Circular**") to all Clearing Members and Trading Members, drawing the attention of all members to the 2008 SEBI Circular and expressly making it clear that the 2008 SEBI Circular was being circulated for "*ready reference and compliance with the provisions thereof*".

Emphasis Supplied

(iii) Regulation 10.2.4 of the NCL F&O Regulations also states:

"No F&O Clearing Member or person associated with a F&O Clearing Member shall make improper use of constituents securities or funds."

(iv) Regulation 4.5.4 of the NCL F&O Regulations states as under:

"*The Clearing Member shall not allow the utilization of margin monies paid by one client to the margin money dues of his own account or of other clients*"

In regard to the above, it is pertinent to note that Regulation 1.7 of the NCL F&O Regulations defines "Client / Constituent" as under :

"*A Client / Constituent means a person, on whose instructions and on whose account the Clearing Member clears and settles deals. For this purpose, the term "Client" shall include all registered constituents of trading members of Specified Exchange.*

Explanation 1 : The terms 'Constituent' and 'Client' are used interchangeably in the Byelaws, Rules and Regulations ….."

(Emphasis Supplied)

Thus, as regards a Clearing Member, the terms "Clients" / "Constituents", include also the clients/ constituents of the Trading Members for whom the Clearing Member undertakes the clearing of trades.

(2) In the facts of the present case, it is:

(a) admitted by the Noticee that it has liquidated securities worth Rs 1.50 crores on November 15, 2019 and worth Rs 20.45 crores on December 04, 2019;

(b) also not disputed by the Noticee that such liquidation / sale of securities was for recovery by the Noticee of the proprietary trading dues of its Trading Member VRISE;

(c) also established, and not disputed by the Noticee that as per the details uploaded by the Noticee itself to NCL, the securities sold by the Noticee belonged to clients of VRISE;

(3) It is, therefore, clear beyond doubt that there has been a violation by the Noticee of the aforesaid prohibitions relating to misuse of clients' securities for recovering the proprietary trading dues of the Trading Member VRISE to the Noticee.

(4) In this regard, it is most pertinent to note the relevant sequence of facts and events, *inter alia*, as follows :-

(a) From August 19, 2019 onwards and up to November 12, 2019, the Noticee had admittedly been uploading to NCL on a weekly basis client-wise and ISIN-wise details of the non – cash (securities) collateral placed by VRISE with it. As per the details uploaded by the Noticee on November 12, 2019, the securities collateral that it had received from VRISE belonged to 542 clients of VRISE (clients identified on the basis of PAN).

(b) Although the Noticee has repeatedly attempted to take the plea that it has received the securities collateral from the depository account of the Trading Member VRISE, and has not received any collateral from the depository accounts of clients of VRISE, it is seen that this is untenable as the securities were in fact received by the Noticee from a depository account, being a collateral demat account of VRISE, which infact contained Trading Member's own securities as well as clients' securities.

(c) The Noticee has submitted that it had obtained an undertaking dated July 30, 2019 from VRISE with respect to the securities submitted to the Noticee as collateral. It is observed that in the said undertaking that VRISE had specifically mentioned securities being placed by it with the Noticee as collateral belonging to the clients. The relevant clauses are reproduced below:

"*1. We have the authority and power to place the securities/ funds <u>of clients</u> (emphasis supplied) as collaterals with clearing member ECSL for trading on Exchange.*

2. The securities/ funds are placed as collateral with ECSL is in accordance with the provisions of SEBI Circulars SEBI/HO/MIRSD/MIRSD2/CIR/P/2016/95 dated September 26, 2016 and CIR/HO/MIRSD/MIRSD2/CIR/P/2017/64 dated June 22, 2017 and any other circular issued by the Market Regulators from time to time.

***3. The securities/ funds of our clients** placed as collateral with ECSL **will be utilized towards the respective clients positions** and not for other clients or for Own purpose.*

4. We have ensured clear segregation of client and Own funds/ securities, which has been placed with you as collaterals.

***5. The securities; which are placed as collaterals are in existence, owned by the respective clients and are and shall be free from any charge, lien or encumbrance whether prior or otherwise**.*"

(Emphasis Supplied)

In view of the above clauses of the undertaking, it is clear that VRISE had represented to the Noticee that the collateral being placed belongs to the clients and hence, it is not open to the Noticee to contend that it was unaware of the ownership of the securities as belonging to the clients.

(d) In addition to the above, the Noticee has itself admitted in its email dated November 13, 2019 to NCL that after VRISE had defaulted (but before the Noticee had sold the collateral securities), VRISE had by an email dated November 8, 2019 informed the Noticee that the collateral offered by it belonged to some of its clients. Evidently, this would serve as further intimation to the Noticee from the Trading Member that as VRISE had defaulted on dues arising from its proprietary trading, the Noticee should not liquidate collateral securities provided by clients to recover VRISE's outstandings to the Noticee on account of proprietary trading of the TM (VRISE)

(e) Further, as admitted by the Noticee in its letters /emails to NCL, the Noticee had also received a number of client complaints seeking release of their securities;

(f) In addition to all the above, the NSE (with the NCL copied on the emails) had repeatedly advised the Noticee that it should not sell the client securities to recover VRISE's outstandings on account of its proprietary trading and had also alerted the Noticee that it should maintain status quo i.e. the Noticee should not sell any of the shares that it was holding.

(g) Further, the Noticee *vide* its email dated December 20, 2019, confirmed that "*End Clients not traded since Apr'19 with TM in FnO segment. Gross value of securities sold for the said clients ~10.84 Cr (Annexure 4)*" and further stated that "*End Client complaints received. (No source to validate the information) ~3.1 cr. (Annexure 3)*". The Noticee

confirmed that *"Risk team liquidated the collateral based upon the residue available considering the market equilibrium, liquidity and impact cost."* Hence, from the contents from the said email, it is clear that the Noticee was well and truly aware of the securities which belonged to the clients and which formed part of the collateral placed by VRISE with it and the Noticee was fully aware of the bifurcation of the securities belonging to the clients.

(h) Further, with respect to the contention of the Noticee of NCL having acted in haste, the Committee observed that the opportunity of hearing was being given to the Noticee comprehensively and consider all the submissions by the Noticee being made, both during the personal hearing as well through written submissions viz letter of the Noticee dated January 06,2020, the Reply and Additional Submissions.

(5) The aforesaid sequence of events makes it clear beyond any doubt that the Noticee was well aware that the securities belonged to the clients and had also been repeatedly warned by NSE to ensure that clients' securities were not sold off to meet the proprietary trading liabilities of its Trading Member VRISE.

(6) The Noticee has contended that it is not required to bifurcate the Trading Member's limits between the Trading Member's proprietary trading and the clients' trading and that the Noticee cannot examine the ownership trail of the collateral and that the Clearing Member is akin to that of a Clearing Corporation.

- These contentions are not relevant in the facts of the present case since the Noticee had clearly and admittedly reported that the securities which were being held by it as collateral at the time (including the securities that it sold) in fact belonged to clients of VRISE. In any case, in terms of Clause 2(7) of the clearing Member-Trading Member agreement dated October 06, 2016 ("**TM-CM Agreement**"), the Noticee was "*entitled to receive from the Trading Member a statement containing … (ii) a list of client codes, names of the clients, client-wise margin amount, collected by the Trading Member from his clients and paid to the Clearing Member…*"

- Additionally, the Committee observed that the 2019 SEBI Circular reiterates the 2008 SEBI Circular, in which SEBI has also specified that "*brokers should have adequate systems and procedures in place to ensure that client collateral is not used for any purposes other than meeting the respective client's margin requirements / pay-ins. Brokers should also maintain records to ensure proper audit trail of use of client collateral.*"

(7) The Noticee alleges that the Clearing Member - Trading Member Agreement in the present format does not contain any provision requiring the Clearing Member to segregate the margins provided by the Trading Member. As stated above, in terms of Clause 2(7) of the TM-CM Agreement, the Noticee was entitled to receive a statement containing

details about the client-wise margins. The said allegation is anyway not relevant in view of the aforesaid fact that the Noticee was fully aware that the securities belonged to clients.

(8) The Noticee contends that it was only after VRISE defaulted in meeting its pay-in obligations, it began to contend that the securities placed with the Noticee were actually client securities. This contention also is factually incorrect since the Noticee's prior reportings from August 19, 2019 to November 12, 2019 had clearly disclosed that the securities were belonging to the clients of the Trading Member. This, along with the other facts stated above, proves that prior to the Noticee liquidating the clients' securities, the Noticee was completely aware that the securities belonged to the clients of the Trading Member.

(9) The Noticee's allegations that it had acted in good faith and voluntarily kept NSE and NCL appraised of the situation is belied by the record as stated above.

(10) The Noticee contends that it received the securities from the "VRISE's demat account" and the Noticee was not in a position to ascertain the ultimate ownership of the securities; and that the NSE / NCL did not inform the Noticee that the securities given as collateral by VRISE were in fact belonging to the clients of VRISE. As aforesaid, this is contradicted by the Noticee's own reporting wherein it itself admitted that the securities belonged to clients of the Trading Member and the record above.There is

no obligation on NSE/NCL to inform the Noticee. It is observed that the shares were received by the Noticee from the VRISE's Collateral Account, in which securities belonging to both the clients and the trading member are contained.

(11) The Noticee contends that neither the Byelaws nor the Regulations require the Noticee to collect collateral from the Trading Member in a segregated form or bifurcate the same for the Trading Member's proprietary trades and clients' trades. This contention is not relevant since the Noticee was aware that VRISE's proprietary trades were on the basis of collateral which actually belonged to the clients and that the securities that were sold by it to recover the proprietary trading dues of VRISE in fact belonged to the clients and therefore, should not have been sold by the Noticee as repeatedly warned by NSE.

(12) The Noticee's allegations that demat shares are fungible and that in view of the provisions of the Depositories Act and Depository Participant Regulations, the beneficial owner (of the demat account) is entitled to all the rights and benefits of the securities in that account, and therefore VRISE must be held to be the full owner of all shares in its demat account from which the shares were transferred / handed over to the Noticee, is untenable in the facts of this case. The shares were transferred to the Noticee's "Client Collateral Account" which necessarily holds shares provided by Trading Member and their clients (through the Trading Member). According to the Noticee itself , VRISE had reported to the Noticee that these securities were

client securities – and the Noticee had also reported these securities as client securities to the NCL. The contention of the Noticee is thus untenable as the Noticee was fully aware that the securities belonged to the clients as the Noticee itself uploaded trading member wise client wise securities details in accordance with NCL circular dated May 20, 2019.

(13) As regards the details reported by the Noticee to NCL on the basis of the information provided by the Trading Member VRISE, the Noticee seeks to contend that they were provided by the Noticee to NCL pursuant to NCL's circular dated May 20, 2019 ("**NCL 2019 Circular**") merely as a "pass through agency" of information provided by the Trading Member to the Noticee, and that the Noticee does not have the mechanism to verify its accuracy or correctness. This contention of the Noticee is untenable as the Noticee is duty bound to take note of client wise securities wise details provided by trading member. .. Accordingly, the contention of the Noticee that "the CM is only a pass through agency which submits information that has been provided to by the TM" is not acceptable.

(14) The Noticee's allegations that the SEBI 2008 Circular and the NSE 2008 Circular cast no obligation on the Clearing Member for misutilisation of client collateral is not acceptable. The NSE 2008 Circular, which reproduces the SEBI 2008 Circular states that it was being circulated also to the Clearing Members and also that it was being circulated to them for their compliance. Further, it is not open for the Noticee to contend that it is entitled to liquidate the collateral since the Noticee was aware that the

securities belonged to the clients and not to VRISE. Further, as stated above, the definition of "constituent" (reproduced above) in NCL's Regulations also includes the end client of the Trading Member and the Noticee cannot contend that "client" would only mean the trading member and not the clients of the trading member.

(15) SEBI has also issued Circular No. CIR/HO/MIRSD/DOP/CIR/P/2019/75 dated June 20, 2019 ("**the 2019 SEBI Circular"**) by which it has stipulated that the term "stock broker" means Trading Member/ Clearing Member and in the said circular, SEBI had referred to all the previous SEBI circulars, including the 2008 SEBI Circular which are applicable to both Trading Members and Clearing Members with respect to handling of client's funds and securities. The 2019 SEBI Circular was issued by SEBI to, *inter alia*, all Trading Members/ Clearing Members through stock exchanges/ clearing corporations. Clause 1 of the 2019 SEBI Circular states as under:

"*In order to protect clients' funds and securities, the Securities Contracts (Regulation) Act, 1956 and Securities and Exchange Board of India (Stock-Brokers) Regulations, 1992 specifies that the stock broker shall segregate securities or moneys of the client or clients or shall not use the securities or moneys of a client or clients for self or for any other client*."

(16) The Noticee has relied on several orders / judgments. But none of them are relevant or applicable to the facts of the present case. The Noticee's attempt to distinguish the facts of the Karvy case from the facts of this case cannot

be accepted. The principle drawn in the Karvy case is applicable in the present case since the securities belonging to the clients have not been used for meeting the obligations of the clients but have been used for meeting the proprietary obligations of VRISE.

(17) The Noticee's contention that the dispute between VRISE and its client may be referred to arbitration, but cannot be the subject matter of regulatory action is not acceptable. The Committee observed that pursuant to the LPI, it was concluded that there was a mis-use of client securities by the Noticee and, therefore the SCN was issued to the Noticee. The dispute resolution mechanism between the clients and the trading members is not relevant with the instant case. The conduct of the clearing member is even more aggravated in view of the intentional disregard of specific directions from NSE to ensure client shares are not sold off for recovering proprietary liability of a Trading Member and to ensure that the interests of investors are protected.

(18) The Noticee's allegation that NSE's repeated warnings not to sell the client securities for proprietary dues of the Trading Member was beyond its regulatory purview and that the Noticee was not bound to comply with the same, only undermines the regulatory authority of the regulators. This is more so when the Noticee itself sought guidance from the NSE only in respect of surplus securities

(19) The Noticee's contention that the NSE / NCL had failed to provide details of the clients to whom the surplus shares have to be returned is not tenable

as the Noticee was instructed to return the same to the Trading Member who would in turn have to return them to the respective clients;

(20) The Noticee's allegations that NSE's investigations are not completed is not relevant since the present showcause is based on the aforesaid indisputable facts. It may be noted that even the Noticee has not denied or disputed that the Noticee itself has repeatedly reported that said shares /securities in fact belonged to the clients of VRISE.

(21) The Noticee has in its Additional Submissions relied on SEBI's circular that "*In case of complaints against brokers related to misuse of collateral deposited by clients, exchanges should look into the allegations, conduct inspection of broker if required and based on its findings take necessary action*". In this context, the Committee notes that NSE is looking into the complaints received from the investors against the trading member, VRISE and therefore, had advised the Noticee to ensure that client securities are not utilized for meeting the trading member's proprietary account obligations. However, the Noticee disposed the securities in gross disregard of the advices received from the NSE.

17.1.3 MCSGFC's conclusions on the violations

The established facts in the present case make it clear that when the Noticee purported to sell off the said securities for recovery of the proprietary trading dues / losses of the Trading Member (VRISE), the Noticee was aware of the fact that the shares belonged to the clients of VRISE and not to VRISE itself as is clear from the details provided by the Noticee itself to the NCL as per the laid down process in

NCL circular dated May 20, 2020. Amongst other things, as mentioned above, the Noticee had received numerous complaints from the clients that their shares had been misused by VRISE and the Trading Member (VRISE) had also informed the Noticee that the shares belonged to the clients and NSE had also warned them repeatedly. Thus the charge on Noticee in terms of misuse of client securities is established.

17.2 Violation with respect to collection of margins

17.2.1 Details of violation

The Clearing Member is required to collect margins from its Trading Members and report the margin collection details for proprietary obligations for the Trading Members. It was observed that the Noticee has reported that they have collected all margins for proprietary obligations of VRISE. However, on scrutiny, it was found that some of the collaterals which were considered as collected for proprietary obligations included securities which had been declared to the Noticee as client securities by VRISE. Since client securities cannot be utilized for proprietary obligations of the Trading Member, in effect margins for proprietary obligations were not collected by the Noticee.

17.2.2 MCSGFC's observations on the violation

The Committee observes that the Noticee had reported all collaterals received from the Trading Member including those received from clients in the MG12 report. The Noticee has been uploading the Trading Member-wise and client-wise details to NCL. The Committee also observes the collaterals were available;

however, if the collaterals belonging to the clients they could not be reckoned/ considered towards the margin, then the same would result in a shortfall in terms of collaterals available towards proprietary positions of VRISE. The Committee, however, observed that on account of the reports provided/ uploaded to NCL with respect to client-wise securities holding, the Noticee ought to have reviewed the margin reporting being done for proprietary positions taking into account the securities of the clients. The Committee also considered the submissions made by the Noticee that there was a miscommunication arising on account of the email correspondence exchanged between the Noticee and the NSE in this regard. The position was clarified to the Noticee by the NSE vide its email of December 2, 2019 in response to the Noticee's email of November 22, 2019. The Committee noted that the Noticee, during the personal hearing, has submitted that the position has now been fully clarified on account of the circular dated January 10, 2020.

17.2.3 MCSGFC's conclusion on the violation

The Committee, after considering the submissions made by the Noticee, was of the view that the Noticee could have misunderstood/misinterpreted the clarification given pursuant to the email dated August 19, 2019 in the context of the query raised by it for not reviewing the margin reporting being done for proprietary positions.

Accordingly, the Committee was of the view that henceforth, the Noticee is advised to review the margin requirements for proprietary and client positions on due consideration of the collateral report uploaded by the Noticee.

17.3 Non adherence of the directives of NSE

17.3.1 Details of the violation

The Noticee had itself written to the NSE and the NCL and sought guidance from the NSE and the NCL in the matter of VRISE. In response to the Noticee's email, the Noticee had been repeatedly advised by emails by NSE to ensure that client securities are not utilised for meeting the Trading Member's proprietary account obligations/dues. The Committee observed that *vide* emails dated November 14, 2019, November 24, 2019 and December 13, 2019, NSE had directed the Noticee to: (a) ensure client securities not to be utilised for meeting the Trading Member's proprietary account obligations/dues; (b) maintain status quo in the matter; and (c) release to VRISE the securities of clients which have not been utilised for client obligations.

17.3.2 Observations of MCSGFC

The Committee observed that the Noticee, in gross disregard of the directives of NSE, sold the clients' securities. The Committee had considered the defence of the Noticee that it is not bound by the directives of NSE as NSE is not the Relevant Authority under the Bye-laws and Rules of the NCL. The Committee notes that NSE may not be the Relevant Authority under the Rules, Bye-Laws and Regulations of the NCL but is, however, a regulatory authority under the provisions of the Securities Contracts Regulation Act, 1956. The Committee noted in this regard that as a CM, the Noticee is duty bound to follow the directives of any regulator such as SEBI, NSE and/or RBI while dealing with the

collateral placed with it by the Trading Member since such Regulatory Authorities would be the relevant regulatory authorities not only for the Clearing Member but also for the Trading Member. The Committee observed that the Noticee itself, in the TM-CM agreement dated October 06, 2016, has indicated "*NSEIL, NSCCL, SEBI and all other regulatory, statutory, governmental, judicial, quasi-judicial and other authorities that may have competent jurisdiction over the Trading Member, the Clearing Member or the terms of this Agreement may be collectively referred to as "**Competent Authorities**""* under Clause 3 to the header "Interpretation". Further, the Committee observed that the Clearing Member is bound by the provisions of the Code of Conduct stipulated under Schedule II (Chapter II) of the SEBI (Stock Brokers) Regulations, 1992 ("**SB Regulations**"). Under the SB Regulations, a stock broker is obliged to abide by Clause A(5) of the Code of Conduct, which states that *"a stock broker shall abide by all the provisions of the Act and the rules, regulations issued by the Government, the Board and the Stock Exchange from time to time as may be applicable to him."* It is pertinent to note that the provisions of Chapters II, IV, V and VI of the SB Regulations are also applicable to a Clearing Member in terms of Regulation 10B and Regulation 10F of the SB Regulations. The Committee had further observed that having sought guidance from a Regulatory Authority such as NSE with respect to the manner in which the Noticee had to deal with the clients' securities, if the Noticee had any doubts about the authority of the NSE vis-à-vis the Noticee, it ought to have sought clarification either from NSE and/or from the NCL before disregarding their directive. The Committee observed that in the first instance, the NSE had directed the Noticee to ensure that client securities are not utilized for meeting the Trading Member's proprietary account

obligations/ dues "*in accordance with the rules and regulations of SEBI/Exchange/CC and the TM/CM Agreement*". If the Noticee was of the view that it was not bound by the directives of NSE or had doubts about the power of NSE to pass such directives, it ought to have sought clarification with respect to the relevant rules and regulations pursuant to which the directives have been issued without, in any manner, dealing with the clients' securities. On the contrary, it is observed that the Noticee had been in discussions with the NSE and had sought further guidance from NSE while making submissions *vide* its letter and email dated November 22, 2019, and had stated that "*we are of the view that TM's collaterals can be used by us for recovery of our dues as they are not clients' securities as per our records and also they are free from encumbrance"*. The Noticee had thus sought the concurrence of the NSE with the view of the Noticee. However, the NSE did not concur with the views of the Noticee and *vide* its email dated November 24, 2019 had once again directed the Noticee to ensure that client securities are not utilized for meeting the Trading Member's proprietary account obligations/ dues and requested the Noticee to maintain status quo in the matter. The Committee further noted that, the NSE, after considering the submissions of the Noticee had, *vide* its email dated December 02, 2019, once again directed the Noticee to "*ensure that client securities are not utilized for meeting the trading members proprietary account obligations.*" However, the Committee noted that on December 04, 2019, the Noticee had sold the client securities without notice to the NSE and/or the NCL, in gross disregard of the directives of the NSE. In view of the aforesaid conduct of the Noticee seeking the guidance of the NSE, the Committee is of the view that it is not open for the Noticee to contend that it is not bound by the directives of the NSE and therefore,

the contentions of the Noticee in this regard are not tenable.

17.3.3 MCSGFC's conclusion on the violation

The Committee observes that despite NSE advising to ensure that client securities are not utilized for meeting the Trading Member's proprietary account obligations/dues and to maintain status quo, the Noticee had sold securities on November 15, 2019 and December 04, 2019. The Committee observes that the Noticee had completely ignored the guidance provided by NSE. Specifically, when the NSE had directed the Noticee to not dispose any client securities and to maintain status quo, the Noticee should not have sold such securities, most pertinently when it was aware of such securities belonging to the clients of VRISE (and not VRISE itself) and complaints have been received from clients seeking release of their securities.

DECISION

The Committee observed that since the securities have been disposed of in gross disregard to the express directions of the NSE, it is a violation of Clauses 1 and 2 read with Clauses 3(1)(b) and 3(1)(c) of the NCL Rules since the said conduct of the Noticee is not only improper conduct but also violative of securities laws governing the activities, business and operations of the Noticee as a clearing member, as stated above. Such conduct is unbecoming of a Clearing Member and inconsistent with just and equitable principles. It is also observed in the LPI that the Noticee has misused the clients securities of VRISE, i.e. it sold securities not belonging to its client VRISE, to recover its outstanding dues and accordingly violated the directives of SEBI/Exchange and Rules/Byelaws/Regulations of NCL. In this regard, it may be noted that the NSE had directed the Noticee to release to VRISE the securities of the clients which have should not have been utilized for client obligations at the earliest under intimation to the NSE, vide its email dated December 13, 2019. In view of the aforesaid violations, it is incumbent upon the Noticee to undo the improper action of disposing of the client securities in gross disregard of the guidance/directions of the NSE, so as to ensure that the securities which did not belong to VRISE are reinstated and are to be dealt with in accordance with the directions of the NSE. Such action would be consistent with the established principles of restitution. Accordingly, the Committee, in the interest of justice, equity and good conscience, directs the Noticee to reinstate the securities within a period of fifteen (15) days from the date of this order, pending which, an amount equivalent to the value of securities as on the 16th day (end of day) price of NSE(or BSE , if NSE prices are not available) plus a mark up value of 5% shall be blocked from the available collateral of the Noticee with the NCL from the date of expiry of the aforesaid period of 15 days till the Noticee confirms compliance with this direction. The Noticee is further directed to credit the reinstated securities in a new identifiable beneficiary demat account of the Noticee to be dealt

with appropriately for restitution to the clients in accordance with the directions of the NSE. Details of such demat account shall be provided to the NSE and the NCL. The Noticee shall provide the demat account holding and transaction statement to the NSE and the NCL as and when called for by NSE and/or NCL. To clarify, the Noticee shall not create any encumbrance on the securities in the demat account directly or indirectly. The Noticee further is warned to adhere to the guidance/directives issued by Regulatory Authorities, including the NSE, while conducting its activities, business and operations as a Clearing Member in future. This order shall be independent of and without prejudice to the action that may be taken by the Exchange i.e NSE or other Regulatory Authorities as may be required.

Sd/-	Sd/-	Sd/-	Sd/-
Harun R Khan (Chairman)	**Bhagyam Ramani (Committee Member)**	**N K Maini (Committee Member)**	**Vikram Kothari (Committee Member)**

Date: