



## Regulatory Framework for Securities Market Intermediaries

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### WHY A REGULATORY FRAMEWORK?

The securities market is the place where funds are raised to meet mostly the needs of investment / liquidity through issue / sale of securities. There are a set of economic agents who demand securities in lieu of funds and another set who supply securities for funds. The supply of securities comes from those who wish to invest but do not have resources or who hold securities but are in need of liquidity. They create and / or exchange securities for funds.

The demand for securities comes from those who generally have surplus resources, but do not have use for them. They exchange funds for securities. It is not that the suppliers of funds and suppliers of securities meet each other and exchange funds for securities. It is difficult to accomplish such double coincidence of wants. The amount of funds supplied by the supplier of funds may not be the amount needed by the supplier of securities. Similarly, the risk, liquidity and maturity characteristics of the securities may not match preference of the supplier of funds. In such cases, they incur substantial search costs to find each other. Search costs are minimised by the intermediaries who match and bring these suppliers together. They may act as agents to match the needs of the suppliers of funds / securities, help them in creation and sale of securities or buy the securities issued by supplier of securities and in turn, sell their own securities to suppliers of funds. It is, thus, a misnomer that securities market disintermediates by establishing a direct relationship between the suppliers of funds and suppliers of securities. The market does not work in a vacuum; it requires services of a large variety of intermediaries like merchant bankers, brokers, etc to bring the suppliers of funds and suppliers of securities together for a variety of transactions. The disintermediation in the securities market is in fact an intermediation with a difference; it is a risk-less intermediation, where the ultimate risks are borne by the suppliers of funds/securities (issuers of securities and investors in securities), and not the intermediaries. Since the intermediaries do not bear the risks while undertaking transactions and handling the securities and funds for or on behalf of the issuers of and investors in securities, who bear the ultimate risks, it is necessary to ensure that they have the

necessary competence and motivation to work in the best interest of the issuers and investors. Further, since the intermediaries are in a position to influence the transaction decisions of the issuers and investors and act as partners in regulation and development of the market, it is necessary to ensure that they have the necessary competence and motivation to work in the best interests of the market and the economy. This is generally achieved through a comprehensive, objective and transparent regulatory framework, which prescribes and enforces the standards for quality intermediation services in the market so as to ensure that the participants undertake more and more transactions with ease, efficiency and security and securities market becomes an engine of economic development.

***The regulatory framework for intermediaries which has been evolving since 1992, has stood the test of time and has been able to ensure quality intermediation services in the market. Several suggestions are put forth in this article to bring about marginal improvements in the regulatory framework for intermediaries.***

### EXTANT REGULATORY FRAMEWORK

SEBI has specific responsibility under the SEBI Act, 1992 to:

- register and regulate the working of the stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustee of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisors and such other intermediaries associated with the securities market,
- register and regulate the working of the depositories, depository participants, custodian of securities, foreign institutional investors, credit rating agencies, or any other intermediary associated with the securities market as SEBI may specify by notification, and
- register and regulate the working of the venture capital funds, collective investment schemes, including mutual funds.

None of the above intermediaries can deal in securities or operate in the securities market unless it obtains a certificate of registration from SEBI in accordance with the regulations made by SEBI. The certificate of registration can be suspended or cancelled by SEBI in the manner prescribed in the regulations. SEBI has further responsibility to promote and regulate self regulatory organizations, prohibit fraudulent and unfair trade practices relating to securities market, prohibit insider trading in securities, etc. which ensures that the intermediaries behave in a desirable manner.

### GLOBAL RECOGNITION TO COMPETITION COMPLIANCE PROGRAMME

Recognizing the need for and usefulness thereof, in the wake of high profile crackdown on cartels and modernization of competition jurisdictions worldwide, the 'Enterprises' and their Advisors globally have either launched or are contemplating to initiate 'competition compliance programmes' to minimize the risks, and the enormous costs involved, of breaching the law. Needless to state that fines and penalties provided in other competition regimes are either same, similar or even more than what are envisaged under the Act of 2002. It is amply proved by a recent order dated 24.03.2004 handed down by European Competition Commission against Microsoft, the world's largest software company, guilty of abusing its dominant position in the market for personal computer operating system and for tying Windows Media Player (WMP) with its software 'Windows 2000, by imposing a record fine of Euro 497 million (US \$ 612 million equivalent to approximately Rs.2630 Crores). In US, the fine imposed is US \$ 900 million against Vitamins Cartel and German National Authority has imposed was fine of US \$ 725 million against Cement Cartel. Needless to say that imposition of such huge penalties can put financial planning/working of any 'Enterprise' into disarray.

### CONTENTS OF COMPETITION COMPLIANCE PROGRAMME

The effective compliance programme would include imparting awareness and training to employees who may engage themselves or are exposed to anti competitive conducts. The programme should provide for identifying possible violations so as to take pro-active, corrective and remedial steps. The effective compliance not only reduces the risk of contraventions, but also facilitate timely detections and can be useful in mitigating penalties by suggesting disclosure of information at the first opportunity. To make the programme really effective, a continuous review is essential. It also requires continuous backup from senior management which should be visible and reinforced from time to time.

### WHO CAN BE INVOLVED IN THE PROGRAMME

The Competition Compliance Programme/Department may make use of professionals professing law, company secretaries, chartered accountants, costs and works accountants, marketing and financial analysts etc. They can also represent and make appearances before the Director General and the CCI during investigation and/or Enquiry respectively. Such a Department may either be separate one or be adjunct to Secretarial and Legal Department of a corporate entity.

### TAILOR MADE PROGRAMME : A MYTH

The business and the trade scenario of one enterprise is different from that of another. The relevant market, the product market and the geographical market, dominant position is to be

determined by host of factors and further the weightage to be assigned to different parameters to determine these economic concepts are at variance and as such it is not possible to tailor the programme for each and every enterprise which is subject to the jurisdiction of the Act.

### ANTI-TRUST AUDIT

A good anti trust audit can further assist in revealing the major breaches and thereby strengthens the compliance programme. In case an 'enterprise' initiates an in house programme, it is advisable that the document need to be audited by an outside agency and in case the audit or compliance is outsourced, a peer review/audit of compliance programme by yet another agency would be more appropriate.

### EXPECTATIONS FROM CCI

To encourage enterprises to launch Competition Compliance Programme on perennial basis and on sound lines, it may be beneficial for the is warranted of Commission to publish Manuals on achieving Compliance in terms of Act on the lines published by Office of Fair Trading (OFT) in UK, the Australian Competition & Consumer Commission (AS 3806) and the Department of Justice (DOJ) in US. These guidelines could set out essential elements for establishing, implementing and maintaining an effective compliance programme with in an organization and provides guidelines in using these elements. "The fact that a compliance programme is in place may be taken into account as a mitigating factor when imposing financial penalty by an adjudicating authority as is being case in other jurisdictions including US, UK, Australia, Canada, Japan etc.

### CONCLUSIONS

The message is loud and clear that a well planned exhaustive competition compliance programme can be of great benefit to all enterprises irrespective of their size, area of operation, jurisdiction involved, nature of products supplied or services rendered and the same is essential for companies, its directors and the delegatee key corporate executives to avoid insurmountable hardships of monetary fines, civil imprisonment, beside loss of hard-earned reputation when the Competition Authorities, the media and others reveal the misdeeds in public.

Such Department or Programme can also facilitate the enterprise to make best use of Commission in taking remedial action if it is hurt or likely to be hurt by an anti-competitive behaviour by its suppliers, stockists, competitors, trade association. Through such programme, an 'enterprise' can also create positive public opinion to tame anti competitive behaviour emanating from a public action in the guise of statutes, rules, procedures, regulations and policies of the Government.

Prudence suggests that 'Enterprise needs to undertake review of its marketing arrangements, market position and policies, restructuring , if any, in the pipeline so that it can take timely corrective measures or align its policies conforming to new competition regime. □

The Act has armed SEBI with adequate wherewithal to discipline the intermediaries. The powers include:

- Issuing directions to all intermediaries and other persons associated with the securities market (i) in the interest of investors, (ii) in the interest of orderly development of the securities market, (iii) to prevent the affairs of any intermediary including a mutual fund from being conducted in a manner detrimental to the interest of investors or of the securities market, or (iv) to secure the proper management of any such entity.
- Calling for information from, undertaking inspection, conducting inquiries and audits of the stock exchanges, mutual funds, other persons associated with the securities market, intermediaries and SROs.
- Appointing a person as investigating authority to investigate the affairs of an intermediary or persons associated with the securities market.
- Appointing adjudicating officers to adjudicate a wide range of violations and impose monetary penalties on any intermediary or other participants in the securities market. The penalty can be up to Rs. 25 crore or three times the amount of profits made out of violations. The violations include failure to submit any document, information or furnish any return, failure to maintain required books of accounts or records, failure to enter into agreement with clients, insider trading, failure to redress the grievances of investors, failure to issue contract notes, charging excessive brokerage by brokers, etc.
- Attaching for a period not exceeding one month, one or more bank accounts of any intermediary or any person associated with the securities market in any manner involved in violation of any of the provisions of the Act or rules or regulations made there under; and directing any intermediary or any person associated with the securities market in any manner not to dispose of or alienate an asset forming part of any transaction which is under investigation, in the interest of investors or securities market.
- Suspending or canceling registration of an intermediary in the manner prescribed in the regulations.

The Act originally empowered the Central Government to frame rules to govern the conditions of registration. By an amendment in 1995, SEBI was empowered to frame regulations to govern conditions of registration. However, before 1995, central government had framed a few rules to provide for conditions of registration (Table 1). For example, the SEBI (Brokers and Sub-brokers) Rules, 1992 provide that SEBI shall grant a certificate of registration to a broker subject to the following conditions:

- he holds membership of any stock exchange.
- he shall abide by the rules, regulations and byelaws of the stock exchange of which he is a member.
- in case of any change in status and constitution, the stock broker shall obtain prior permission of SEBI to continue to

buy, sell or deal in securities in any exchange.

- he shall pay the amount of fees for registration in the manner provided in the regulations.
- he shall take adequate steps for redressal of grievance of the investors within one month of the date of receipt of the complaint.

Though Central Government now does not have powers to determine the conditions through rules, the conditions already prescribed thorough the rules are in force and need to be complied with by the intermediaries.

The Act empowers SEBI to frame regulations for regulating the intermediaries. In pursuance to this, SEBI has framed a number of regulations for different intermediaries and registers and regulates them under these regulations (Table 1). While the rules and the regulations at Nos. 1 to 19 prescribe requirements for specific category of intermediaries, the regulations at No. 20 prescribe requirements for intermediaries in general.

**Table 1: Details of Intermediaries Registered with SEBI**

1 Sl. No.	2 Intermediary	3 Rules / Regulations / Schemes Governing the Intermediary	4 No. as on March 31, 2004
1	Brokers	SEBI (Stock Brokers and Sub Brokers) Rules and Regulations, 1992	9,368
2.	Sub-Brokers	SEBI (Stock Brokers and Sub Brokers) Rules and Regulations, 1992	12, 815
3	Derivative Brokers (Trading Members and Clearing Members)	SEBI (Stock Brokers and Sub Brokers) Rules and Regulations, 1992	829
4	Merchant Bankers	SEBI (Merchant Bankers) Rules and Regulations, 1992	123
5	Portfolio Managers	SEBI (Portfolio Managers) Rules and Regulations, 1993	60
6	Registrar to an Issue and Share Transfer Agents	SEBI (Registrars to an Issue and Share Transfer Agents) Rules and Regulations, 1993	78
7	Underwriters	SEBI (Underwriters) Rules and Regulations, 1993	47
8	Debenture Trustees	SEBI (Debenture Trustees) Rules and Regulations, 1993	34

1	2	3	4
9	Bankers to an Issue	SEBI (Bankers to an Issue) Rules and Regulations, 1994	55
10	Foreign Institutional Investors	SEBI (Foreign Institutional Investors) Regulations, 1995	540
11	Custodians	SEBI (Custodian of Securities) Regulations, 1996	11
12	Depositories	SEBI (Depositories and Participants) Regulations, 1996	2
13	Depository Participants	SEBI (Depositories and Participants) Regulations, 1996	431
14	Venture Capital Funds	SEBI (Venture Capital Funds) Regulations, 1996	45
15	Mutual Funds	SEBI (Mutual Funds) Regulations, 1996	37
16	Credit Rating Agencies	SEBI (Credit Rating Agencies) Regulations, 1999	4
17	Collective Investment Schemes	SEBI (Collective Investment Schemes) Regulations, 1999	0
18	Foreign Venture Capital Investors	SEBI (Foreign Venture Capital Investors) Regulations, 2000	9
19	Approved Intermediaries under Stock Lending Scheme	Securities Lending Scheme, 1997	3
20	All Intermediaries	SEBI (Prohibition of Insider Trading) Regulations, 1992 SEBI (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002 SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003 SEBI (Central Database of Market Participants) Regulations, 2003 SEBI (Self Regulatory Organisations) Regulations, 2004 SEBI (Criteria for Fit and Proper Person) Regulations, 2004.	24,491

Source: SEBI.

The regulations in respect of each intermediary generally prescribe the following:

- (a) Requirements of becoming an intermediary,
- (b) Procedure for becoming an intermediary,
- (c) Fees payable by the intermediary,
- (d) General obligations and responsibilities of a registered intermediary,
- (e) Code of conduct to be followed by the intermediary,
- (f) Procedure for inspection of an intermediary,
- (g) Procedure for action in case of default, and
- (h) Surrender / cancellation of certificate of registration.

Besides, the SROs have framed Rules and byelaws to regulate their members. The Central Government, SEBI and the SROs have issued a number of guidelines and circulars to govern the working of the intermediaries.

### TOOLS OF REGULATION

Generally four sets of tools are used to regulate the intermediaries: a) Registration, (b) Monitoring the Compliance, c) Enforcement, and d) Self-regulation.

### Registration

An entity intending to act as an intermediary is required to have a registration / license to do so. It prevents incapable and undesirable entities and persons behind them from entering into the market and rendering intermediation services. The registration process checks the credentials and capability of the entities intending to act as an intermediary and persons behind them and grants registration, if found suitable. The process also ensures that if the intermediary fails to meet the requirements of registration at any time after it is granted registration, the registration is withdrawn or cancelled. The fear of withdrawal / cancellation of the registration provides a powerful incentive for market intermediaries to comply with the applicable laws.

The Regulations framed by SEBI prescribe minimum eligibility criteria and standards for registering each class of intermediaries. For example, the SEBI (Merchant Bankers) Regulation, 1992 requires SEBI, while considering grant of registration to a merchant banker, to take into account all relevant matters, including the following:

- (a) The applicant is a body corporate.
- (b) The applicant has the necessary infrastructure like adequate office space, equipments, and manpower to effectively discharge his activities.
- (c) The applicant has in his employment minimum of two persons, who have the experience to conduct the business of the merchant banker.
- (d) A person directly or indirectly connected with the applicant has not been granted registration by SEBI.
- (e) The applicant fulfils the capital adequacy requirements (Net worth of Rs. 5 crore for category - I merchant banker).
- (f) The applicant, his partner, director or principal officer is not involved in any litigation connected with the securities

market which has an adverse bearing on the business of the applicant.

(g) The applicant, his director, partner or principal officer has not at any time been convicted for any offence involving moral turpitude or has been found guilty of any economic offence.

(h) The applicant has the professional qualification from an institution recognised by the Government in finance, law or business management.

(i) The applicant is a fit and proper person.

(j) Grant of certificate to the applicant is in the interest of investors.

Some intermediaries like brokers and sub-brokers are granted permanent registration while others like merchant bankers / depository participants are granted registration for 3 / 5 years. On expiry of registration of the initial period of 3/ 5 years, the intermediary is required to seek renewal of registration. The same standards and procedures, as followed for initial registration, are followed for renewal of registration. If an applicant is not found suitable for grant or renewal of registration, SEBI refuses to grant or renew the registration after giving an opportunity of hearing to the applicant. An applicant aggrieved by the decision of SEBI can prefer an appeal before the Securities Appellate Tribunal. These transparent provisions ensure that the standards are applied uniformly and any body and every body who qualifies in terms of the prescribed criteria are allowed to act as an intermediary.

All registered intermediaries are required to pay prescribed fees during the currency of their registration. Some intermediaries are required to pay fees based on the volume of business they do while others pay fees annually.

Thus the registration process envisaged in the regulations generally ensures that the person intending to act as an intermediary is:

(a) a fit and proper person; this ensures that undesirable persons do not sneak into the market.

(b) has necessary infrastructure, competent / qualified personnel, and adequate capitalization required to carry on the licensed activity. This ensures that the entity has adequate competence and facilities to render quality intermediation services

(c) agreeing to comply with the rules and regulations, the code of conduct and any condition that may be imposed along with registration. For example, as a condition of registration, the intermediary may be required to set up systems and procedures to prevent fraudulent / manipulative trading. This ensures that the entity behaves in a desirable manner in the best interests of the market.

### Fit and Proper Person

A major objective of registration is to prevent undesirable persons sneaking into securities market. Before granting registration, SEBI ensures that the person seeking registration is a fit and proper person. In order to determine if an applicant seeking registration as intermediary is a 'fit and proper person',

SEBI takes account of any consideration as it deems fit, including:

- (a) financial integrity;
- (b) absence of convictions or civil liabilities,
- (c) competence,
- (d) good reputation and character,
- (e) efficiency and honesty, and
- (f) absence of any disqualification to act as an intermediary.

A person is not considered fit and proper for the purpose of grant or renewal of certificate to act as an intermediary or to continue to act as an intermediary, if he incurs any of the following disqualifications:

- (a) The applicant or the intermediary, as the case may be, or its whole time director or managing partner has been convicted by a Court for any offence involving moral turpitude, economic offence, securities laws or fraud.
- (b) An order for winding up has been passed against the applicant or the intermediary.
- (c) The applicant or the intermediary, or its whole time director, or managing partner has been declared insolvent and has not been discharged.
- (d) An order, other than an order of suspension of certificate of registration as an intermediary, restraining, prohibiting or debarring the applicant or the intermediary, or its whole time director or managing partner from dealing in securities in the capital market or from accessing the capital market has been passed by SEBI or any other regulatory authority and a period of three years from the date of the expiry of the period specified in the order has not elapsed.
- (e) An order canceling the certificate of registration of the applicant or the intermediary has been passed by SEBI on the ground of its indulging in insider trading, fraudulent and unfair trade practices or market manipulation and a period of three years from the date of the order has not elapsed.
- (f) An order withdrawing or refusing to grant any license / approval to the applicant or the intermediary, or its whole time director or managing partner which has a bearing on the capital market, has been passed by SEBI or any other regulatory authority and a period of three years from the date of the order has not elapsed.
- (g) The applicant or the intermediary is financially not sound;
- (h) Any other reason, to be recorded in writing by SEBI, which in the opinion of the SEBI, renders the applicant or the intermediary, or its whole time director or managing partner unfit to operate in the capital market.

Not only the person should be fit and proper at the time of registration; he must continue to remain fit and proper for the registration to remain valid. Hence the conduct of an intermediary is continuously watched by SEBI. Further, all the rules relating to intermediaries require every intermediary to obtain prior approval of SEBI before it changes its status and

constitution. For example, the change in control, change in directors, transfer of registration, etc. require prior approval of SEBI so that no undesirable person sneaks in through the back door.

### Capital Adequacy and Infrastructure

The authorities prescribe capital adequacy norms for the intermediaries as tool to manage the risks associated with transactions intermediated by them and a proxy for the adequacy of infrastructure / facilities to render quality intermediation services. These have been prescribed by SEBI through regulations and circulars. Over and above the norms prescribed by SEBI, the SROs at times prescribe higher norms. SEBI regulations prescribe capital adequacy norms as eligibility

for registration. These take the form of net worth, paid up capital and base minimum capital (BMC). The capital adequacy norms prescribed for different intermediaries by SEBI are presented in Table 2.

The quality of intermediation services depends on the quality and quantity of human resources and physical infrastructure at the disposal of the intermediary. Keeping this in view, SEBI regulations prescribe minimum requirements with regard to infrastructure, systems, skill and experience of personnel, etc. For example, it has been prescribed that a person seeking the registration of a broker must have passed 12<sup>th</sup> standard and must have two years experience in dealing with securities. It has also been prescribed that the approved users and sales

**Table-2: Capital Adequacy Norms for Intermediaries Prescribed by SEBI**

Sl. No.	Intermediary	Net Worth	Paid up Capital	BMC / Exposure Limits
1.	Category I Merchant Banker	Rs. 5 crore	NP	NP
2.	Portfolio Manager	Rs. 50 lakh	NP	Limits placed by the clients
3.	Category I Registrar to an Issue	Rs. 6 lakh	NP	NP
4.	Underwriter	Rs. 20 lakh	NP	20 times of the net worth.
5.	Debenture Trustee	Rs. 1 crore. The entity should also be a scheduled bank or PFI or an insurance company or body corporate	NP	NP
6.	Banker to an Issue	Should be a Scheduled Bank.	NP	NP
7.	Custodian of Securities	Rs. 50 crore	NP	NP
8.	Depository	Rs. 100 crore	NP	NP
9.	Depository Participant	Should be a PFI or Scheduled Bank or SFC or CC. Rs. 50 lakh, if broker	NP	100 times of the net worth, if broker. No limits for others.
10.	Mutual Funds	Sponsor to have positive net worth, which is more than the capital contribution of the sponsor in the AMC	NP	NP
11.	Venture Capital Fund	Each scheme / fund to have firm commitment from the investors for contribution of at least Rs. 5 crore.	NP	NP
12.	Collective Investment Management Company	Rs. 5 crore	NP	NP
13.	Credit Rating Agency	Rs. 5 crore	NP	NP
14.	Stock Broker (Cash Segment)	NP	Rs. 30 lakh for large exchanges	BMC of Rs. 10 lakh for large exchanges. Gross exposure not to exceed 20 times BMC and additional capital.

1	2	3	4	5
15.	Trading Member (Derivative Segment)	As may be specified by the derivatives exchange or segment from time to time.	NP	NP
16.	Clearing Member	Rs.3 crore (Deposit of at least Rs. 50 lakh with CC)	NP	3% of notional value of gross open position in index futures and short index options, and 5% of notional value of futures and short option position in stocks not to exceed liquid net worth.
17.	Self-clearing Member	Rs. 1 crore (Deposit of Rs. 50 lakh with the CC)	NP	- do -
18	Sub-Broker	NP	NP	NP
19	FII	NP	NP	NP
20	Approved Intermediary	Rs. 50 crore under SLS	NP	NP

NP: Not Prescribed.

personnel of a derivative broker must pass a certification programme approved by SEBI. It has been made mandatory for all mutual funds to appoint agents/distributors who have obtained AMFI certification. The employees of mutual funds, particularly those who are involved in sales and marketing, are encouraged to pass the certification. In addition to SEBI requirement, market participants, on their own, have also mandated certification for different functionaries working with intermediaries. For example, NSDL requires that every depository participant branch must a person who is certified in depository operations. NSE has mandated that every person having with an user id of its trading system must be certified in trading operations. Reportedly SEBI is working to mandate a market wide certification programme for person working with or as intermediaries.

### Code of Conduct

The authorities generally prescribe standards of business practices for intermediaries to foster investor confidence and to protect the market integrity. These standards require intermediaries to act with full care, skill and diligence and honestly in the best interests of their clients and the integrity of the market. Such standards are prescribed in the form of a code of conduct. The regulations relating to each kind of intermediary prescribe a code of conduct. For example, the code of conduct prescribed for debenture trustees requires them to:

- make all efforts to protect the interests of debenture holders,
- maintain high standards of integrity, dignity and fairness in the conduct of its business,

- fulfill its obligations in a prompt, ethical and professional manner,
- exercise due diligence, ensure proper care and exercise independent professional judgment,
- 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,
- 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,
- avoid conflict of interest and make adequate disclosure of its interest,
- 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, etc.

In addition, the regulations impose certain general obligations and responsibilities on intermediaries. These generally require the intermediary to abide by code of conduct, maintain books of account and records, appoint compliance officers, etc. Every intermediary is required to obtain a unique identification number for itself as well as for its related persons such as its principal officer and personnel engaged in operational activities, directors

/ partners / proprietor, promoter, associates and their directors, sponsors / trustees / asset management companies / asset managers, and the relatives. It is required to frame a code on internal procedure and conduct to prevent insider trading. The intermediaries and their employees can not give advice to the clients or in public media unless they make proper disclosure of their interest in the security.

### Monitoring the Compliance

The Regulations cast huge obligations and responsibilities on the intermediaries, which are monitored by the regulator and SROs. They monitor the day-to-day activity in the markets and the conduct of market intermediaries and collect and analyse information gathered from the activities of the intermediaries.

#### Compliance Officer

Every market intermediary is required to appoint a compliance officer who is responsible for monitoring the compliance of the Act, rules and regulations, notification, guidelines, instructions etc. issued by SEBI and central government and for redressal of grievances. The compliance officer is under obligation to report immediately and independently to SEBI any non-compliance observed by him.

#### Disclosures and Reporting

Intermediaries are required to prepare and maintain on a continuous basis certain records and accounts relating to their business and operations and report certain details periodically to the regulator and/or the SRO. The details to be reported are modified as and when required to take into account newer circumstances.

#### Inspection and Investigation

SEBI appoints inspecting authorities to undertake inspection of books of account and other records with a view to ensure that the books of accounts and records are being maintained in the required manner and the provisions of the Act, rules and regulations are being complied with. SEBI undertakes such inspection also to investigate into the complaints received from investors, or to investigate into the affairs of the intermediary in the interest of securities business or investors' interest. SEBI also appoints qualified auditors to investigate into books of account or the affairs of the intermediary. The SROs also inspect the books and records and investigate into affairs of the intermediaries.

#### Market Surveillance

SEBI has an effective market surveillance system to discover patterns in transactions indicating infractions of prescribed business practices and codes of conduct of intermediaries.

### Enforcement

An effective enforcement system safeguards the integrity of the market by deterring intermediaries from violating Acts, rules and regulations. This requires the regulator to have adequate resources and a range of disciplinary tools at its disposal. Such tools at the disposal of SEBI include investigation and prosecution for fraudulent, manipulative, and other illegal forms of conduct and sanctions such as censure, monetary penalty, suspension or revocation of registration, etc.

The SEBI Act provides for two alternative types of punishment

for violations of the provisions of the Act, in addition to power of direction under section 11 and 11 (B) of the SEBI Act, cease and desist and prosecution orders. They are: (a) suspension or cancellation of certificates of registration to be imposed by SEBI as per Regulations framed by it, or (b) monetary penalty to be imposed by an adjudicating officer, appointed by SEBI, as per Rules framed by government. These two types of punishments are mutually exclusive. In cases where findings of the inspection / investigation warrant suspension or cancellation of registration of an intermediary, SEBI appoints an enquiry officer under the SEBI (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002 to determine if any violation has taken place and recommend appropriate penalty. Based on the recommendations of the enquiry officer, SEBI hears the party and imposes final penalty. If the alleged violation warrants monetary penalty, SEBI appoints an adjudicating officer to adjudicate the violation and impose monetary penalty under the SEBI (Procedure for Holding Enquiries and Imposing penalties by Adjudicating Officer) Rules, 1995. To ensure fair enquiry / adjudication and penalty, the Act provides for appeal before the securities appellate tribunal.

The SEBI (Brokers and Sub-Brokers) Regulations, 1992 provides an illustrative list of violations which may warrant monetary penalty, suspension or cancellation of registration or prosecution. A stock broker or a sub-broker is liable for monetary penalty in respect of the following violations:

- (i) Failure to file any return or report with SEBI.
- (ii) Failure to furnish any information, books or other documents within 15 days of issue of notice by SEBI.
- (iii) Failure to maintain books of accounts or records as per the Act, rules or regulations framed there under.
- (iv) Failure to redress the grievances of investors within 30 days of receipt of notice from SEBI.
- (v) Failure to issue contract notes in the form and manner specified by the Stock Exchange of which such broker is a member.
- (vi) 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.
- (vii) Charging of brokerage which is in excess of brokerage specified in the regulations or the bye-laws of the stock exchange.
- (viii) Dealing in securities of a body corporate listed on any stock exchange on his own behalf or on behalf of any other person on the basis of any unpublished price sensitive information.
- (ix) Procuring or communicating any unpublished price sensitive information to any person except as required in the ordinary course of business or under any law.
- (x) Counseling any person to deal in securities of any body corporate on the basis of unpublished price sensitive information.
- (xi) Indulging in fraudulent and unfair trade practices relating to securities.

- (xii) Execution of trade without entering into agreement with the client under the Act, rules or regulations framed there under or failure to maintain client registration form or commission of any irregularities in maintaining the client agreement.
- (xiii) 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.
- (xiv) Acting as an unregistered sub-broker or dealing with unregistered sub-brokers.
- (xv) Failure to comply with directions issued by SEBI under the Act or the regulations framed there under.
- (xvi) Failure to exercise due skill, care and diligence.
- (xvii) Failure to seek prior permission of SEBI in case of any change in its status and constitution.
- (xviii) Failure to satisfy the net worth or capital adequacy norms, if any, specified by SEBI.
- (xix) Extending use of trading terminal to any unauthorized person or place.
- (xx) Violations for which no separate penalty has been provided under the regulations.

A stock broker or a sub-broker is liable for suspension / cancellation of registration in respect of the following violations:

- (i) ceases to be a member of a stock exchange; or
- (ii) has been declared defaulter by a stock exchange and not readmitted as a member within a period of six months; or
- (iii) surrenders his certificate of registration to SEBI; or
- (iv) has been found to be not a fit and proper person by SEBI under any regulations; or
- (v) has been declared insolvent or order for winding up has been passed in the case of a broker or sub-broker being a company registered under the Companies Act, 1956; or
- (vi) any of the partners or any whole-time director in case a broker or sub-broker is a company registered under the Companies Act, 1956 has been convicted by a court of competent jurisdiction for an offence involving moral turpitude; or
- (vii) fails to pay fee as per regulations; or
- (viii) fails to comply with the rules, regulations and bye-laws of the stock exchange of which he is a member; or
- (ix) fails to co-operate with the inspecting or investigating authority; or
- (x) fails to abide by any award of the Ombudsman or decision of SEBI under the SEBI (Ombudsman) Regulations, 2003; or
- (xi) fails to pay the penalty imposed by the Adjudicating Officer; or
- (xii) indulges in market manipulation of securities or index; or
- (xiii) indulges in insider trading in violation of SEBI (Prohibition of Insider Trading) Regulations, 1992; or

- (xiv) violates SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003; or
- (xv) commits violation of any of the provisions for which monetary penalty or other penalties could be imposed; or
- (xvi) fails to comply with the circulars issued by SEBI; or
- (xvii) commits violations, which attract monetary penalty, which in the opinion of SEBI are of a grievous nature.

A stock broker or a sub-broker is liable for prosecution in respect of the following violations:

- (i) Dealing in securities without obtaining certificate of registration from SEBI as a stock broker or a sub-broker.
- (ii) Dealing in securities or providing trading floor or assisting in trading outside the recognized stock exchange in violation of provisions of the Securities Contract (Regulation) Act, 1956 or rules made or notifications issued there under.
- (iii) Market manipulation of securities or index.
- (iv) Indulging in insider trading in violation of SEBI (Prohibition of Insider Trading) Regulations, 1992.
- (v) Violating the SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003.
- (vi) Failure without reasonable cause-
  - a. 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
  - b. to appear before the investigating authority personally or to answer any question which is put to him by the investigating authority; or
  - c. to sign the notes of any examination taken down by the investigating authority.
- (vii) Failure to pay penalty imposed by the adjudicating officer or failure to comply with any of his directions or orders.

### Self Regulation

The SROs are expected to share the responsibility with the regulator in framing and administering regulations. SEBI is, therefore, mandated to promote and regulate SROs. SEBI has accordingly framed the SEBI (Self Regulatory Organisations) Regulation, 2003, which obligate SROs to:

- (a) always abide by the directions of SEBI.
- (b) be responsible for investor protection and education of investors or its members and shall ensure observance of securities laws by its members.
- (c) specify standard of conduct for its members and also shall be responsible for the implementation of the same by its members.
- (d) conduct inspection and audit of its members, on regular basis, through independent auditors.
- (e) submit its annual report to SEBI.
- (f) treat all its members and the applications for membership in a fair and transparent manner.

- (g) collect admission and membership fees from its members for carrying out the purposes of the regulations.
- (h) promptly inform SEBI of violations of the provisions of the Act, the rules, the regulations, the directions, the circulars or the guidelines by any of its members.
- (i) conduct screening and certification tests for its members, agents and such other persons as it may determine.
- (j) conduct training programmes for its members or agents and also conduct awareness programmes for securities market investors.
- (k) make endeavours for introduction of best business practices amongst its members.
- (l) act in utmost good faith and shall avoid conflict of interest in the conduct of its functions.
- (m) comply with the norms of corporate governance as applicable to listed companies.
- (n) discharge such other functions and obligations as may be specified by SEBI, from time to time.

It may be noted that self regulation is not an independent tool; it complements other tools. The SROs assist the regulators in use of the other tools such as registration, monitoring and enforcement. Further, the SROs are also subject to same tools of registration, monitoring and enforcement by SEBI as the intermediaries are.

### GLOBAL BENCHMARK

The 30 principles of securities regulations enunciated by IOSCO (International Organization of Securities Commissions) provide a yardstick against which progress towards effective regulation can be measured. IOSCO members, including SEBI, through their endorsement to these principles, intend to use their best endeavours within their jurisdiction to ensure adherence to these principles. Principles 21-24 of these principles deal with market intermediaries. These principles require that regulations for various types of intermediaries should address entry criteria, capital and prudential requirements, ongoing supervision and discipline of entrants, and the consequences of default and financial failure and that the oversight of market intermediaries should primarily be directed to the areas where their capital, client money and public confidence may most be put at risk. The status of implementation of these principles in India market is as follows:

#### Principle 21

Regulation should provide for minimum entry standards for market intermediaries. It should reduce the risk to investors of loss caused by negligent or illegal behavior or inadequate capital. The licensing process should require a comprehensive assessment of the applicant and the licensing authority should have power to withdraw or suspend the license. The regulator should ensure that the public have access to relevant information concerning the licensee.

The eligibility criteria have been prescribed for the intermediaries by SEBI as well as SROs, which need to be fulfilled before granting registration. For example, a broker is admitted to membership of an exchange in terms of the provisions of the Securities Contracts (Regulation) Act, 1956, the SEBI Act 1992,

the rules, circulars, notifications, guidelines, etc. prescribed there under and the byelaws, rules and regulations of the concerned exchange. No stock broker or sub-broker is allowed to buy, sell or deal in securities, unless he or she holds a certificate of registration granted by SEBI. A broker/sub-broker complies with the code of conduct prescribed by SEBI. The standards for admission stress on factors, such as, corporate structure, capital adequacy, track record, education, experience, etc. and reflect a conscious endeavour to ensure quality broking services. The brokers are subject to limits on trading volumes in a day as well as exposure at any point of time. An on-line monitoring and surveillance system monitors exposure of the brokers on a real time basis. They are not allowed to commingle their assets with the assets of clients. In case of their failure to meet their settlement obligations towards settlement agency or clients, there are arrangements in the form of settlement guarantee fund / investor protection fund to make up for their inability. There is an established procedure provided in the regulations for granting as well as revoking license of the intermediaries. The intermediaries are required display their registration certificate in their places of operation. The details of registered intermediaries are available on the web site of the regulator and SROs. The penal actions taken against intermediaries are also disseminated through web site of SEBI.

#### Principle 22

There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.

The entry norms for the intermediaries provide for the capital clause as well as the maintenance of the same on a continuing basis. The risks assumed by intermediaries are related to their capital adequacy. The SEBI Regulations as well as the rules of the SROs provide for inspection, investigation, enforcement and disciplinary measures including revocation of licence.

#### Principle 23

Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters. All listed companies and organisations associated with securities market including the intermediaries, asset management company, trustees of mutual funds, self regulatory organisations, stock exchanges, clearing house/corporations, public financial institutions, professional firms such as auditors, accounting firms, law firms, analysts, consultants etc. assisting or advising listed companies are required to frame a code on internal procedure and conduct. These entities abide by the Code for Corporate Disclosure Practices specified in the regulations. Regulations for intermediaries specify a code of conduct, which contains provisions to protect the interest of the clients and ensure proper management of risk. An intermediary is expected to observe high standards of integrity and fair dealing and act with due care and diligence in the

best interests of its customers and integrity of the market. Every market intermediary appoints a compliance officer to ensure compliance with the prescribed standards.

### Principle 24

There should be a procedure for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.

There are arrangements like Settlement/Trade Guarantee Funds and the Investor Protection Funds for dealing with the eventuality of failure by market intermediaries. The regulations provide for maintenance and inspection of records to ensure compliance with relevant requirements, investigatory and enforcement remedies, fair and expeditious process leading to discipline, etc. SEBI and SROs have developed mechanism for resolution of investor complaints.

## AREAS FOR IMPROVEMENT

### Repeal of Rules

Before the Securities Laws (Amendment) Ordinance, 1995 was promulgated the Central Government used to frame rules to govern the conditions of registration. Although the Central Government does not have powers now to frame rules, these rules continue to be in force. Even if some of the provisions of the rules have become redundant in the changed circumstances, the Central Government cannot amend them. Hence the obsolete rules would continue to be in force. It is, therefore, desirable that such rules are repealed and the relevant provisions from these rules are incorporated in the regulations.

### Surrender of Registration

The SEBI Act empowers the SEBI to suspend or cancel a certificate of registration in such manner as may be determined by regulations. While the regulations provide for penal suspension or cancellation of registration; they do not provide a procedure for voluntary surrender of registration. Some of the regulations provide for enquiry proceedings to cancel the registration even when the intermediary surrenders his registration voluntarily. The regulations should provide for cancellation of registration, if surrendered voluntarily, subject to certain compliances.

### Change in Status and Constitution

All the rules framed by the Central Government require that the intermediaries must obtain prior approval of SEBI for any change in status and constitution. However, the rules or regulations do not define what constitutes change in status and constitution, although SEBI has clarified this through circulars in respect of some intermediaries. It is desirable that the change in status and constitution is defined through regulations / circulars uniformly for all intermediaries so that they know clearly what change requires SEBI's prior approval.

### Restriction on Activities

Most of the intermediaries are carrying on only one type of intermediation service because of the restrictions placed by rules / regulations. This prevents them from reaping benefits from the economies of scale and scope and to encash synergies

across complementary intermediation services. The regulations should permit the intermediaries to carry on all kinds of intermediation services simultaneously and promote their consolidation. As may be seen from Table 1, the number of intermediaries is too huge to have effective regulation.

### Disclosure

An investor normally deals in securities through an intermediary, whose acts of omission and commission can cause loss to him. In order for the investor to choose the right intermediary through whom he may transact business, it may be useful to help him in taking informed decision by making details of intermediaries available to him. The details may include the form of organization, management, capital adequacy, liabilities, defaults and penal actions taken by the regulator and self-regulatory organizations against the intermediary in the past and other relevant information. If possible, the intermediaries may be rated and their ratings are disseminated. The intermediary may be mandated to make continuous disclosures about its performance and financial positions through a web site such as EDIFAR. For example, if an intermediary fails to comply with the prescribed eligibility criteria and particularly the capital requirements, it should come to the notice of the regulator and the investors instantly. The disclosures may be mandated through regulations.

### Certification

The confidence of the investors can be maintained and enhanced by making provision for professional intermediation services. Industry/SROs/Regulators have made a modest beginning, but not adequate given the dimensions of the market. A central agency, as may be accredited by SEBI, may offer a certification for each type of intermediation service. The certified people may be required to update their skills and expertise by seeking certification at periodic intervals. While this requirement should apply at the entry point for all new employees joining the intermediaries, the existing agents / employees may be allowed say, about a year, to obtain the certification. This requirement may be prescribed through amendments in the regulations as has been done in the SEBI (Brokers and Sub-Brokers) Regulations, 1992 for derivative brokers.

### Validity of Registration

Some kinds of intermediaries are granted registration for 3 / 5 years and are required to seek periodic renewals, while some others are granted permanent registration. It may be desirable that all intermediaries are treated uniformly and are granted registration for specified periods so that the competence and credential of the intermediary and the persons behind it are verified at the time of every renewal. Further there should be an arrangement to ensure painless and costless transfer of business from one intermediary to another within a definite time frame if the registration of the former intermediary is cancelled or not renewed.

### Fees Payable

SEBI follows different basis for levying fees from intermediaries. Since regulatory load of SEBI depends on the volume of market

transactions, the fees should be related to the volume of transactions intermediated by the intermediary.

### **Investment Advisors**

Investment manager like portfolio managers, collective investment schemes and mutual funds who manage funds or portfolio on behalf of a client/ultimate investor are required to fulfill the capital and other operational controls for getting and continuing with the registration. There are capital adequacy, professional and operational standards prescribed in the regulations for such intermediaries. However, as yet there is no exclusive regulatory framework for investment advisors, even though the SEBI Act clearly requires investment advisers to obtain registration from SEBI. It is, therefore, desirable that SEBI frames regulations for investment advisors.

### **Winding Up**

The regulations do not provide procedure to be followed when

an intermediary goes bankrupt or is wound up. The aspects such as the use of assets of such intermediary and the claims of the client need to be provided in the regulations.

### **Electronic Servicing**

Most of the regulations were framed in the early 1990s when electronic servicing was not in vogue. While all the transactions in securities are now taking place electronically, the intermediaries continue to deal with the regulator through papers. In the interest of efficiency, the regulations could provide for electronic registration, compliance, disclosure, surrender, etc.

### **CONCLUSION**

The regulatory framework for intermediaries, which has been evolving since 1992, has stood the test of time and has been able to ensure, by and large, quality intermediation services in the market. The suggestion made in earlier section would make at best marginal improvements in the regulatory framework for intermediaries.□