

CIRCULAR

SEBI/HO/MIRSD/DOP/CIR/P/2018/153

December 17, 2018

To,

**All Recognised Stock Exchanges
All Recognised Clearing Corporations
All Depositories**

Dear Sir / Madam

Subject: Early Warning Mechanism to prevent diversion of client securities

1. There have been instances where stock brokers had diverted clients' securities received as collaterals towards margin obligations and / or settlement obligations, for raising loan against shares on their own account and / or for meeting securities shortages in settlement obligations on its own account. However, such instances of diversion of securities come to light when stock broker failed in meeting the margin and/ or settlement obligations to Stock Exchange / Clearing Corporation.
2. It has been decided to put in place an Early Warning Mechanism and sharing of information between Stock Exchanges, Depositories and Clearing Corporations to detect the diversion of client's securities by the stock broker at an early stage so as to take appropriate preventive measures. The threshold for such early warning signals shall be decided by the Stock Exchanges, Depositories and Clearing Corporations with mutual consultation.
3. Early warning signals, for prevention of diversion of clients' securities, may include the following:
 - 3.1. Deterioration in financial health of the stock broker/ depository participant based on any of the following parameters:
 - a) Significant reduction in net worth over previous half-year / year.
 - b) Significant losses in the previous half years / years.
 - c) Delay in reporting of Annual Report, Balance Sheet, Internal Audit Reports, Risk Based Supervision (RBS) data and any other data related to its financial health to the Stock Exchanges / Depositories.
 - d) Failure to submit information sought by the Stock Exchange / Depositories on its dealing with related parties / promoters.
 - e) Significant mark-to-market loss on proprietary account/ related party accounts
 - f) Repeated instances of pay-in shortages.
 - g) Significant trading exposure or amount of loans or advances given to and investments made in related parties/ group.
 - h) Sudden activation of significant number of dormant client's accounts and / or significant activity in the dormant account/s.

- i) Significant number of UCC modifications.
 - j) Resignation of Statutory Auditors or Directors.
- 3.2. Early warning signals in relation to securities pledge transactions by the stock broker to be identified by the Depositories and shall be shared with Stock Exchanges which may include:
- a) Alerts for stock brokers maintaining multiple proprietary demat accounts and opening any new demat account in the name of stock broker for client purpose.
 - b) Movement of shares to / from a large number of clients' demat accounts or large value shares to stock broker proprietary accounts and vice a versa.
 - c) Transfer of large value of shares through off-market transfers other than for settlement purposes.
 - d) Invocation of pledge of securities by lenders against stock broker or his clients.
 - e) Significant depletion of client's shares in the stock broker client account maintained by the stock broker.
- 3.3. Increase in number of investor complaints against the stock broker / depository participant alleging un-authorized trading / unauthorized delivery instructions being processed and non-receipt of funds and securities and non-resolution of the same.
- 3.4. Alerts generated from the monthly / weekly submissions made by stock broker under Risk Based Supervision (RBS) or Enhanced Supervision to the Stock Exchanges.
- a) Non-recovery of significant dues from debit balance clients over a period of time.
 - b) Significant dues to credit balance clients over a period of time.
 - c) Failure by stock broker to upload weekly data regarding monitoring of clients' funds as specified in SEBI's circular on Enhanced Supervision, for 3 consecutive weeks.
 - d) Pledging securities in case of clients having credit balance and using the funds so raised against them for own purposes or for funding debit balance of clients.
 - e) Mis-reporting / wrong reporting about the client funds / securities.
 - f) Significant increase in RBS score.
- 3.5. Stock broker's terminal disabled for certain number of days in any segment / Stock Exchange in previous quarter.
4. Stock Exchanges and Depositories shall frame an internal policy / guidelines regarding non-cooperation by stock brokers and depository participants during inspections which shall lay down the time period, the type of documents critical for closing the inspections, which if not submitted, can be treated as non-cooperation.
- 4.1. Failure to submit data sought for inspections especially relating to bank / demat accounts, client ledgers etc. despite repeated reminders.
 - 4.2. Failure to provide reasonable access to the records or any office premises.

5. Stock Exchanges / Clearing Corporations / Depositories, shall devise a mechanism to detect diversion of clients' securities and to share information among themselves in respect of:
 - 5.1 Diversion of pay-out of securities to non-client accounts
 - 5.2 Mis-matches between gross (client-wise) securities pay-in and pay-out files of a stock brokers generated by the Clearing Corporation which shall be compared with actual transfer of securities to/from the client's depository accounts by the Depository. The cases of any mismatch found out by the Depository shall be informed to the concerned Stock Exchange / Clearing Corporation.
 - 5.3 Stock Exchange shall seek clarification from the concerned stock broker on the mismatches reported by Depository and identify transfer to a non-client / third party, without any trade obligation.
 - 5.4 Such information on wrong / fraudulent / unauthorized transfer shall be shared by the Stock Exchange with other Stock Exchange/s.
6. Any other alerts as the Stock Exchanges / Clearing Corporations and Depositories may deem fit.
7. Alerts triggered at one Stock Exchange / Clearing Corporation / Depository through early warning mechanism shall be immediately shared with other Stock Exchanges / Depositories with respect to the stock broker / depository participant.
8. Based on the analysis of the early warning data, if it is established that the stock broker's financial health has deteriorated and/ or he has made unauthorized transfer of funds / securities of the client, in such cases Stock Exchanges / Depositories shall jointly take preventive actions on the stock broker which may include one or more of, but not limited, to the following:
 - 8.1. Actions to be initiated by the Stock Exchanges like:
 - a) Blocking of certain percentage of available collaterals towards margin.
 - b) Check securities register in respect of securities received and transferred against pay-in / pay-out against settlement and client's securities received as collateral.
 - c) Check details of funds and securities available with the clearing member, Clearing Corporation and the Depository of that stock broker.
 - d) Impose limits on proprietary trading by the stock broker.
 - e) Prescribe and monitor shorter time duration for settlement of Running Account of clients.
 - f) Conduct meeting with the designated directors of the stock broker to seek appropriate explanation.
 - g) Uniform action of deactivation of trading terminals by all Stock Exchanges based on the communication received from other Stock Exchange.
 - h) Initiate inspection of the stock broker / depository participant.
 - i) Cross check information submitted by stock broker with other independent sources like collateral details with the Clearing Corporation, transactions in Bank and Depositories, with statement collected directly etc.

- j) Where client money and securities diversion is suspected, appoint forensic auditor to trace trails of entire funds and securities of clients.
- 8.2. Actions to be taken by the Depositories:
- Restriction on further pledge of client securities from the client's account by freezing the stock broker client account for debit.
 - Imposition of 100% concurrent audit on the depository participant.
 - Cessation / restriction on uses of Power of Attorney (POA) given to stock broker by clients mapped to such brokers only to meet settlement obligation of that client. Clients to issue instructions electronically or through Delivery Instruction Slip (DIS) for delivery of shares for off market transfers.
- 8.3. Any other measures that Stock Exchanges / Clearing Corporations / Depositories may deem fit.
9. Stock Exchanges, Clearing Corporations and Depositories are directed to implement the above early warning mechanism and preventive actions, with effect from February 01, 2019.
10. This circular is being issued in exercise of powers conferred under Section 11 (1) of the Securities and Exchange Board of India Act, 1992 and Section 19 of the Depositories Act, to protect the interests of investors in securities and to promote the development of, and to regulate the securities market.

Yours faithfully,

D Rajesh Kumar
General Manager