

THE GAZETTE OF INDIA
EXTRAORDINARY
PART – II SECTION – 3 SUB-SECTION (ii)
PUBLISHED BY AUTHORITY
SECURITIES AND EXCHANGE BOARD OF INDIA
NOTIFICATION
MUMBAI, THE 31st DAY OF AUGUST, 2004

1. S.O. 971(E) - The Mangalore Stock Exchange (hereinafter referred to as “MGSE”) is a company limited by guarantee and was granted recognition as a stock exchange under section 4 of the Securities Contracts (Regulation) Act, 1956 (hereinafter referred to as “SC(R)A”) on September 09, 1985. The renewal of recognition of MGSE has been granted since then from time to time and the last recognition of MGSE was valid up to September 08, 2003.
2. The Securities and Exchange Board of India (hereinafter referred to as “SEBI”) conducted an inspection of MGSE between August 21-24, 2002 and the findings of the inspection were communicated to MGSE. Thereafter, in the interest of trade and also in the public interest, SEBI, by virtue of the powers conferred upon it by section 4 of the SC(R)A, granted renewal of recognition to MGSE for one year, commencing on the 9th day of September 2002 and ending on the 8th day of September 2003, subject to the condition that all the suggestions made in Part I of the report on inspection of MGSE, conducted during August 2002, be complied with, by MGSE, within 2 months from the date of notification of the renewal.
3. Subsequently, an inspection of MGSE was conducted from August 6-9, 2003, in order to determine whether the exchange should be granted further renewal of recognition, after expiry of the renewal granted till September 08, 2003. During the course of the said inspection, the status of compliance of the suggestions made in the previous inspection report were specifically looked into and it was observed that

MGSE had implemented only 5 suggestions completely, while the following 13 suggestions had not been implemented:

- i) Setting up of the Settlement Guarantee Fund, as advised by SEBI Circular dated 09.06.1997.
- ii) Filling up the post of Executive Director immediately, by a suitable competent person with professional qualification in the area of finance, adequate post qualification experience in the financial sector or Capital market with a proven track record.
- iii) Drawing up a list of approved securities which are liquid, which are to be considered towards Base Minimum Capital (BMC) deposited by the members and not accepting infrequently traded scrip/below par scrips.
- iv) Ensuring that the member brokers make good their shortfall in BMC within a reasonable period; immediately suspending members failing to comply with this requirement.
- v) Transferring 50% of the interest earned on 1% Security Deposit to Investor Protection Fund.(IPF)
- vi) Prescribing contribution to IPF from members, based on their turnover, as per GOI Directives dated 22.08.1985.
- vii) Not to stop collecting under any circumstances, the contributions from the members towards IPF, as the members trade through ICSEIL(ISE) and to continue to transfer 2% of the listing fees collected to IPF.
- viii) Taking steps to immediately modify the existing software/procuring new software to cater to the requirement of the present settlement cycle system of T+3.
- ix) Taking necessary steps to amend its bye-laws with regard to Arbitration, on the lines of the new Arbitration Act.
- x) Amending its articles/bye-laws to provide for treating the claims of investors at par with those of member brokers, as per SEBI directives. Fixing a proper time frame for processing and settlement of claims.
- xi) Taking immediate appropriate steps to ensure that the composition of the Council of Management and other statutory committees are in the prescribed ratio of 50:50 and 60:40 respectively.

- xii) Expediting the compilation of the database in respect of the remaining members within a specific time frame.
 - xiii) Ensuring that the sub brokers affiliated to the member brokers of the Exchange enter into the revised agreement as prescribed by SEBI vide letter dated May 23, 1997. Collecting the arrears of registration fees from the sub brokers concerned, at the earliest and remitting the same to SEBI.
4. Apart from the non compliance with the suggestions made in the Part I of the report on inspection of the 'MGSE' conducted during August 2002, on which the renewal of recognition of the Exchange was conditional, certain major irregularities were also observed by the inspection team in the functioning of the exchange viz non-compliance with the stated investment policy/norms of the exchange, use of temporary employees as authorized signatories for signing cheques, drain of the exchange's resources and inadequate provisioning of software for T+3/T+2 trading system etc, which can have serious ramifications on the functioning of an exchange. This non compliance of suggestions on which the renewal of recognition was conditional and deficiencies/flaws in the management of the affairs of the Exchange is in violation of the provisions of SC(R)A, the Securities Contracts (Regulation) Rules, 1957 (hereinafter referred to as the 'SC(R)R'), the SEBI Act, 1992 (hereinafter referred to as 'the Act') the Rules and Regulations made there under, the circulars / directives issued by SEBI and the Rules, Regulations and Bye laws of MGSE.
5. Hence, SEBI issued a notice dated September 8, 2003, under Section 4(4) of SC(R)A, to the Governing Board of MGSE, calling upon them to show cause as to why the request for renewal of recognition of MGSE should not be refused. SEBI advised them to reply to the notice within 15 days from the receipt of the same. They were also advised that in case they failed to reply to the said show cause notice, SEBI would be constrained to presume that the Governing Board has nothing to say in the matter and SEBI would be free to take such action as it

considered appropriate under the provision of the Section 4(4) of SC(R)A and other applicable provisions.

6. In response to the said show cause notice, the Governing Board made its submissions vide its letter dated September 20, 2003 and requested for a personal representation to SEBI in this regard. SEBI advised the Governing Board to appear on October 7, 2003 for a personal hearing before me, along with supporting documents, if any. On the said date, Dr T. Mallikarjunappa, Public Representative Director, Shri Ashish Parikh, Member Director and Ms Namitha W. Pais, Chief Manager appeared before me and made their submissions. Thereafter, additional submissions were made by the Governing Board vide letter dated October 13, 2003.
7. A gist of the violations alleged against the Governing Board and its submissions, made vide their letters dated September 20, 2003 and October 13, 2003 and during the hearing held on October 7, 2003, before me, is summarized below:

Inspection 2002 – Status of compliance

7.1 Delay in the setting up of the Settlement Guarantee Fund (SGF)

The Governing Board submitted that the SGF had not been set up as there was no trading on the floor of the Exchange since 2000-01. As a promoter exchange of Interconnected Stock Exchange of India Ltd (hereinafter referred to as ISE) MGSE had contributed Rs.10 lacs to the SGF of ISE. It was further stated that MGSE had now set up its SGF with a corpus of Rs.2 lacs, as resolved in the Board resolution passed in the meeting held on September 20, 2003 and that there was also a Brokers Protection Fund formed earlier for a similar purpose. It was submitted that steps were being taken to close the said fund and transfer the proceeds therein to the SGF.

7.2 Failure to appoint the Executive Director :

While MGSE did not have an Executive Director since December 2000, Ms Pais was appointed as the Executive Director of the MGSE, without SEBI's approval. SEBI directed Ms. Pais to immediately relinquish the office of Executive Director. Moreover, when her name was subsequently recommended by the exchange for the said post, SEBI rejected her candidature vide letter dated September 20, 2002, as she did not possess the requisite experience in the capital market/securities market. However, MGSE appointed Ms Pais as Chief Manager of MGSE and assigned duties and powers to her which were such as could be exercised and discharged only by an Executive Director of an Exchange.

In response to the said charges, the Governing Board submitted that as per the directive of SEBI, sincere attempts had been made to appoint an Executive Director from amongst the applicants, while also keeping in view the financial impact on the Exchange, the declining trading activity and the crunch in the financial avenues of the exchange. Defending their appointment of Ms. Pais, it was submitted that among all the applicants, she was found to be suitable by the Selection Committee for appointment as Executive Director. Since SEBI turned down the said appointment, a fresh attempt was made for selecting the Executive Director of MGSE. While seven candidates responded to the advertisement, only four candidates turned up for the interview and out of these, the names of the three candidates, which included the name of Ms Pais, were forwarded to SEBI vide letter dated June 02, 2003 along with the report of the Selection Committee dated May 31, 2003. It was submitted that as Ms. Pais was one of the candidates who had turned up for the interview, an opportunity was granted to her on par with other candidates, and hence her selection should not be construed as having granted her any preference.

7.3 List of infrequently traded / below par scrips contributed towards Base Minimum Capital (BMC) :

With reference to the said charge, it was submitted that the Exchange had drawn up a list of approved securities which were liquid and consisted of scrips which formed part of BSE Sensex/S&P Nifty/BSE 100/CNX Nifty Junior/BSE 200/CNX Midcap 200 and the same shall be considered towards BMC deposited by the members.

7.4 Shortfall of BMC:

With reference to the same, it was submitted that in view of the fact that the average daily turnover of MGSE was less than Rs.1 crore since April 1999, the exchange had reduced the BMC to Rs.1 lakh as per the SEBI circular June 18, 2003. It was further submitted that as there had been an incidental shortfall of BMC prior to June 2003, appropriate penalties were being considered for levy against such members whose BMC had fallen short of the requirements. MGSE has submitted that at present, all the members were maintaining the requisite BMC.

7.5 Failure to transfer 50% of the interest earned on 1% Security Deposit to the Investor Protection Fund:

It was submitted that the Governing Board, at its meeting held on 23.8.2003, had passed a resolution to transfer 50% of the interest earned on 1% security deposit to the IPF and presently the amount to the credit of IPF is Rs.16,35,994.

7.6 Failure to prescribe contribution to IPF from members based on their turnover:

It was submitted that the Board, at its meeting held on September 20, 2003, had passed a resolution prescribing contribution to IPF from members based on their turnover. It was submitted by MGSE that at present the members are contributing Rs.500/- towards IPF, which was higher than the amount that would have been

collected if the contribution was linked to turnover. Hence there was no violation in respect of the contribution to IPF.

7.7 Failure to collect contribution from members towards IPF and transfer 2% of the listing fee collected to IPF:

It was submitted that notice of the same had been taken and this requirement has been complied with.

7.8 Failure to modify the existing software to meet T+3 settlement cycle system:

It was submitted that given the facts that the stock exchange had had no trading in the last four years, the members of MGSE were trading only through ISE, and the substantial expenditure expected to be incurred on the modification of existing software or procurement of new software to meet with the T+3 settlement requirement, the proposal to modify the software had been postponed. However, steps were now being taken to update the trading software to meet the said requirement by November 15, 2003.

7.9 Byelaws relating to arbitration :

As regards the amendment of the byelaws relating to arbitration, it was stated that necessary steps had been taken to amend its Byelaws on the lines of the new Arbitration Act.

7.10 Amendment of Article / Byelaw for treatment of claims of investors at par with those of member brokers as per SEBI directive:

It was stated that the required changes had been effected for the said purpose, through a resolution passed at the Board Meeting held on November 04, 2002.

7.11 Failure to maintain the composition of the Council of Management and the Statutory Committees in the prescribed ratio of 50:50 and 60:40 respectively:

With reference to the same, it was initially submitted that necessary resolutions would be moved in the AGM to be held on September 30, 2003 to comply with the requirements and that the composition of the present Board was 6 elected directors and 5 public representatives, including one SEBI nominee while that of the Statutory Committees was in the prescribed ratio of 60:40. Subsequently, it was stated that since there were only five public representatives instead of the sanctioned strength of six, only one broker director had been elected to the Board at the AGM held on October 07, 2003, as against the vacancies of two broker directors, who had retired by rotation. Therefore, as per the submissions made by the Exchange, the ratio of 50:50 on the Council of Management is maintained.

7.12 Compilation of the database:

It was submitted that the database in respect of 42 out of 69 members was prepared and it was now proposed to approach the remaining members in order to complete the compilation of the entire database by December 31, 2003.

7.13 Termination of sub-brokership:

It was stated that the sub-brokers had been directed to pay the arrears of registration fees to SEBI, failing which steps would be initiated to cancel their certificates of registration. It was subsequently submitted that there is only one case of sub broker pending, whose fees is outstanding at the Exchange.

Inspection 2003

7.14 Non-compliance of investment policy/norms of the Exchange:

The Exchange had invested more than 60 % of its funds in a single private mutual fund namely, JM Mutual Fund, the act being in discord with the then prevalent investment policy/norms of MGSE. This investment was done without prior approval of the Governing Board, which ratified the said decision subsequently. The minutes of the meeting did not reflect either the deliberations on the need for shifting the funds from scheduled commercial banks to the private mutual fund or the relevant details such as the period for which such investment would be deployed, quantum of return on the investments etc or any work sheets based on which such decision was taken.

MGSE has submitted that the said decision was taken to counter the falling listing revenues and negligible transaction fees of the Exchange. The Exchange also submitted that with the recent fall in interest rates, the stream of interest income was being seriously undermined. It was stated that the Governing Board, at its meeting held on August 23, 2003, had taken a decision to transfer Rs.18 lakhs from J. M. Mutual Fund to RBI Relief Bonds and had also decided to withdraw Rs.20 lakhs, which were held in Fixed Deposits in private sector banks, and invest the matured amount in RBI Relief Bonds. Thereafter, the Governing Board, at its meeting held on September 20, 2003, passed a resolution to reduce the exposure to a single mutual fund. The Exchange has submitted during the personal hearing that the minutes on the issue of investment in J M Mutual Fund were not fully recorded and hence, did not include the discussions on the said subject.

7.15 Temporary employees authorized to sign cheques:

The Governing Board had conferred the power to sign cheques, on behalf of the Exchange, to three temporary staff members, contrary to the directive issued by

SEBI vide circular dated December 20,2001, to the effect that only authorised executives of the Exchange should be authorized to sign cheques upto such amount as may be decided by the Board and for amounts above the specified limits, the office bearers of the Exchange, including the Executive Director, should be authorized to sign the cheques.

With reference to the same, it was stated that consequent to the VRS offered by the Governing Board in February 2002, the Exchange did not have any permanent employees, although steps had been initiated by it to appoint an Executive Director. Hence, in the interim period, employees employed on a contract basis were operating the bank accounts on behalf of MGSE, though only for routine expenditure and on a temporary basis. The Exchange submitted that this too would be stopped after the appointment of the Executive Director. It was submitted that in the matter of operation of bank accounts, necessary checks and balances existed and no lapses had been committed until now. Furthermore, the Governing Board, at its meeting held on September 20, 2003, had passed a resolution to take a fidelity insurance policy to cover any exigencies.

7.16 Drain of Exchange's Resources:

It was observed that the members and elected directors, with specific reference to Shri Ivan Eugene Lobo, were using the infrastructure of the Exchange such as server, computer systems, software etc as well as its staff, for their day to day trading activities. Further, exclusive terminals were provided to Shri Lobo to log on to ISE Securities and Services Ltd. (hereinafter referred to as 'ISS') through the server of MGSE, at a subsidized rate, whereby the cost incurred by MGSE was in excess of the charges collected by it for providing this service, thereby resulting in a resource drain from the Exchange, for the benefit of a few members.

In response to this charge, the Governing Board submitted that the members incurred their own cost of network connectivity from their office to the exchange

and each such member was also charged Rs.1,250/- per month for each of the terminals connected to the Exchange and the said amount was being collected from all members at Mangalore who were connected to the Exchange. It was also submitted that the said facility was available to all members, without exception. Furthermore, since Mangalore experienced frequent dislocation of connectivity due to poor infrastructure, the Exchange had a system to provide a back-up facility to all WAN members in case of a contingency, if requested for. Hence, the facility to square off the transactions of the members from the Exchange, in case of a break down in connectivity between their office and the Exchange, was a contingency pool arrangement available to all their members. No extra or special facilities had been extended to Shri Lobo. On the day of the Inspection, the back-up facility had been extended to him only upon his request, as his terminal had lost connectivity. It was also stated that transaction fees were collected from all the members trading through ISS, based on their turnover i.e. Rs.3 per every lakh and in slabs thereof.

7.17 Indirect refund of non refundable one time payment of deposits paid by the members for registration in ISE :

It was observed that fifty two members had paid a one time entry fee for participating in trading through ISE. Subsequently, some of the members who had not taken up trading in ISE, had requested for refund of the said sum. However, the Governing Board, in its meeting held on September 22, 2001, decided not to refund the same as it was a one time entry fee for obtaining trading rights on ISE. However, subsequently, the Governing Board provided PCs worth Rs 30,000/- to all those members who had submitted the one time entry fee to obtain trading rights at ISE. This appears to be an act meant to circumvent the earlier decision of non refund of the amount.

The Governing Board stated that the computers were provided solely to facilitate trading on the national grid of the ISE, as the computers that were earlier supplied to the members, when trading on the MGSE was automated in 1996, were

inadequate and obsolete. MGSE further submitted that these Pentium III computers supplied to the members was never intended to be the property of the member but would always remain the property of the exchange.

7.18 Use of unauthorized software:

It was also observed that the configuration of the PCs provided by MGSE allowed the members to get connected to other members of the exchange who were trading in ISE, by using the provisions of CTCL/SBS (Secondary Broadcasting Station). In such cases, an approved terminal of a member could be accessed by any other person by means of software, at a low cost. Further, it was observed that such persons were functioning as a sub-terminal or as a sub-broker without complying with the formalities of registration with SEBI or seeking prior approval from MGSE, thereby contravening the provisions of the SEBI (Stock Brokers and Sub Brokers) Regulations, 1992.

In reply to the same, the Governing Board stated that the authorized sub-brokers of ISS, who are also members of 'MGSE', used only the authorized version of ODIN software and there was no other unauthorized software in use at 'MGSE'.

7.19 Contravention of SEBI (Stock Brokers and Sub brokers) Regulations 1992:-

It was observed that some non members of MGSE like Shri Rama Pujari and Shri Prakash regularly logged on to ISS through MGSE. Upon verification, it was revealed that the said two entities were acting as sub brokers of one of the prominent elected directors, Shri Lobo, himself a sub-broker of ISS. Thus, it appears that Shri Lobo had permitted his clients, Shri Pujari and Shri Prakash to act as sub brokers. Thus, an elected director was found to be not only utilizing the infra-structure of the MGSE for his own purpose but was also providing it to a few non – members, thereby violating the provisions of the SEBI (Stock Brokers and Sub brokers) Regulations, 1992, according to which a sub-broker is not permitted to

engage any other person/s as his sub-broker or permit his clients to act as sub-brokers, as was being done here. Thus, MGSE infrastructure was being used to log on to ISE by a non member, which was illegal and unauthorized.

In reply to the same, it was contended that ISE had allowed its sub brokers to have as many trading terminals as one required, after seeking its prior permission. In the said case, Shri Lobo had taken the permission and authorization from ISE to have four terminals, each to be operated by authorized persons and thus Shri Pujari and Shri. Prakash had been authorized to operate two of his terminals.

- 8 . In addition to the above, it was also submitted by MGSE that although there was no trading on the floor of MGSE, a number of services were being offered to and availed of, by the local investors and hence, the proposed action under section 4(4) of the SC(R)A be dropped and the recognition of the exchange be renewed.
9. I have taken into consideration the facts and circumstances of the case and the material available on record, which includes the show cause notice, replies and the documents submitted by the Governing Board as well as the submissions made before me, during the personal hearing.
10. I find that there is substantial non-compliance by MGSE with respect to the various suggestions contained in Part I of the report, for the inspection carried out in the year 2002, on which the renewal of recognition of MGSE was conditional. MGSE has failed to comply with 13 of the 18 suggestions made in the report. The details of the status of compliance vis-a -vis the suggestions made in the report are as under:

THE STATUS OF IMPLEMENTATION OF SUGGESTIONS MADE IN THE PREVIOUS INSPECTION REPORT

S.no	Suggestions made in the Inspection Report of 2002	Status
1)	The Exchange should ensure that arrears of SEBI registration fees is collected in full from those members who have resigned from	Implemented

	membership, before Security Deposit/Capital Adequacy Deposit is refunded to them.	
2)	The Exchange should immediately evaluate the BMCs of all the members and wherever FDRs are required to be renewed, the same should be renewed, the short fall in BMC should immediately be made good.	Implemented
3)	The Exchange should ensure that arbitration awards are properly and fully implemented and in the manner prescribed in SEBI Circular SMD/Policy/CIR-06/2002 dated 27.3.2002	Implemented
4)	The Exchange should initiate appropriate disciplinary action against members failing to submit the auditors report within the due dates/extended due date.	Implemented
5)	The exchange should take steps to double the BMC from Rs.2.00 lacs to Rs.4.00 lacs in terms of SEBI Circular SMD/SED/RCG/270/96 dated 19.1.96.	Need not be pursued
6)	The Exchange should expedite the compilation of the database in respect of the remaining members within a specific time frame.	Being implemented
7)	The Exchange should immediately fill up the post of Executive Director by a suitable competent person with professional qualification in the area of finance, adequate post qualification experience in the financial sector and Capital market with a proven track record.	Being implemented
8)	The Exchange should take necessary steps to amend its bye-laws with regard to Arbitration on the lines of the new Arbitration Act.	Being implemented
9)	The Exchange should amend its articles/bye-laws to provide for treating the claims of investors at par with those of member brokers as per SEBI directives. Proper time frame should be fixed for processing and settlement of claims and the same should be strictly complied with.	Being implemented
10)	The exchange should ensure that the sub brokers affiliated to the	Not

	member brokers of the Exchange enter into the revised agreement as prescribed by SEBI vide letter dated May 23, 1997. The arrears of registration fees from the sub brokers concerned should be collected at the earliest and remitted to SEBI.	Implemented
11)	The Exchange should expedite setting up of Settlement Guarantee Fund, as advised by SEBI Circular dated 09.06.1997.	Not implemented in time.
12)	The exchange should draw up a list of approved securities which are liquid and the same may alone be considered towards BMC deposited by the members. Infrequently traded scrips/below par scrips should not be accepted.	Not implemented.
13)	Exchange has to ensure that the member brokers make good their shortfall in BMC within a reasonable period. Members failing to comply with this requirement shall be suspended immediately.	Not implemented in time.
14)	The Exchange should transfer 50% of the interest earned on 1% Security Deposit to Investor Protection Fund.	Not implemented
15)	The Exchange should prescribe contribution to IPF from members, based on their turnover as per GoI Directives dated 22.08.1985	Not implemented
16)	The Exchange should not under any circumstances stop collecting the contributions from the members towards IPF as the members trade through ICSEIL and should continue to transfer 2%of the listing fees collected to IPF.	Not implemented
17)	The Exchange should take immediate appropriate steps to ensure that the composition of the Council of Management and other statutory committees are in the prescribed ratio of 50:50 and 60:40 respectively.	Not Implemented in time.
18)	The Exchange should immediately take steps to modify the existing software/procure new software to cater to the requirement of the present settlement cycle system of T+3.	Not implemented

11. The pertinent point to mention here is that these suggestions had been stipulated as conditions to be complied with, by MGSE, within two months from the date of grant of renewal of recognition. However, in case of most of the suggestions made in Part I of inspection report of year 2002, the Exchange has taken action or proposed to take action by passing Board resolution, only after the show cause notice dated September 08, 2003 was issued to the Exchange. I have examined the reasons assigned for the said non compliances/delayed compliances and find them inadequate to explain why these conditions have not been complied within the time frame specified by SEBI, at the time of granting renewal of recognition. The Exchange appears to have been negligent and casual in its approach towards the implementation of these suggestions. Even if the delay in implementation of the suggestions was to be condoned, I find that the current inspection has revealed several other serious irregularities in the conduct of the affairs of MGSE, some of which are in breach of even the basic requirements of law and ethics, as expected of a Governing Board of an Exchange.

INVESTMENT POLICY

12. In this context, I have noted the fact that during the course of Inspection in 2002, MGSE was found to have invested about 90 % of its total funds, amounting to Rs 1.06 crores, in scheduled commercial banks like Vysya bank, Karnataka Bank and Global Trust Bank and the balance 10 % was deployed in a mutual fund i.e. JM High Liquidity Fund.
13. However, the Governing Board, in its meeting held on May 31, 2003, ratified the decision to invest an amount of Rs 37.50 lakhs in JM Income Fund and Rs 15 lakhs in JM High Liquidity Fund and while doing so, it also modified its earlier investment policy (recorded in the minutes of the meeting held on November 04, 2002) of investing 60 % of its funds in AAA rated Income Funds, liquid funds, RBI Relief Bonds and Govt. Securities and 40% of its funds in the nationalized banks/ Scheduled Banks.

14. Thus, more than 60% of the funds of MGSE, were invested in a private mutual fund, without the prior approval of the Governing Board and in contravention of its then existing investment policies. I think it is pertinent to note that the said investment was ratified only after the investment was made and the investment norms were later amended to ratify such a deployment. I think it is also pertinent to state that there is no record of any discussions on the justification of deployment of such huge funds in one particular mutual fund, on the safety of the funds so deployed, or the analysis of the strength of the said mutual fund etc, being preliminary scrutinies which any prudent management council would have undertaken, for the safety and security of their funds. There is not even any mention in the minutes about the period for which such investment was to be deployed in the fund, quantum of return on the investments etc or any work sheets based on which such decision was taken. Seen in this context, any subsequent justification made by the Governing Board seems inadequate to counter the lack of adherence to any prudent norm while investing more than 60 % of the exchange's funds in one particular fund, while completely disregarding the requirement of taking a well considered decision before deployment of its funds. It is also evident that MGSE did not follow its own norm of staggering the deployment of funds across various categories of investments and also failed to record any reasons / justifications for ignoring the same. Thus, even if the 'merits' of deployment of funds in the mutual funds are to be accepted, the fact remains that a major portion of the funds of a public institution, involving the interest of the general public, were deployed in a single mutual fund, without even a preliminary due diligence process or any diversification among various similar such funds. Hence, the act of MGSE in not following any prudent investment norms in such a major decision deserves to be severely condemned.

APPOINTMENT OF EXECUTIVE DIRECTOR

15. I have noted that in the earlier inspection report, it had been pointed out that MGSE had appointed an Executive Director without complying with the stipulated directives/Rules and procedures required to be followed in the matter and also without the prior approval of SEBI. Since no prior approval was sought from SEBI for appointment of Executive Director, the incumbent so appointed was directed to relinquish the office immediately, vide our letter dated August 26, 2002 and the Exchange was directed that steps should be taken afresh for the appointment of a new Executive Director. I find that the Exchange has subsequently forwarded the name of the same incumbent for the post of Executive Director, for SEBI's approval. The Exchange was informed vide letter dated September 20, 2002 that the incumbent did not satisfy the minimum requirements with respect to an Executive Director of a stock exchange, in terms of experience in Capital Markets / Securities Market etc and was directed to call for fresh names for the post of Executive Director.
16. However, I am distressed to note that although the incumbent resigned from the post, she was re-appointed immediately as a "Chief Manager" and such duties and powers were assigned to her which could be exercised and discharged only by an Executive Director of an Exchange. Thus, by re-appointing the same person as Chief Manager and conferring on her the same powers and duties as that of an Executive Director, despite the fact that the appointment of the said person had earlier been rejected by SEBI on the grounds of not meeting the requirements of an Executive Director in terms of qualification and experience, MGSE has not only deliberately ignored and circumvented the directions of SEBI in this matter but also exercised favor and bias for a particular candidate. I have also taken note that apart from this, her name, along with that of two other candidates, has once again been sent to seek the approval of SEBI in the matter of appointment to the same post for which she was once rejected by SEBI. I also note that the Exchange had mentioned in its submission that the declining trading activity and crunch in financial avenues

were impediments in appointment of a suitable Executive Director. However, not once has the Exchange informed SEBI about the existence of such financial constraints in appointment of Executive Director and it is surprising to note that the Exchange has started facing such financial constraints after the issuance of showcause notice by SEBI.

INDIRECT REFUND OF NON REFUNDABLE ONE TIME PAYMENT OF DEPOSITS PAID BY THE MEMBERS FOR REGISTRATION IN ISE

17. I have noted from the records that in the year 1997-98, after a series of meetings, the Governing Board had, in its meeting held on April 22, 1998, resolved to collect a sum of Rs 30,000/- as one time non refundable fees (that was subsequently increased to Rs 35,000/- and to Rs 40,000/- at various stages) from those members who had opted to join the ISE, for obtaining trading rights from ISE. I have noted that 52 members were said to have paid a sum of Rs 30,000/- each, 2 members were said to have paid a sum of Rs 35,000/- each and 1 member a sum of Rs 40,000/-, totaling in all to Rs 16.70 lakhs. Subsequently, although some of these members, who did not join ISE, are said to have requested for refund of the said sum, the Governing Board in their meeting held on September 22, 2001, decided not to refund the said sum as the amount was treated as a one time entry fee for participating to trade through ISE. Even in the subsequent meetings, the Governing Board reiterated that such a sum could not be refunded. However, in the meeting of January 28, 2002, one of the sitting elected directors, Shri N M Shenoy, requested the Governing Board to consider throwing open trading on ISE/ISS to all members without insisting on the initial payment of Rs 30,000/-, given their "improved financial position" and the need to "improve the volume of trading" by the members, through the newly formed subsidiary of ISE. Subsequently, in the meeting held on March 02, 2002, the said director once again proposed that it would be necessary to provide all members of MGSE with a PC to enhance their capacities at a cost of Rs 30,000/- each and agreeing to the suggestion, PCs were provided by MGSE to its members.

18. Even though this decision of the Governing Board, read in isolation, would appear as a normal and development oriented decision, when the same is linked to the earlier series of discussions regarding the refund of non refundable portion of Rs 30,000/- paid by the members, it can be inferred that the decision to provide each PC at the cost of Rs 30,000/-, was only an act to circumvent the prohibitive decision taken earlier by the Governing Board, of not refunding the amount. Thus, the Governing Board has, by providing the members with PCs, effectively refunded the amount of Rs. 30,000. This is further established by the fact that on comparison of the list of members who had paid the said Rs 30,000 (which is about 52), and the list of members who had received the PCs (which is around 40), the latter list contains only the names of those members who had earlier paid the said sum to the Exchange. The Exchange has, in the process, incurred a total cost of Rs 8 lakhs to benefit a select group of members only. I find that providing of personal computers to some select members, who did not trade in the Exchange for the last three years, allegedly for the purpose of enhancing their capacities and that too, at a time where financial condition of the Exchange was not sound and had also ceased to record any trades for more than three years, defies any logic. Furthermore, I have noted that there has been no increase in the members getting registered as sub brokers to trade through ISS so far, thereby raising doubts about the need to give PCs to members who were allegedly not trading either on MGSE or ISE.

UTILISATION OF THE INFRA-STRUCTURE AND STAFF OF THE EXCHANGE BY THE ELECTED DIRECTORS FOR THEIR DAILY TRADING ACTIVITIES IN ISS

19. I have noted from the records that some of the members of MGSE, based at Mangalore and trading through ISE/ISS were provided a unique facility, such that the infrastructure of the Exchange viz, server, computer systems, software etc was being utilised by these members for accessing and trading in ISE/ISS by logging on to the servers and terminals of the Exchange which were in turn connected to the servers of ISE/ISS. It is noted that two terminals were provided exclusively for

these members to log on to ISS, through the server of the Exchange and in addition to this, two terminals were provided exclusively for executing trades in ISS by the said members. The arrangement was such that two members would log on to ISS through VSAT and the rest would log on through dial up mode. For members using the dial up mode, the Exchange had also provided few ISDN lines for the members, VSAT connection etc at its own cost.

20. An exclusive terminal was found to have been provided to one of the directors, Shri Lobo, for logging on to ISS and the other terminal was being used by the remaining members. Similarly, an exclusive ISDN line had been provided to one of the other directors, Shri Norbert Morris Shenoy, trading in the name of M/s Arunanjali Securities. The entire fixed cost of providing the VSAT, ISDN lines, servers, exclusive terminals was borne by the Exchange and there was no express provision or arrangement with the ISE or ISS for that matter, for the Exchange to provide such facilities to its members. In addition to this, the Exchange also had to bear the recurring cost of providing such facilities, e.g telephone charges, electricity charges, charges towards maintenance of the servers, terminals etc. I have noted from the inspection report that till recently, the Exchange was not collecting any charges from the members. The exchange has recently started collecting very nominal charges which is allegedly far lower than the cost that was actually being incurred by the exchange. Thus, an arrangement existed, whereby enormous subsidy was offered to some members causing a drain on the resources of the Exchange. Of the 8 brokers who accessed the ISS through the Exchange's server, three were found to be present elected directors of the Exchange. It is quite evident that the elected directors not only utilized the infra-structure of the Exchange for their own purpose but that they also provided the same to a few non-members having trading relations with them. It is to be noted that a member of an Exchange who trades through the subsidiary of his Exchange, can only do so as a sub-broker. SEBI (Stock Brokers and Sub-brokers) Regulations, 1992 do not permit a sub-broker to in turn have a sub-broker or permit his clients to act as a sub-broker. Despite the Regulation, the said arrangement was present in the Exchange. There have been instances of

elected directors and members indulging in the act of utilizing the services of the staff of the Exchange on a daily basis, especially the EDP staff, in routing their trade orders through the Exchange terminal. It was noticed that the EDP staff of the exchange performed the duty of executing orders for the members, especially for Shri Lobo. It is distressing to note that the elected directors were found to misuse their powers and abuse their position in the Exchange and also cause erosion of the resources of the Exchange, for their own commercial needs and benefits.

21. The Governing Board of an exchange is entrusted with the duty of implementation and administration of the Rules and Regulations and directives of SEBI in the Exchange, so as to ensure an orderly development of the capital market. When the persons entrusted with such duties themselves violate the Rules, for their own advantage, it cannot be perceived as a free, fair and just manner of administration.

EXERCISE OF FINANCIAL POWERS AND EXECUTION OF OTHER IMPORTANT AND SENSITIVE WORK

22. SEBI has already directed all stock exchanges (including 'MGSE') vide circular SMDRP/Policy/Cir52 /2001 dated December 20, 2001 that the Governing Board shall authorize the executives of the Exchange to sign cheques up to such amount as decided by the Governing Board and above that amount, the Governing Board shall authorize office bearers of the exchange, including the executive director, to sign cheques. I have also noted the instructions issued by SEBI to the effect that none of the elected directors be authorized to issue cheques on behalf of the Exchange. However, the Governing Board has, instead of granting this right to a person of authority, conferred this power on 3 staff members of the Exchange, who were not even in the permanent employment of the Exchange but were employed only on contractual terms and on assignment basis, which is akin to casual employment. It is apparent that any casual or temporary employee would not have any accountability or responsibility for their acts of omission or commission, if any. These employees, without the necessary authorization, were also being asked to

look after various works pertaining to operations and administration, which included market surveillance, accounts, EDP, legal, listing, underwriting and investor grievances, in the absence of any permanent employees in the exchange. I have noted that without the necessary discretion to issue any cheques, these temporary employees were issuing cheques on a regular basis and had even authorized the transfer of huge funds of the Exchange to a private mutual fund, without the express approval of the Board, based solely on the instructions of a single director. Even the annual returns of the Exchange to be filed with the RoC/DCA were signed only by one of these contractual employees and not by any directors, while the notice of EGM had been issued by the Chief Manager (a contractual employee).

23. I find that the elected directors have carefully and deliberately kept themselves outside the purview of any accountability/ responsibility for the Exchange, on records. Going by the various instances of questionable acts and decisions of the Governing Board, which do not meet the requirements of law and ethics as detailed above, it is clear that the Board had acted as an authority unto itself, throwing to winds, the norms and ethics to be followed in running an exchange, while still keeping itself outside the purview of any financial accountability and responsibility. I have noted that little has been done to rectify these shortcomings. An exchange with such vulnerabilities can pose a systemic threat to the entire securities market.
24. It also appears that MGSE is not interested in reviving trading on the exchange, which, as per SEBI's advice in June 2002, can commence only after upon establishment of SGF by the exchange. However, MGSE is yet to initiate any concrete and realistic action towards the realization of the said condition. If MGSE was serious about reviving trading on the exchange, it would have prepared itself by setting up a SGF, modified the software to meet the current requirement of the latest trading and settlement cycle system, established connectivity with the depository etc. I have also noted that the elected directors of the Governing Board continue to concentrate only on their trading in ISS, as against developing MGSE or taking steps to revive the trading and to bring back the inactive members to the

exchange. Further, MGSE has also exhibited a lack of seriousness in appointment of an Executive Director, who could possibly provide direction to the exchange. Further, there appear to be reasons to doubt the integrity of some of the elected directors, in view of the decisions undertaken by them.

25. From the material on record, it is clear that the affairs of the Governing Board are not being managed and conducted in a free, fair, transparent and just manner but are being run by a couple of elected directors, who have misused and abused their position with the sole motive of deriving pecuniary and unjust gains at all times from the Exchange. The purpose of establishment of stock exchange recognized under SC(R)A is to be in the interest of the trade and also in public interest. However, in this case, this objective seems to have been undermined, as is evident from the findings of the current inspection.
26. Apart from the irregularities mentioned earlier, I have noted that the total number of members in the “MGSE” has been reduced from the previous 80 to 69, as on the date of inspection, with not even one of them being active on MGSE. Out of this 69, 12 are trading through ISS of ISE, as on date. This state of affairs is indicative of the fact that the existing members are not interested in reviving the trading in MGSE. Moreover, as mentioned above, the Governing Board has not taken any effective steps for the revival of the exchange. I have also noted that MGSE has not recorded any turnover during the last four years (from 2000-01 till date) and the current trading and settlement system is available only “on paper” in the exchange. Further, without setting up of SGF as per the SEBI circular no SMD/POLICY/Cir 13/1997 dated June 9, 1997, the exchange cannot begin trading on its floor. Even though Exchange had submitted that there was a Broker Protection Fund created for similar purpose, it is pertinent to note that no proposal for such a fund was sent to SEBI for approval, which is clearly provided in the aforementioned circular. Therefore, the submissions of MGSE that they had formed a fund for similar purpose, are incorrect.

27. The earlier mentioned violations carry significance even though 'MGSE' has not recorded any trading for the past few years, as certain issues like maintenance of BMC, submission of audit reports, collection of contributions from the members towards IPF etc are requirements which have to be complied with, by the members, at all times during their period of holding membership in an exchange, irrespective of whether they trade or not. Admittedly, the operational management is weak, if not virtually absent. In addition to these shortcomings, there are other factors such as the presence of 44 companies listed on the MGSE as on date, out of which 26 are listed in the 'MGSE' as regional companies. I find that almost all the companies are in compulsory demat mode for trading, whereas "MGSE" does not even have depository connectivity as on date. I also find that almost all these scrips are listed in either NSE or BSE where they are traded even as on date. I have also taken note of the fact that during the current inspection, about 7 companies had opted for voluntary de-listing from the Exchange.
28. Thus, it is evident that there is a huge gap between the resources currently available and the requirements, in terms of manpower, material etc, for MGSE to function as a stock exchange, in as much as the 'MGSE', as it stands today, is without the requisite software / hardware to meet the requirement of the latest trading and settlement cycle system, any Settlement Guarantee Fund, surveillance and monitoring systems, Depository connectivity, a competent and full time Executive Director for steering the Exchange in the right direction etc. Mere existence of a stock exchange, without possessing such essential and basic requirements to function as one, would not have any meaning or serve any purpose towards protection of the interest of the investors and the development of the capital market as a whole. It also defeats the purpose of granting recognition to an Exchange under Section 4 of SC(R)A, which is to be in the interest of the trade and also public interest. I also find that the Exchange does not serve any economic purpose for existence as there is nil trading, no fresh listing and above all there are companies seeking voluntary delisting.

29. Thus, apart from the serious irregularities noted in the running of the MGSE, there are lapses in its basic functions and instances of non initiation of effective steps for the general functioning and administration of the Exchange in terms of the provisions of SEBI directives, Circulars, SC(R)A and the SC(R)R. There have also been non compliances by MGSE of the various circulars /directives/instructions issued by SEBI time and again, which displays an apparent disregard for statutory compliance requirements. I believe that it is imperative that an exchange should not only comply with the directives issued by SEBI and the provisions of law, but also ensure the smooth functioning of the exchange in accordance with law, business ethics, corporate governance etc and in tune with the developments of securities market. However, in the case of MGSE, the deficiencies elaborated above are indicators of a stock exchange functioning in a manner against the interest of the public at large.
30. Considering the current scenario of the capital market, where only those institutions, which are capable of adapting to the rapidly changing market structure, alone can survive, MGSE with the aforesaid inadequacies even in the basic requirements to exist as a stock exchange, would only find itself redundant, especially in view of the absence of any realistic efforts on the part of the Governing Board for the revival of the exchange. If MGSE is allowed to function in the present manner without any immediate remedial action, it would not only lose its relevance as a public institution but also erode the confidence of the investors, which would in turn compromise the orderly development of the securities market.
31. When the activities of an exchange are carried out contrary to the interest of the investing public and in a manner which is adverse to the interest of the investors, members and the public; the same is bound to injure and damage their interests. Moreover, the failure of the Governing Board to ensure proper governance and implementation of the provisions of the SC(R)A, Bye-Laws of the Exchange and the SEBI directives, circulars etc could erode the confidence of the investors. The

functioning of the 'MGSE' has created uncertainty and insecurity amongst the investors.

32. SEBI is mandated to ensure that there are adequate systems, procedures and effective management in an Exchange, which shall protect the interest of investors and develop the securities market. On a cumulative analysis of the facts abovementioned, I am of the opinion that allowing MGSE to continue in its present form may not be in the interest of trade or public interest. Therefore, it is essential that immediate measures are adopted to ensure that the interests of the investors are not further jeopardized. I am of the opinion that the Governing Board is unable to either perform effectively or provide guidance and direction to MGSE and hence, any further renewal of recognition of MGSE does not seem reasonable and justified, as it would only serve the commercial needs of few broker members.

33. In view of the above facts and circumstances, and in exercise of the powers conferred upon me under Section 19 of the Securities and Exchange Board of India Act, 1992, read with Section 4(4) of the Securities Contracts (Regulation) Act, 1956, read with the Government of India Notification number F.No. 1/57/SE/93 dated September 13, 1994, I hereby refuse to grant renewal of recognition to MGSE. This order shall come into force after 3 weeks from the date of the order.

34. In view of this Order, MGSE shall cease to be a recognized stock exchange and therefore, it is imperative to pass necessary directions in the interest of investors/shareholders of the listed companies in MGSE and in the overall interest of the securities market. I, therefore, in exercise of powers conferred upon me under Section 19 read with section 11 (1) of SEBI Act pass the following directions:-

- 1) The money available in the Investor Protection Fund and Investor Services Cell of MGSE shall be utilized only for the purpose for which these funds have been created, as per the Articles of MGSE. Any pending claims of any investors

should not be appropriated for any other purpose or for payment to the members/shareholders of MGSE.

- 2) MGSE shall set aside sufficient funds in order to provide for settlement of any claims, pertaining to pending arbitration cases, pending non-implemented arbitration award, if any, liabilities/claims of contingent nature, if any, and unresolved investors complaints/grievances lying with the exchange, on the date of this order.
- 3) The companies which are exclusively listed in the MGSE, may consider seeking listing at other stock exchanges or provide for exit option to the shareholders as per SEBI Delisting Guidelines.
- 4) Consequent upon de-recognition of MGSE, the members/shareholders of MGSE shall cease to be members of a recognized stock exchange and therefore liable to be de-registered as stock brokers, and hence, their certificate of registration granted by SEBI shall stand automatically cancelled. However, the said members/shareholders of MGSE shall be liable to pay SEBI registration fees as per Schedule III of the said regulations, till the date of this Order.

F.No. SEBI/LE/ 19048 /2004

A.K.BATRA
WHOLE TIME MEMBER
SECURITIES AND EXCHANGE BOARD OF INDIA