

SECURITIES AND EXCHANGE BOARD OF INDIA

ORDER

IN THE MATTER OF SHOW CAUSE NOTICE UNDER SECTION 11 OF THE SECURITIES CONTRACTS (REGULATION) ACT, 1956 READ WITH SECTION 11, 11B OF SEBI ACT, 1992 AND SECTION 12A OF SECURITIES CONTRACTS (REGULATION) ACT, 1956 AGAINST COCHIN STOCK EXCHANGE LTD.

1.0 BACKGROUND:

- 1.1 The Securities and Exchange Board of India (hereinafter referred to as "SEBI") conducted an inspection for the period October 06-13, 2004 to ensure compliance of various provisions of Securities Contract (Regulations) Act, 1956 (hereinafter referred to as SCRA), Securities Contract (Regulation) Rules, 1957 (hereinafter referred to as SCRR), Securities and Exchange Board of India Act, 1992, Rules and Regulations, SEBI Circulars/directives and Rules, Byelaws and Regulations of the Exchange by the Cochin Stock Exchange, (hereinafter referred to as 'CoSE').
- 1.2 The final Inspection Report comprising of 33 suggestions/observations allegedly not complied by CoSE warranting immediate corrective action was forwarded by SEBI to CoSE vide letter dated November 17, 2004. Pursuant to this, CoSE submitted its Initial Compliance Report vide letter dated December 16, 2004, and mentioned the implementation status of the aforesaid suggestions/observations stated in the Inspection Report.
- 1.3 From the Initial Compliance Report submitted by CoSE, it was found that out of 33 suggestions/observations, the exchange had implemented 16 observations only and 17 observations were under implementation.
- 1.4 The major observations and suggestions which were not complied by CoSE were as follows:
 - a) The subsidiary of CoSE was unauthorizedly dealing in F & O segment of National Stock Exchange (NSE) through ISS, subsidiary of Inter-Connected Stock Exchange of India (ISE) and CoSE was aiding in such trading.
 - b) It failed to implement all the pending observations/suggestions like filing of Audit Reports by members, recovery of dues from members, recovery of annual subscription fees from members, realization of deficit amount for four auctioned cards etc. contained in the inspection report dated October 28, 2003.
 - c) It transferred membership cards without collecting dues of the exchange.
 - d) CoSE was not having any written leave and license agreement with the subsidiary for leasing office space.
 - e) There was arbitrariness on the part of CoSE in declaring the members with dues as defaulters.
 - f) It failed to recover dues from the members and impose fines/penalties for non payment/late payment.
 - g) CoSE enhanced its share value without proper consent from members.
 - h) It diversified its activities into the field of education without following proper procedure.
 - i) CoSE was functioning without proper/adequate infrastructure.
- 1.5 During the inspection of CoSE, it was also observed that the Exchange did not take effective preventive steps and the general functioning and administration of the Exchange had not been carried out as per the provisions of SCRA and SCRR.
- 1.6 It was also observed that various circulars / directives / instructions issued by SEBI under the provision of SEBI Act, 1992, was not complied with by the Exchange.

2.0 SHOW CAUSE NOTICE AND ITS REPLY

- 2.1 On the basis of the aforesaid findings a detailed show cause notice dated June 06, 2005 was issued to the Governing Board of CoSE under Section 11 of Securities Contracts (Regulation) Act, 1956 (hereinafter referred to as SCRA). Vide said show cause notice, while referring to the observations made in the inspection report which were not complied by CoSE, the Governing Board of CoSE was called upon to show cause as to why appropriate action including supercession of the Governing Board of CoSE under Section 11 of SCRA should not be taken against it in light of the aforesaid observations made in the inspection report.
- 2.2 CoSE vide its letter dated June 21, 2005 replied to the show cause notice wherein while denying the allegations of irregularities / lapses in the functioning of the Exchange as alleged in the show cause notice, submitted a detailed reply with respect to all the deficiencies.
- 2.3 With regard to the allegation of unauthorised trading in F & O Segment of NSE, the notification dated August 16, 2002 was issued pursuant to a meeting of the Members of CoSE addressed by the Executive Directors of ISE and CoSE. In that

meeting, it was pointed out that ISE will appoint Cochin Stock Brokers Ltd. (CSBL) as the authorised person for F&O segment in NSE and that all sub-brokers of CSBL and their clients can register as clients of ISS in Derivative segments. The guarantee commitment by CoSE was for this purpose. Hence, the observation which would give the impression that this was done to facilitate two members to trade is not correct. The Bank guarantee was issued as per the prescribed format.

It was further stated that neither in the Board resolution of June 2004 nor in the resolution in July 2004 members were permitted to start trading in the F& O segment. The facilitation was limited to the extent of allowing the members to select their authorised persons who are members of ISS to trade in F&O. It has to be emphasized that there was no intent on the part of the CoSE to pursue unauthorised trading in F&O by its members. The observation that the Governing Board in its meeting held on July 13, 2004 "approved the proposal to recommence its trading in F &O segment" is therefore factually incorrect. In the circumstances, it was submitted that it is not correct to say that the CoSE passed a resolution to start trading in F&O Segment. CoSE has further submitted that as soon as ISE informed CoSE that it was not a permitted mode of trading in F & O segment, the trading was immediately stopped. The subsequent resolution passed on July 13, 2004 were intended only to provide communication facility to enable an activity and it had no intention to defy any of the directions of SEBI.

- 2.4 On the issue of filing Audit Reports by members, CoSE submitted that in the year 2001-2002, only one active member has failed to submit Audit Report and he has been deactivated from trading. In 2002-2003 out of 98 active members, 5 members have not submitted audited reports and all the five had been deactivated. It was further submitted that in 2003-2004 out of 94 active members, only 12 members had not submitted audit reports and a fine of Rs. 250/- was imposed and further action is being pursued against them. Therefore it may be seen that action has already been taken against the Members who have not submitted the Audit Reports.

- 2.5 With regard to the non-recovery of dues of Rs. 1.86 Crores from members, CoSE submitted that in pursuance of the observations in the Inspection Report and the instructions given in the said meeting, action was taken as follows:

Members Suspended - 208

Declared as defaulters - 42

Members Expelled - 2

Total dues collected - Rs. 25, 37,274.99

- 2.6 On the allegation of non-realization of deficit amount of Rs.87.95 lakhs for four acutioned cards, it was submitted by CoSE that it has explained the action taken on the matter in our Compliance Report dated 16/12/2004. The respective period of last transaction by the Members and the date of declaring them as defaulters were as follows:

P C Johny – 30/04/1992

George Mathew–09/03/1996

Westfin Securities–15/07/1997

Capshare investments – 28/02/2002

It was also submitted that the Exchange has conducted enquiries regarding the assets of the members and were unable to find out any assets. Moreover, the first 3 cases are time barred. Therefore, the Exchange has exhausted all options for recovery.

- 2.7 Regarding the allegation of non recovery of annual subscription fees from members, CoSE submitted that it has suspended 193 members for non payment of subscription fees for more than two years and has also sent a notice requesting them to clear the membership subscription.
- 2.8 With regard to the allegation of non recovery of sub broker registration fee dues, CoSE while reiterating its earlier stand taken as per its compliance report, submitted that out of the 23 brokers whose sub brokers had SEBI registration fee dues, 5 brokers have cleared their total dues and the exchange is pursuing the matter for clearance of the remaining cases.
- 2.9. On the allegation of non maintaining of capital adequacy norms, CoSE ,reiterating the same reply as given by it in its compliance report, submitted that the Base Minimum Capital (BMC) norms have been complied with and the members who have not maintained the stipulated minimum BMC have been suspended from membership w.e.f. from August 31, 2004.
- 2.10 With regard to the allegation of transfer of membership without collecting dues of the exchange, CoSE submitted that the exchange has completely stopped the practice of transfer of BMC from the transferor to the transferee. No transfers are being effected, without clearance of the dues. The transfers are also being effected only after getting the prior approval from SEBI.

- 2.11 On the issue of absence of leave and license agreement with the subsidiary for leasing office space, CoSE submitted that in view of the objection raised in the Inspection Report, renewal of the rental agreement was kept pending and shall be executed on getting SEBI's approval for which a separate request was submitted. However, CoSE has subsequently confirmed that it has entered into rental agreement on August 31, 2005.
- 2.12 With regard to the allegation of arbitrariness in declaring the members with dues as defaulters, CoSE reiterating its reply as made in its compliance report submitted that it is not following arbitrariness in declaring the members as defaulters.
- 2.13 With regard to the allegation of non recovery of dues from members and non imposition of fines/penalties for non payment/late payment, CoSE reproduced the same reply as made by it in its compliance report.
- 2.14 With regard to the allegation of enhancing its share value without proper consent from member, it was submitted by CoSE that it is in the process of collecting the consent from the remaining members. Further, vide letter dated February 01, 2006 the Executive Director of CoSE has informed SEBI that only 4 - 5 members of CoSE had renounced their right to non-members and even in those cases, Executive Director informed that the shares have not yet been issued. He further assured that the shares shall be withheld and shall be issued only to the members of CoSE.
- 2.15 On the issue of diversification into the field of education, CoSE submitted that according to legal advise it received, Clause No. 1 of the main objects of the company and Clause no. 17 of the objects incidental or ancillary to the attainment of the main objects should cover the DCA requirements. They are as follows:
- To foster the development of a healthy, orderly and transparent capital market to facilitate channeling the savings of investors.
 - To do all such other things as the incidental or conducive to the attainment of the above objects or any of them.

However, in deference to the comments in the Inspection Report, CoSE is taking steps to amend the Articles. CoSE has also submitted that in the Annual General Meeting held on September 30, 2005, it passed a special resolution under Section 149 (2A) of the Companies Act, 1956 for commencement of new business stated in "other objects" of the Memorandum of Association, as suggested in the Inspection Report.

- 2.16 With regard to the issue of inadequate infrastructure facilities of the exchange, it was submitted by CoSE that the exchange had set up huge infrastructure facilities, which were not being utilised in the absence of active trading on the exchange. The subsidiary was also set up to utilise the infrastructure facilities available with the Exchange. The Exchange had accordingly transferred the infrastructure available to the subsidiary. As instructed by SEBI the Exchange has stopped payment of the hire charges to the Subsidiary w.e.f 1st April, 2004.

The Exchange had the infrastructure facilities required for its current functioning, either on its own or on hire from the Subsidiary. The Exchange function has not suffered due to lack of infrastructure facilities. It is submitted that creation of further infrastructure facilities involves substantial cost and it is felt that the existing facilities be best utilised between the exchange and the subsidiary for economic considerations.

- 2.17 CoSE also submitted that the Exchange has complied with the observations/suggestions of the Inspection Report and has not acted in defiance of the SEBI directives, as alleged in the show cause notice.

3.0 HEARING AND SUBMISSIONS

- 3.1 The hearing was held on September 1, 2005 before me wherein three Public Representative Directors namely Shri M. Joseph, Shri T.N.T. Nayar and Shri E.I. Thomas, two Elected Directors namely Shri K.V. Thomas and Shri Varghese Mathew as well as the Executive Director Shri R.K Pillai were present as representatives of the Governing Board of CoSE. While reiterating the reply dated June 21, 2005 CoSE submitted as under :

- (a) The necessary resolutions on the corrective steps taken/proposed to be taken shall be passed, the minutes of which as well as those resolutions shall be forwarded to SEBI.
- (b) Shortfall in BMC in liquid cash of the members has been restored to the statutory requirements and it has been corrected with regard to all the members as per the requirements of the provisions of the law.
- (c) Adjustment of all the dues including those in BMC shall be certified from statutory auditors.
- (d) With regard to the recovery of dues from members, it will be brought to the notice of the Governing Board and a definite road map would be laid down for the necessary recovery.
- (e) It will take necessary steps towards better Corporate Governance.

4.0 CONSIDERATION OF SUBMISSIONS AND FINDINGS :

- 4.1 I have carefully considered the findings of the inspection report, the compliance report, the show cause notice issued, written and oral submissions made by CoSE.
- 4.2 I have also considered the submissions made by CoSE vide its letter dated September 30, 2005 on the four issues of recovery of dues from members, inadequate infrastructure facilities of the exchange, enhancement of share value and diversification into the field of education. I have also taken into account the fact that CoSE has sent the minutes of all its meetings pertaining to the various items mentioned in the show cause notice beginning from January 17, 2002 to August 27, 2005 vide letter dated November 16, 2005 and the statement of accounts of the members with regard to the dues vide its letter dated November 19, 2005. Further, I note that CoSE vide its letter dated January 27, 2006 had submitted that Corporate Governance /Code of Conduct of the Directors of Governing Board of the Exchange has been adopted by the Governing Board of the Exchange in its meeting held on December 10, 2005.
- 4.3 I note that out of the total observations/suggestions alleged to have been not complied by CoSE as mentioned in the show cause notice, CoSE has apparently taken steps to rectify the deficiencies and comply with the observations in most of the cases.
- 4.4 With regard to the observations/suggestions not complied by CoSE, I note that the most significant are as follows:

a) Recovery of Dues from members/shortfall in BMC

I note that the practice of the exchange, setting off dues from the Additional Security Deposit (which is a notional figure) is not in order and hence exchange has failed to implement the suggestions mentioned in the Inspection Report of SEBI in a timely manner in its true letter and spirit.

b) Inadequate infrastructure facilities of the exchange

I note that exchange proposal to buyback the infrastructure facilities from the subsidiary which was sold earlier may be viewed as circumventing Section 4B (3) of SCRA and Corporatisation & Demutualisation Scheme.

- 4.5 I feel that the exchange needs to be proactive in implementing the decisions and suggestions of SEBI and it needs to be vigilant, cautious and careful in future in this regard.
- 4.6 I note that subsequent to the issuance of the Show Cause Notice dated June 06, 2005 there has been a change in the composition of the Governing Board pursuant to the Notification of Corporatisation and Demutualisation Scheme of CoSE. Further, the Governing Board has taken apparent positive steps to rectify the deficiencies pointed out in the inspection report. However, I still feel that much more needs to be done and for that the Governing Board has to take proactive steps to rectify / remove other deficiencies/shortcomings pointed out by SEBI from time to time and more particularly in the inspection report.
- 4.7 In view of the aforesaid perceptible change and improvement in the functioning of CoSE that has taken place in compliance with the observations/suggestions made in the inspection report, I find that the remaining deficiencies or corrective measures which CoSE is still required to take, are not serious enough which may warrant supersession of the Governing Board of the Exchange under section 11 of SCR Act.
- 4.8 However, in view of the forgoing, I am constrained to observe that the exchange is required to be more vigilant and has to improve its efficiency and timely compliance with the suggestions of SEBI in the interest of investors from time to time. Further, the Exchange needs to implement all the suggestions and instructions of SEBI in true letter and spirit and with utmost expedition. Only by doing so, would the Exchange be able to effectively perform its role as a self-regulatory organisation and achieve the objective of its establishment under SCR Act.

5.0 ORDER

- 5.1 Having regard to the above, I, in exercise of the powers conferred upon me in terms of Section 19 read with Section 11, 11B of SEBI Act, 1992 and Section 12A of Securities Contracts (Regulation) Act, 1956 in the interest of the securities market, hereby direct the Governing Board of the Cochin Stock Exchange Ltd. to submit a compliance report with respect to the observations/suggestions which still have not been complied with as observed in paragraph 4.4(a) and 4.4(b) within three months from the date of this order to the satisfaction of SEBI. It shall be open to SEBI to take appropriate action and even reopen the issue, if necessary, against the CoSE or its Governing Board, if SEBI is not satisfied with the compliances of the suggestions made in the inspection report as aforesaid.

I further direct the Governing Board of Cochin Stock Exchange be more vigilant, cautious and careful in future in discharge of its functions as a self regulatory organisation.

DATE: February 02, 2006

PLACE: Mumbai

**MADHUKAR
WHOLE TIME MEMBER
SECURITIES AND EXCHANGE BOARD OF INDIA**