

**BEFORE THE SECURITIES AND EXCHANGE BOARD OF INDIA
CORAM: Dr. G. MOHAN GOPAL AND SHRI. V LEELADHAR, MEMBERS**

**ON THE NOTICE ISSUED TO M/s. NATIONAL SECURITIES DEPOSITORY
LIMITED IN THE MATTER OF**

M/s. RAJNARAYAN CAPITAL MARKETS SERVICES LIMITED

Date of hearing October 14, 2008

Appearance

For the Noticee: Shri Gagan Rai, Managing Director,
 Shri Jayesh Sule, Executive Director,
 Shri Ganesh Subbaram, Sr. Vice President
 Shri Pankaj Srivastava, Company Secretary
 Shri Rajiv Chhichhikia, Manager
 Shri Zerick Dastur, Advocate, J. Sagar Associates

For SEBI: Shri J Ranganayakulu, Executive Director
 Shri S Ramann, Officer on Special Duty
 Shri S V Krishnamohan, Legal Advisor
 Shri Suresh Menon, General Manager,
 Shri D.V Sekhar, Deputy Legal Adviser and
 Shri Debashis Bandopadhyay, Asst. General Manager,
 Shri Jai Sebastian, Legal Officer

ORDER

**[Under Section 19 of the Depositories Act, 1996 and Section 11B of the Securities and
Exchange Board of India Act, 1992]**

1. Effective governance of securities markets requires vigilant, proactive, timely and effective action by institutions on which the law vests responsibilities for the proper

operation of the market. These proceedings deal with the legal duties of depositories who play a vital role in the operation of the securities market.

2. Part A of this Order sets out relevant background; Part B is a legal analysis of the issues for determination and Part C sets out our decision.

PART A. BACKGROUND

We first set out the background to the establishment of a Committee of two Members for carrying out these proceedings. We then summarize the legal framework of these proceedings.

1. Establishment of a Committee of Members for Conducting these Proceedings

3. Mr. C.B. Bhavé assumed office as Chairman, Securities and Exchange Board of India (SEBI), on February 18, 2008. Prior to his becoming Chairman of SEBI Mr. Bhavé was the Chairman and Managing Director of National Securities Depository Limited (NSDL) from its inception in 1996. At the first Board meeting after assuming office as Chairman, SEBI, Mr. Bhavé requested that he be recused from the proceedings initiated or under consideration by SEBI in respect of NSDL. The Ministry of Finance proposed that in order to oversee the conduct of such proceedings, the SEBI Board constitute a committee consisting of Dr. G. Mohan Gopal, Member, as Chairman, Mr. Leeladhar, Member and Mr. Aurag Goyal, Member, as members, with the mandate to oversee the conduct of all proceedings initiated or under consideration by SEBI against NSDL. The proposal of the Ministry of Finance was accepted and the committee was established by the Board as proposed. After holding preliminary discussions regarding its mandate, this Committee reported back to the SEBI Board on xx that there is need for greater clarity on the Committee's role, responsibility and authority in light of existing delegation of powers within SEBI and in the absence of a general policy framework for dealing with matters involving a conflict of interest of the Chairman. The Committee recommended that such a new policy framework be established and a new Committee be appointed under the new policy framework to handle matters in which the Chairman may have a conflict of interest. Accepting this

recommendation, on August 13, 2008, the SEBI Board established a general policy framework for dealing with matters involving a conflict of interest of the Chairman as follows:

"A committee comprising of one or more members of the Board (from amongst members other than whole time members and the Chairman) shall be established by the Board to exercise the powers referred to in item No. 12 of SEBI's Order dated 24th April 2003 relating to delegation of powers issued under Section 19 of the SEBI Act, 1992 with respect to matters in which, in the opinion of the Board, the Chairman has a conflict of interest, and the delegation of powers in item No.12 of the said Order be modified to the above extent."

4. Pursuant to above decision, the Board established a new Committee consisting of Dr. G. Mohan Gopal and the RBI nominee on the Board (Mr. V. Leeladhar) with the following mandate:

The Committee will take over and dispose of the on-going quasi-judicial proceedings as on 18th February 2008 against NSDL, irrespective of its stage. The Legal Department of SEBI will provide necessary support for this purpose. The Committee will determine the approach to be taken by SEBI in respect of the on-going proceedings in respect of NSDL before SAT or any other Court as on 18th February, 2008. Legal Department of SEBI will take instruction directly from the Committee in this regard.

5. The Committee consisting of Dr. G. Mohan Gopal and Mr. V. Leeladhar, Members, has taken up these proceedings in accordance with the terms of the above Board decision.

2. The Legal Framework for the Proceedings

6. These proceedings arise from a show cause dated February 27, 2006 issued by SEBI to NSDL setting out six charges that NSDL has prima-facie failed to fulfil the obligations cast upon it in terms of Sections 11 and 16 of the Depositories Act, regulations 7(g), 13(1)(i), 16(2), 22(2), 26, 30, 36, 38(1)(cc) of the Depositories

Regulations, NSDL bye-laws 6.3.5, 6.5.4(iv), 6.5.4(vii), 6.3.18, 10.1.1, 10.4.1 and 11.

7. NSDL replied to the above show-cause vide letter dated March 14, 2006 and made detailed submissions. NSDL requested for a personal hearing. A hearing was granted to NSDL on February 27, 2007 by Dr. T. C. Nair, Whole Time Member. Mr. Someshekhar Sundersan, Advocate, and officers of NSDL appeared at the said hearing and made submissions on behalf of NSDL. NSDL filed further written submissions vide letter dated March 20, 2007.
8. Subsequently, this Committee took up further processing of this matter pursuant to the above mentioned Board Resolution. The Committee held a supplementary hearing on October 14, 2008 at the request of NSDL.

PART B: ISSUES FOR DETERMINATION

9. SEBI has set forth six charges against NSDL. These six charges, NSDL's response to them and our findings on each charge are set out below.

Charge # 1: Failure to Communicate Complete Information on Net Worth of DP

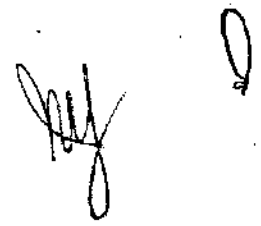
10. The first charge against NSDL is that it failed to fulfil its responsibility, set out in Form E of the SEBI (Depositories and Participants) Regulations, 1996, to ensure that an application for registration of a participant, forwarded by NSDL as a depository to SEBI should set out the net worth and paid up capital of Rs. One Crore as per the latest audited financial statements of the applicant.
11. The Show Cause Notice charges that NSDL failed to disclose in the said Form the material fact of the prevailing uncertainty about the net worth of RCMSL at the time of renewal of registration of RCMSL as a DP.
12. NSDL states that the audited financial statements of RCMSL for the year ending March 31, 2002 showed that RCMSL had a net worth of Rs.1,94,99,568/- which was on the basis of computation of net worth as then required. NSDL submitted that the net worth certificate of RCMSL contained disclosures of contingent liabilities to the extent of Rs.1,01,24,000/- which were on account of disputed income-tax claims, and the NSDL bye-laws, as then applicable, did not require contingent liabilities to be factored into net worth computation. NSDL submits that it raised the issue with

RCMSL and advised RCMSL vide its letter dated February 11, 2003 to infuse more funds and factor in the contingent liability as if it were an actual liability and thereby shore up the net worth.

13. SEBI had granted renewal of registration to RCMSL effective from March 31, 2003. This was intimated to NSDL vide letter dated March 19, 2003. NSDL submitted a proposal to SEBI on net worth computation and amended Business Rules and issued a circular dated March 31, 2003 to provide that contingent liabilities too would have to be factored in. NSDL submitted that this change in rules has prospective effect and hence there is no basis to level any allegation about NSDL having been lax in relation to the recommendation of renewal of registration by RCMSL. As, after the amendment to the net worth computation formula, RCMSL was unable to substantiate its claim regarding contingent liability not being applicable, NSDL terminated the membership of RCMSL as a DP vide its letter dated June 27, 2003 with effect from August 01, 2003.
14. NSDL also contends that the net worth requirement of Rs. One Crore fixed by NSDL was twice the minimum requirement set out by SEBI. RCMSL did meet the eligibility criteria prevailing at the time when its application for renewal was forwarded to SEBI.
15. The regulations require that accurate and complete information on net worth be communicated to SEBI by the depository. Quite apart from the methodology for calculating net worth and whether or not changes to the methodology are applicable retroactively (or, indeed whether or not the quantum of the net worth was adequate), the main issue is that NSDL did not disclose in the Form material information about uncertainty regarding the net worth of RCMSL and the exchange of letters that NSDL was itself having with RCMSL on the quantum of the latter's net worth. As SEBI grants registration of DPs on the recommendation of the Depository, it was incumbent upon NSDL to inform material developments which would have a bearing on the decision by SEBI to grant or not to grant registration. In our view, NSDL should have disclosed to SEBI the fact that there were questions about the net worth of RCMSL and also reported to SEBI about subsequent developments regarding the net worth of RCMSL.

Charge # 2: Failure to Safeguard Interests of Beneficial Owners on Termination of Participant: (a) Failure to Complete Termination Process of DP Promptly:

16. The second charge against NSDL is that it failed to complete the termination process promptly, thus failing to safeguard the interests of investors. Relevant facts are as follows. NSDL terminated the membership of RCMSL as a DP vide its letter dated June 27, 2003 with effect from August 01, 2003. The SEBI charge against NSDL is that NSDL did not take prompt action to protect the interests of BOs, allowing an extended period (of some two and a half years) to pass during which NSDL engaged in a prolonged correspondence with RCMSL without taking timely preventive or corrective action to prevent unauthorized transfers that did take place later.
17. NSDL replies that the termination of a participant is a time-consuming activity and hence, NSDL had vide its letter ref. no. PU/2003/SS/0687 dated July 10, 2003 granted time to RCMSL till September 1, 2003 to expedite the process of winding up of its depository operations. NSDL further submitted that vide letters dated October 10, 2003 advised RCMSL to expedite the process of closing down accounts and vide letter dated February 14, 2004 advised RCMSL to focus on facilitating the BOs to open new BO accounts with other DPs and arranging for transfer of securities to the new BO accounts of the clients expeditiously. NSDL stated that the purpose of corresponding with SEBI was to keep SEBI informed about the regulatory non compliances of the DP and for seeking specific approval from SEBI to initiate necessary action in the matter.
18. We are of the view that the time taken by NSDL for the termination process about 30 months cannot, by any standard, be considered reasonable. The inability of NSDL to complete the termination process in a timely manner violated its duty under the law to act promptly to protect the interests of beneficial owners.



Charge # 3: Failure to Safeguard Interests of Beneficial Owners on Termination of Participant: (b) Unauthorized transfer of securities from accounts of beneficial owners

19. Depositories and participants hold securities of beneficial owners in trust, to be executed in accordance with relevant laws, regulations and the agreements entered into with beneficial owners. Depositories and participants therefore have a duty to safeguard the securities of beneficial owners at all times and in all circumstances with due diligence and prudence. This duty is reflected, for example, in Regulation Section 44 of the Depositories Regulations which requires that "Every participant shall allow a beneficial owner to withdraw or transfer from his account in such manner as specified in the agreement with the beneficial owner." The obligation of depositories to beneficial owners is also evidenced and backed up by the provision in Section 16 of the Depositories Act which provides that "(1) Without prejudice to the provisions of any other law for the time being in force, any loss caused to the beneficial owner due to the negligence of the depository or the participant, the depository shall indemnify such beneficial owner."
20. The third charge against NSDL is that it failed to fulfill its legal duties to protect the interests of investors by failing to prevent or stop unauthorized transfer of securities of beneficial owners to a director of RCMSL/to RCMSL. Having frozen securities of six clients as per NSDL's letter dated December 24, 2004, NSDL should have frozen the securities of all the 243 clients on the basis of its own Bye laws. Instead, NSDL only informed SEBI of the shortages in certain ISINs. Despite the termination of participation of RCMSL, RCMSL transferred securities without authorization from its account to the personal account of a director of RCMSL and also to the pool account of RCMSL. NSDL had not deactivated the DPM (Depository Participant Module) terminal of RCMSL even after more than one and half years from the date of termination of participation of RCMSL. NSDL had allowed securities to be transferred back from the same account into which securities were transferred without authorization in the first place and in which NSDL had already frozen securities in respect of six clients. NSDL allowed a beneficiary account to be opened in the name of a director of RCMSL and allowed the transfer of the securities of the clients of RCMSL to be transferred to that account. NSDL made an unauthorised transfer of funds of Beneficial owners to

the account of Mr. C. Mohan Ram, a director of RCMSL, and to recover the shortages, failed to address the substantive issue for two and half years. Instead, NSDL kept repeating the information about the transfers and the shortages, while asking SEBI to take regulatory action even while NSDL had powers to do so under its own Bye-laws (such as 6.3.18, 6.5.4 (iv), 6.5.4(vii), 10.1.1 and 11).

21. NSDL contends that it had conducted its first inspection of RCMSL on August 13, 2003 and by letter dated October 10, 2003 requested RCMSL to expedite the process of winding up. A second inspection was conducted on February 24, 2004 and it found that the RCMSL was carrying on its winding up process steadily. A third inspection was conducted on August 2, 2004 and only then did NSDL find that securities lying in the accounts of 242 clients were transferred during the period April 17, 2004 to May 21, 2004 to a BO account with Centurion Bank of Punjab Limited in the name of one Mr. C. Mohan Ram, a RCMSL director. NSDL informed SEBI of the developments vide letter dated August 26, 2004 and later asked SEBI to freeze the said account vide letter dated December 24, 2004. Mr. C. Mohan Ram of RCMSL transferred almost all the securities except the ones which were frozen by NSDL from the BO account opened with Centurion Bank of Punjab Ltd to the pool account of RCMSL on March 01, 2005 while NSDL's request to SEBI to freeze the securities held in the BO account opened in the name of Mr. C. Mohan Ram with Centurion Bank of Punjab Ltd. was pending with SEBI.
22. NSDL argues that it did take steps to protect the interests of investors. NSDL contends that the BO account with Centurion Bank of Punjab Limited was opened by the Director of RCMSL without the knowledge of NSDL and NSDL was not a party to the transaction. Since the depository system of RCMSL was already disconnected, its ability to further transfer securities is curtailed. The RCMSL system is under the custody of NSDL and the securities balances that are available in the pool account of RCMSL can be used only under NSDL supervision to meet the claims of clients of RCMSL. The deactivation of the DPM setup (deletion) is a process which can be initiated only after settling the claims of clients of RCMSL. It further submitted that NSDL issued a public notice in the local newspaper advising the clients to come forward and claim their securities by a finite time. NSDL further submitted that it is not possible for a depository to verify the physical documents behind the transaction as clients submit these physical instructions to the DP who in

turn executes them as an electronic instruction which gets recorded in NSDL system. Transactions in this case can be identified as unauthorised only if the clients respond to NSDL's communication. A transaction in a client account cannot be prevented under byelaw 6.3.18 on the grounds that the participant status of a DP has been terminated. The DP is required to have the ability to transfer shares to the client accounts with other DPs and close their existing accounts with it to achieve closure of its depository operations. The transactions purported to have been initiated on behalf of the concerned seven clients could be categorised as unauthorised only after the clients responded to NSDL communication and NSDL promptly initiated action to freeze those securities. However, in the absence of communication from other clients, it could not be concluded that the other transactions were unauthorized and NSDL could not act in the same manner as it had done in respect of those seven clients. However, NSDL had to seek SEBI's approval to freeze the other securities as they appeared to be a case of commingling of securities and the other clients never responded to NSDL's communication till that time. NSDL had sought clarification from RCMSL regarding the shortages in certain ISINs for which it has provided clarifications. NSDL stated that wherever the claims made by clients are established, NSDL has transferred the securities to their new accounts. Similar approach is taken in respect of other clients, as well.

23. As has been observed above, depositories are required under the law to have in place and effectively operate systems that are adequate to ensure that unauthorized transfer of funds/securities does not take place from the accounts of beneficial owners. From the material available to us we are of the view that, beyond routine supervision and inspection, there were no adequate systems in place to prevent or promptly correct such unauthorized transfer. The actions of NSDL even after the unauthorized transfer was detected shows a lack of urgency in dealing with the issue; and a focus on the consequences of such transfer without adequate realization of the importance of the unauthorized transfer itself. Having carefully considered the submissions of NSDL, we are of the view that unauthorized transfer of securities from the accounts of beneficial owners, as well as the delays in detecting and correcting such transfers, as outlined above, constitutes a failure to protect the interests of beneficial owners as required of depositories under the law. This failure

is to be distinguished from whether or not this failure in fact resulted in losses being suffered by the beneficial owners or they have remedies for compensating such loss.

Charge #4: Indemnification of Investors and Grievance Redress

24. The fourth charge made by SEBI against NSDL is that NSDL failed to indemnify investors as required by the law and to effectively resolve grievances of investors.
25. Section 16 of the Depositories Act provides that "(1) Without prejudice to the provisions of any other law for the time being in force, any loss caused to the beneficial owner due to the negligence of the depository or the participant, the depository shall indemnify such beneficial owner. (2) Where the loss due to the negligence of the participant under sub-section (1) is indemnified by the depository, the depository shall have the right to recover the same from such participant.
26. Regulation 7(g) of the Depositories Regulations provides that "the depository shall redress the grievances of the participants and the beneficial owners within thirty days of the date of receipt of any complaint from a participant or a beneficial owner and keep the Board informed about the number and the nature of redressals".
27. The SEBI Show Cause Notice states that NSDL failed to redress the investors' grievances and that NSDL apparently failed to indemnify the beneficial owners of the losses arising from wrongful and fraudulent acts of its depository participant and its own negligence.
28. NSDL replies that it has been constantly reviewing the shortages after receipt of client confirmation and also taking steps to process the claims after confirmation from RCMSL. NSDL submits that RCMSL had made good the loss/ transferred the securities to the clients who had established shortage of securities in their accounts. NSDL further submits that no loss has been established. Shortages wherever identified have been made good by RCMSL. Hence, the question of indemnifying the losses that have not been established has not arisen. RCMSL has made good the shortage and provided clarifications where RCMSL transferred securities based on client authorization. The matter of grievance redressal arises only if the clients

respond and/or raise a grievance. These grievances are resolved as soon as documents are complete and clients have made their claims.

29. We accept the reply given by NSDL in this regard, noting that no investor complaint is pending against NSDL or RCMSL.

Charge # 5: Failure to Reconcile Accounts on a Daily Basis

30. Regulation 30 of the said Regulations and Clause 10.1.1 of NSDL's own bye laws require the reconciliation of accounts on a daily basis. The fifth charge against NSDL is that NSDL did not reconcile the accounts on a daily basis as it was required to do. It was also alleged that NSDL neglected to ensure the receipt of client wise details and security wise details from RCMSL on a daily basis as required under clause 6.3.5 of the bye laws of NSDL and under the said Regulations.
31. NSDL replied that the securities balances were and are being reconciled on a daily basis. Reconciliation in NSDL is a system driven process that considers all transactions and reconciles the same with the total securities balances in the NSDL system and unauthorized debits or shortfall in BO accounts can only be confirmed by the concerned BO and by the DP. Any unauthorized transaction can be confirmed only when the client raises an objection by way of complaint or during an audit by the internal auditor of the DP. It further submitted that it was not possible for a depository to verify the physical documents behind the transaction as clients submit these physical instructions to the DP who in turn executes them as an electronic instruction which gets recorded in NSDL system. It was submitted that transactions in this case can be identified as unauthorized only if the clients respond to NSDL's communication.
32. We accept NSDL's statement that securities balances were and are being reconciled on a daily basis as required under the law.

Charge #6: Causing Hardship and Loss to Beneficial Owners by Failure to Comply with Legal Provisions

33. The sixth charge against NSDL is that NSDL caused hardship and loss to beneficial owners as a result of its failure to comply with the provisions of its bye laws and the

said Regulations and Depositories Act, 1996 and due to continuing inaction, negligence and failure to monitor the activities of RCMSL, and failure to intervene in a timely manner in accordance with the SEBI Act, 1992 Regulations and its own bye laws (as aforementioned), in derogation of the statutory role assigned to NSDL for supervision, monitoring and evaluation of the Depository Participant and indemnifying the loss of the clients.

34. NSDL replied that it had consistently complied with all its obligations under applicable law, Regulations and the bye-laws which include precautionary measures like inspections, press releases amending its own bye-laws from time to time to protect the interests of RCMSL clients and the smooth functioning of the depository system. It further submitted that it had not violated any bye-laws, Regulations or any other provisions of the Depositories Act as alleged.
35. Some of the concerns in this charge are well founded and have been taken up in these various proceedings against NSDL. However, overall, we find this sixth charge is excessively broad and overlaps with some of the other five charges. We recommend to SEBI that charge sheets must be as specific as possible, clearly identifying the legal standard violated and setting out how such violation may have taken place.

PART C. DECISION

36. We direct the NSDL Board to conduct an independent assessment of existing systems and processes with respect to the following, to assess whether they are adequate to ensure the due protection of the interest of investors and the securities market; and identify remedial measures needed :

- (a) Protection of beneficial owners arising from termination/deactivation of Depository Participants;
- (b) Monitoring of the functioning of Depository Participants in cases where an entity has been debarred from functioning as a Depository Participant;

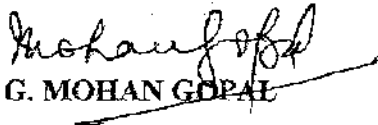
- (c) In all cases of termination, ensuring that the transfer of securities of BOs to another DP takes place in a definite time frame; and the prevention of unauthorized transfers of securities of beneficial owners.

37. The above assessment should be carried out independently in accordance with terms of reference satisfactory to SEBI and shall be completed within six months from the date of this Order.

The show cause notice dated February 27, 2006 stands disposed of as above.

DATE: 4.12.2008

PLACE: MUMBAI


G. MOHAN GOPAL


V. LEELADHAR

MEMBERS OF COMMITTEE

SECURITIES AND EXCHANGE BOARD OF INDIA