

# Misuse of clients' funds and securities by Trading Members



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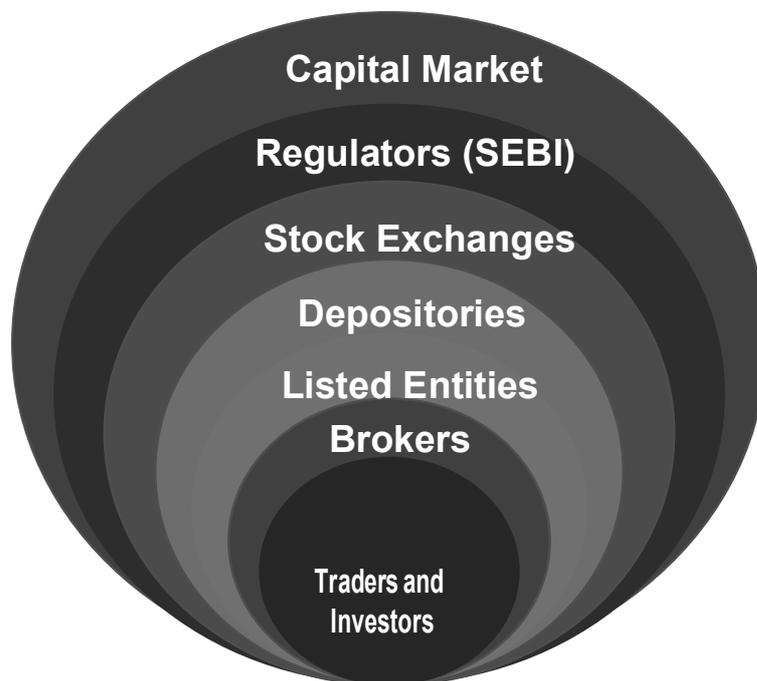


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The Indian equity markets have witnessed a sea change over the last few decades, attributed by advancement in technology, change in regulation and increasing investor participation. From open outcry system to mobile application/ internet-based trading and from traditional trade execution mechanism to high-frequency trades, there has been a huge transformation. The market turnover, number of products offered, and market penetration have risen significantly over the last few decades.

The broking industry has been one of the most important intermediaries in the Indian equity market and has a significant role to play in developing the market. Even though the broking industry in India has many

participants (approximately 6600 SEBI registered brokers<sup>1</sup>), most of the turnover is concentrated in some of the known names. Performance of the broking industry is highly correlated to the performance of equity markets and tends to be cyclical.



Brokers are in a fiduciary position in relation to their clients and trust plays an important role in nurturing this relationship. However, basis some of the recent regulatory action against stockbrokers also known as Trading Members (TM) common malpractices observed were as follows:

1. **Unauthorised pledging, sale or transfer of clients' securities Misuse of clients' securities received as collateral**
2. **Collection of securities/funds from clients on committed periodic return scheme Diversion of clients' funds to meet proprietary or other clients' obligations**
3. **Diversion of clients' funds through related party transactions.**

These instances have resulted, to some extent in an environment of 'Trust deficit' and 'Skepticism'. Securities and Exchange Board of India (SEBI) has been trying to contain such malpractices, by initiating regulatory action against such violators and tightening regulation. The Enhanced Supervision and Inspection mechanism has contributed to detection of malpractices by brokers. Further, in addition to the regulatory action, SEBI has issued multiple circulars to curb such malpractices by brokers.

Some of the recent circulars and key regulatory changes brought by SEBI/Stock Exchanges to curb such malpractices are as follows:

**Prohibition on pledging of clients' securities with banks/NBFCs** – On June 20, 2019 SEBI issued a circular on "Handling of Clients Securities by TMs/Clearing Members (CM)" effective October 1, 2019 which prohibited pledging of clients' securities to banks NBFCs for raising funds.

1. **Margin obligations to be given only by way of Pledge/Re-pledge in the Depository system** – On February 25, 2020 SEBI issued a circular on "Margin obligations to be given only by way of Pledge/Re-pledge in the Depository system" effective August 1, 2020. Key provisions of the circular are as follows:
    - a. With effect from August 1, 2020, TM/CM shall, inter alia, accept collateral from clients in the form of securities, only by way of 'margin pledge', created in the Depository system in accordance with Section 12 of the Depositories Act, 1996 read with Regulation 79 of the SEBI (Depositories and Participants) Regulations, 2018 and relevant bye laws of the Depositories.
    - b. The circular further clarified that an off-market transfer of securities leads to change in ownership and shall not be treated as pledge and misappropriation or misuse would include use of one clients' securities to meet the exposure, margin or settlement obligations of another client or TM/CM.
    - c. Transfer of securities to the demat account of the TM/CM for margin purposes (i.e. title transfer collateral arrangements) shall be prohibited. In case, a client has given Power of Attorney (PoA) in favour of a TM/CM, such holding of PoA shall not be equivalent to collection of margin by the TM/CM in respect of securities held in the demat account of the client.
    - d. Depositories shall provide a separate pledge type viz. 'margin pledge' for pledging clients' securities as margin to the TM/CM. The TM/CM shall open a separate demat account for accepting such margin pledge, which should be tagged as "Clients Securities Margin Pledge Account".
    - e. For the purpose of providing collateral in the form of securities as margin, a client shall pledge securities with TM, and TM shall re-pledge the same to the Clearing Corporation (CC). The complete trail of such re-pledge shall be reflected in the demat account of the pledgor.
    - f. The TM and CM shall ensure that the clients' securities re-pledged to the CC shall be available to give exposure limit to that client only.
    - g. Funded stocks by the TM/CM under the margin trading facility shall be held by the TM/CM only by way of pledge. For this purpose, the TM/CM shall open a separate demat account tagged "Clients Securities Margin Funding Account". The securities lying in this account shall not be available for pledge with any other bank/NBFCs.
    - h. The TM/CM shall be required to close all existing demat accounts tagged as "Client Margin/Collateral" by August 31, 2020. All securities lying in such accounts shall be transferred to the respective client's demat accounts.
    - i. Circular mandates requirement of physical or electronic instruction from the client for initiating margin pledge. The pledge request form shall have a clause regarding express consent by the client for re-pledge of securities by the TM to CM and further by the CM to CC. 2. In cases where a client has given a Power of Attorney (the "POA") to the TM/CM, the TM/CM may be allowed to execute the margin pledge on behalf of such client to the demat account of the TM/CM tagged as 'Client Securities Margin Pledge Account'.
    - j. On receipt of the margin pledge instruction either from the client or by TM/CM as per the POA, DP of a client shall initiate a margin pledge in the client's account and the status of instruction will remain pending till confirmation is received from client/pledgor. The client will submit acceptance by way of One Time Password (the "OTP") confirmation on mobile number/registered e-mail id of the client or other verifiable mechanism. Such OTP confirmation from client shall also be required, if securities of such client are being re-pledged. The Depositories shall develop a verifiable mechanism for confirmation of the pledge by the client.
    - k. In client account, margin pledge or re-pledge shall be reflected against each security, if it is pledged/re-pledged and in whose favour i.e. TM/CM/CC.
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2. **Exchanges (NSE and BSE) Clarifications on Running Account settlement of funds** – On January 16, 2020, NSE and BSE issued clarifications on Running Account settlement of funds This has reference to Exchange circular NSE/INSP/36889 dated February 02, 2018 with respect to actual settlement of client accounts.

According to the existing requirement, TMs are required to mandatorily settle the client accounts on a monthly / quarterly basis, as per the client preference. However, it was observed that TMs are not following the said guidelines and are investing the actual settlement amount (Monthly / Quarterly) of the clients with the consent/without consent of the client / through POA in any scheme or investment products including mutual funds, Exchange traded funds such as liquid bees etc. COVID 19 has also brought volatility in the markets which in turn has brought its own share of challenges in the form of margin calls on investors and Trading Members.

In order to restrict misuse of clients' funds, Exchanges directed TMs to credit the settlement amount (Monthly/ Quarterly) to the client bank account directly and not run any schemes to invest the actual settlement amount (Monthly / Quarterly) with the consent/without consent of the client / through POA in any scheme or investment products.

The above changes are expected to curb the menace of diversion of clients' funds and securities to a large extent. However, there needs to be a stringent and continuous monitoring mechanism in addition to identification and swift action on red flags/early warning signals for effective control on such malpractices. In addition to this, investor awareness, to a large extent will contribute to curbing such instances.

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<sup>1</sup> Source: SEBI Handbook of Statistics – December 2019