BEFORE THE SECURITIES APPELLATE TRIBUNAL MUMBAI

Appeal No. 68 of 2007

Date of Decision :14.1.2009

National Securities Depository Ltd. …… Appellant

Versus

Securities and Exchange Board of India …… Respondent

Mr. Janak Dwarkadas, Senior Advocate with Somasekhar Sundaresan, Advocate for the Appellant.

Mr. Saleh Doctor, Senior Advocate with Dr. Poornima Advani, Advocate for the Respondent.

Coram : Justice N.K. Sodhi, Presiding Officer
Utpal Bhattacharya, Member

Per : Utpal Bhattacharya, Member

This order will dispose of two Appeals no. 68 and 69 of 2007 against separate orders, both dated April 27, 2007 passed by the Adjudicating Officer, Securities and Exchange Board of India (the Board for short) against the National Securities Depository Ltd. (NSDL for short) and the Central Depository Services India Ltd. (CDSL for short). NSDL is the appellant in Appeal no.68 of 2007 and a penalty of Rs.5 crores has been imposed on it in terms of Section 15HB of the Securities and Exchange Board of India Act, 1992 (the Act for short) and Section 19G of the Depositories Act, 1996. CDSL is the appellant in Appeal no. 69 of 2007 and a penalty of Rs.3 crores has been imposed on it under the same provisions of law. The adjudication proceedings originated out of the investigations conducted by the Board into the issue of shares of 21 companies through initial public offerings (IPOs) during the period 2003-2005. Investigations revealed that shares in the aforesaid IPOs, which were reserved for retail investors, were irregularly acquired by many entities

through the medium of thousands of fictitious/benami applications. For this purpose the said entities (hereinafter referred to as key operators) opened a large number of demat accounts in fictitious and benami names and used those to make applications for shares in the IPOs in the category of retail investors. On allotment, the shares were transferred to the demat accounts of the key operators who in turn allegedly transferred the shares through off market deals to the ultimate beneficiaries who had financed the purchase of such large number of shares. The financiers sold the shares immediately after they were listed in the stock exchanges to garner huge profits. The two appeals in which the charges as well as the arguments on both sides are very similar to each other and somewhat interrelated, have been heard by us one after the other. For the sake of convenience, we shall deal with NSDL'S Appeal no. 68 of 2007 first followed by CDSL's Appeal no.69 of 2007. However, before going into the merits of the two cases, it is necessary to take note of the salient features of the working of the depository system in India so that the facts and arguments in the cases can be appreciated in the proper background.

2. The depository model adopted in India provides for a competitive multi-depository system and there can be various entities providing depository services. NSDL is one such entity. It was started in December, 1995 with a view to setting up a depository system in India and creating an efficient market infrastructure that would obviate the risks of paper-based trading and settlement of transactions in securities. The Depositories Act was enacted in 1996 to provide a statutory framework for the functioning of Depositories. NSDL was the country's first Depository to be granted registration by the Board under the Depositories Act. CDSL is the only other Depository in the country that is registered by the Board. The basic function of the Depositories is to maintain electronically the demat accounts of every holder of securities. The Depositories become the registered owners of the securities in the books of the issuer company while the beneficial ownership vests in the demat account holders. As registered owners, the Depositories have the authority to effect

transfer of ownership of the securities on behalf of the beneficial owners but the latter are entitled to all other rights and benefits (including voting rights) and the liabilities in respect of their securities held by a Depository. The Depositories are responsible for giving effect to all transfers of securities to and from the demat accounts of the beneficial owners and also of keeping track of events like pledging of shares, freezing of accounts ordered by the Board etc. The Depositories, however, do not deal directly with individual investors who are the demat account holders. The interface with investors is handled by another set of intermediaries commonly called Depository Participants who are also registered by the Board. The Depository Participants have investors as their clients whom they service directly. The transactions of individual investors are reflected in their demat accounts by the Depositories on the basis of intimations given by the Depository Participant concerned. The Depository Participants, thus, act as agents of the Depositories. The detailed duties, responsibilities and obligations of the Depositories and the Depository Participants are laid down in the Depositories Act, the Regulations framed thereunder and also in various orders and circulars issued by the Board from time to time. This apart, the Depositories frame their own bye laws with the approval of the Board to regulate their own operations. Both the Depositories have also issued separate sets of operating instructions for their respective Depository Participants. With the introduction of the depository system, the risk associated with handling paper certificates and transfer deeds has been eliminated and the framework for settlement of transactions in the securities market has evolved into a cleaner, more efficient and more transparent one.

Appeal no 68 of 2007

3. In the show cause notice dated November 23, 2006 which was issued to NSDL under Rule 4 of the Securities and Exchange Board of India (Proceedure for Holding Enquiry and Imposing Penalty by Adjudicating Officer) Rules, 1995, it has

been alleged by the Board that by facilitating the key operators to open fictitious/benami accounts, the appellant had actively assisted the key operators in cornering the IPO allotments in retail category. More specifically, the following charges were levelled against the appellant:-

- Failure to notice unauthorised outsourcing by the Depository Participants,
- Failure to put in place adequate mechanisms for the purpose of reviewing, monitoring and evaluating the controls, systems, procedures and safeguards,
- Failure to prevent the opening/ existence of multiple beneficial owner accounts,
- Failure to verify the infrastructural facilities of the Depository Participants and
- Failure to take appropriate action against the Depository Participants for various irregularities repeatedly committed by them.

In view of the alleged failures, the appellant was charged with violation of the following provisions:-

(1) Section 26(2)(p) of the Depositories Act, 1996,

(2) Regulation 7, 16(2), 22, 23, 34, 35, 37, 39, and 52 of the Securities and Exchange Board of India (Depositories and Participants) Regulations, 1996.

(3) Regulation 3 of the Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003, and

(4) Bye laws 6.2.1 (vii), 7.2.1, 10.4.1, 10.4.1(b) and 11 of the National Securities Depositories Ltd.

4. The specific charges levelled against the appellant by the Board are primarily based on a system audit of the appellant which was got conducted by the Board through an independent body called iSec Services Pvt. Ltd. (iSec for short) and the final report of iSec was annexed to the show cause notice. While arguing his case, the learned senior counsel for the appellant took us through the impugned order dated 27.4.2007 as well as the iSec report. For the sake of convenience, we shall deal with the charges against the appellant one by one.

5. The charge of failure to prevent the opening/existence of multiple beneficiary ownership accounts is a particularly important one because according to the Board, it is this failure that directly led to the so called IPO scam. Though the demat accounts are maintained by the Depositories (including the appellant) in their computerised data base, these accounts are opened for the clients (beneficial owners) by the Depository Participants (DPs) after ensuring adherence to the Know Your Client (KYC) norms. Detailed instructions in this regard have been issued by the Board and the Depositories also have issued various communications in this regard to the DPs. It has been noted in the impugned order that as many as 34,924 fictitious/benami accounts of beneficial owners were opened with the DPs for 21 IPO's including thousands of accounts which had the same address and most of which were closed soon after the allotment process. The respondent Board's case is that the failure of the appellant to prevent the opening of such multiple beneficiary ownership accounts with the same address occurred mainly because the application forms for opening beneficial ownership accounts provided for two addresses and the process of making illegal profits by cornering the retail category shares in the IPO's was facilitated by using the address of the financiers as the correspondence address or the second address. According to the iSec report, the provision for the second address was introduced on the insistence of the appellant. This was vehemently denied by the learned senior counsel for NSDL who argued that the feature regarding correspondence address was introduced in the form for opening demat accounts at the

instance of the Board in as much as on 11.10.2004 the Board advised NSDL to examine the feasibility of incorporating this feature. NSDL informed the Board on 18.10.2004 that this was being examined. Subsequently in June, 2005, NSDL incorporated this feature in its business rules and intimated the Board accordingly. This argument could not be controverted by the learned senior counsel for the Board. Copies of the correspondence between NSDL and the Board in this regard are on record and were referred to in detail.

6. It has been observed by the Adjudicating Officer in the impugned order that it is the duty and the responsibility of the DP to ensure compliance with KYC requirements but the appellant as the Depository cannot also disown its responsibility in this regard because the DPs are the agents of the Depository, as has been expressly mentioned in the Depositories Act. According to the Adjudicating Officer, "opening of hundreds of accounts with the same address and on same day by some of the DPs should have alerted the Depository as to whether the requirements of KYC documentation were complied with by the DPs." The Adjudicating Officer doubted if the requirements of the Board's circular SMDRP/POLICY/CIR-36/2000 dated August 4, 2000 regarding adherence to KYC norms were complied with and held that the Depository i.e. the appellant had to take responsibility for such noncompliance. Having heard the learned senior counsel on both sides and examined the relevant records, we find that the Board's circular of August 4, 2000 makes the DPs squarely responsible for compliance with the KYC norms as can be seen from the following excerpt from the circular:

> "The depository participants are hereby advised that a beneficiary account must be opened only after obtaining a proof of identity of the applicant. The applicant's signature and photograph must be authenticated by an existing account holder or by the applicant's bank or after due verification made with the original of the applicant's valid passport, voter ID, driving license or PAN card with photograph; and further the account opening form should be supported with proof of address such as verified copies of ration card / passport / voter ID / PAN card / driving license / bank passbook. An authorized official of the depository participant, under his signature shall verify the original documents."

The circular of August 4, 2000 was addressed not to the Depositories but to the DPs, though copies were endorsed to the Depositories as well. We also find that there is absolutely no bar in the Depositories Act or the Regulations framed thereunder on opening of multiple accounts by a beneficial owner. In fact, the Board itself advises investors in its own website that an investor can open more than one account in the same name with the same DP and also with different DPs. Thus, more than one account can be opened in the same name and also with the same address. Given this situation, it is no wonder that the appellant did not provide any system level check on the number of accounts that could use the same address. The learned senior counsel for the appellant also pointed out that only 153 accounts out of 34,924 fictitious/benami accounts actually had a second address different from the first one and thus this could not be any factor in facilitating the opening of such a large number of afferent accounts. This assertion could not be controverted by the respondent Board. Considering all aspects of the matter we are of the view that the Depositories have only a very limited role in the process of compliance with the KYC norms which is squarely the responsibility of the DPs. In the normal course of things, it is during the inspection of DPs by the Depository concerned that the latter gets to check whether the DPs are following the procedure for compliance with the KYC norms meticulously. There is material on record that a few failures and deviations on the part of the DPs in this regard have actually been pointed out by the appellant during its inspection though none relating to the occurrence of the same address in accounts opened in different names. Though much has been made of the adverse impact of the provision for the second address in the account opening form, it seems clear to us that the provision for a correspondence address in an account opening form is not a feature to be avoided and in fact, it is a desirable and even a necessary feature. Similar feature exists in almost all other forms that an individual is required to fill in for conducting his day to day business like opening of bank account, application for passport and so on. It is another matter that the financiers of the so called IPO scam might have benefitted by the misuse of this address as the second address of the

applicant but the system as it existed at the time of the scam or for that matter, exists even now, does not have any check to prevent opening of such accounts. In the absence of any prohibition in any Act or Regulations or any circular issued by the Board, it is not in the least fair to expect the Depositories to detect and stop such a practice.

7. The next charge against the appellant was that it failed to notice the unauthorized outsourcing of their operations by the DPs and thus contravened Regulation 52 of the Securities and Exchange Board of India (Depositories and Participants) Regulations, 1996 (DP Regulations for short) which lays down that no participant shall assign or delegate its functions as participant to any other person, without the prior approval of the Depository. This charge relates to one particular Depository Participant namely Karvy Stock Broking Ltd (Karvy for short). The learned senior counsel for the appellant argued that use of an agent for collection of application forms from intending investors and their submission to the DPs does not amount to assignment or delegation of the functions of a participant, as alleged by the Board. In view of the rush for opening new demat accounts before an IPO issue opens, it is a common practice, according to the appellant, for DPs to use certain individuals as their agents to source new clients. This is only a marketing activity and does not at all amount to outsourcing within the meaning of Regulation 52 of the DP Regulations. We are inclined to agree with the learned senior counsel for the appellant because such outsourcing does not in any way dilute the responsibility of the DP to ensure strict compliance with the KYC norms. It would appear to be a common practice in the market for DPs to employ agents to approach and get new clients for expanding their business. Such agents do not discharge any of the functions of a DP but are engaged only for marketing activity. It has also been recorded in the impugned order that "NSDL failed to make any norms to define the nature and scope of the outsourcing being resorted to by its Depository Participants. In the absence of any norms, these agents started performing activities like KYC

verification also which should have been done by the Depository Participant." We have not found any material whatever in the records of the case to support the conclusion that it was the agents who performed KYC verification nor is there anything in any Rules or Regulations etc. to suggest that NSDL has the responsibility of defining the nature and scope of outsourcing by the DPs. We are therefore, of the view that this charge has not been established.

8. We shall now deal with the third charge namely the failure to put in place adequate mechanisms for the purpose of reviewing, monitoring and evaluating the controls, systems, procedures and safeguards. This charge is really one of complete violation of Regulation 34 of the DP Regulations which lays down that "every depository shall have adequate mechanism for the purpose of reviewing, monitoring and evaluating the depository's controls, systems, procedures and safeguards." There are two findings in the impugned order relating to this charge. The first finding is that the appellant had failed to maintain data in an appropriate manner and their data integrity is suspect. This finding has been recorded on the basis of the fact that in the fields within the data base meant to record the dates of opening of accounts, dummy dates have been recorded in many cases. It was clarified by the learned senior counsel for the appellant that dummy dates like "0001-01-01" and "9999-12-31" were used in case of old accounts in order to identify them and to maintain the audit trail when the entire depository system was migrated from the old decentralised model to the current centralised model. According to the appellant such migration is still under way. It was also clarified on behalf of the appellant that such entries are used as default entries in certain fields where data may not be required in all cases. For example, the date of approval by Reserve Bank of India is not necessary in the case of opening of an account by a domestic Indian resident and therefore the date field for such approval in such an account would normally have a default entry which should be easily identifiable as such. It was also forcefully argued on behalf of the appellant that in order to understand on what basis

such a serious charge had been levelled and to clarify the position, it was essential for the appellant to cross examine the authors of the iSec report on the basis of which this charge has been framed but this request was turned down by the Adjudicating Officer. We find absolutely no rationale behind such refusal by the Adjudicating Officer of the appellant's right of cross examination. The Adjudicating Officer has recorded his findings basing himself solely on the iSec report. Granting that iSec is an expert body, NSDL is also a professional body whose system is operated by personnel who are also experts in designing and operating compurterised data bases. Faced with the charge of lack of data integrity, NSDL has come up with detailed explanation which is prima facie quite plausible. Under these circumstances, there can be hardly any justification for the adjudicating officer to totally ignore the submissions by NSDL and rely entirely upon the views of iSec. In the present case, when two sets of experts have expressed different views about a highly technical matter, we do not think there was any better way for the Adjudicating Officer to arrive at the truth other than by permitting cross examination of the author(s) of the iSec report by NSDL. This, in fact, would have been in accordance with the very basic principles of natural justice. This would also have assisted the Adjudicating Officer in taking a more balanced and better informed view in the matter. Be that as it may, we find no material in regard to any illegality or irregularity in the maintenance of the data base by the appellant. The Board has also not cited any specific case where the integrity of data mentioned by the appellant has been found to be suspect and we cannot accept the finding in this regard on the basis of vague and insufficient material.

9. The second finding in respect of this charge is that the appellant has no bye laws for internal control standards including the procedure for auditing, reviewing and monitoring which led to lack of proper monitoring and control exercised by the appellant over the DPs. From a perusal of the relevant paragraphs 9.3.1 and 9.3.2 of the impugned order, it is not clear whether the Adjudicating Officer is referring to the absence of internal controls of the systems and procedures within the Depository or

the absence of controls by the Depository over the systems prevailing in and followed by the DPs. Be that as it may, the standards and procedures to be followed by the DPs for the purpose of their internal control have been prescribed by the appellant in bye law 10.2. Observance of these standards and procedures is to be verified by the appellant at the time of inspection of the DPs. As regards the appellant's own internal controls, it was pointed out that there is a regular system of internal audit review as well as operations audit and that the relevant reports alongwith management comments thereon are reviewed on a regular basis by the appellant at the level of the Board of Directors. Again, in the absence of any specific instances being cited by the Board, we are not in a position to accept the finding of the Adjudicating Officer in this respect which could only be termed vague and without any basis. The charge must, therefore, fail.

10. The next charge is failure to verify the infrastructural facilities of the DPs. The Adjudicating Officer has held that the appellant never physically verifies the DP prior to recommending its registration with the Board though bye law 6.2.1(vii) of the appellant provides that the applicant should have adequate office space exclusively for depository operations. The appellant admits that physical inspection is not undertaken as a matter of course before recommending registration but that is because the applicants have to be electronically connected to the appellant and this cannot be done unless the former have adequate infrastructure. After hearing the learned senior counsel on both sides and examining the records, we are of the view that physical inspection of a DP's site before recommending registration need not be considered an absolute must in all cases. This is because the appellant itself arranges the electronic connectivity of the DP applicants with service providers (MTNL for example) and the software installed by a DP applicant is also provided by the appellant only. The connectivity cannot be established and sustained and the system cannot run unless compatible hardware and other infrastructure are in place with the DP. The DP applicants are recommended for registration only after rigorous testing of the software and hardware installed by it as well as the connectivity with

NSDL. In any case, the DP applicants are not unknown entities but are entities like banks, NBFCs, stock brokers etc., who are already registered either with the Board or with the Reserve Bank of India. In some cases, the DP applicant may be located in some remote corner of this country and physical inspection prior to recommending for registration may not even be feasible. After considering the submissions by the parties and perusing the relevant portions of the iSec report, we are of the view that *a priori* physical inspection of DP applicants may not be essential and in any case, since there is no such stipulation in any statute, absence of physical inspection cannot be considered an irregularity that calls for a penalty.

11. There is only one more charge in the show cause notice dated November 23, 2006 issued to the appellant and that is failure to take appropriate action against the DPs for the various irregularities repeatedly committed by them. The specific finding in the impugned order in support of this charge is that most of the penalties imposed by the appellant on DPs are for failure to appoint qualified personnel and that the amount of penalty levied for non-compliance with KYC requirements is significantly lower than that for other violations. The Adjudicating Officer "assumed" that the lesser penalty for account opening deficiencies gave a signal that such deficiencies would be treated leniently and this encouraged the opening of a large number of afferent accounts. We are unable to appreciate the basis for the view expressed by the Adjudicating Officer that the penalty for a minor lapse in observing KYC norms should be as severe as that for having unqualified personnel for operating a client account. The second offence is much more severe and is comparable with that of a person not possessing a driving licence driving a motor car while the first one is like a case where an indicator light of the car is not working. While we cannot but agree that any penalty has to be commensurate with the seriousness of the offence that it penalises, there is no apparent reason for us to doubt the judgment of the appellant in deciding the right kind of penalty for the lapses noticed by it during its inspection of the DPs.

12. Apart from the five charges dealt with above, the Board in a supplementary show cause notice issued to the appellant on 14.2.2007 sought clarification from the former on its alleged failure to comply with the direction issued by the Board in its orders dated January 12, 2006 and April 27, 2006 in respect of the demat account of one Biren Kantilal Shah. It was also alleged in the said show cause notice that the appellant had failed to comply with the directions issued by the Board in its letter no. ISD/SD/HSE/03/2006 dated 16.11.2006 regarding audit of one particular account of Karvy. The Adjudicating Officer did not give any adverse finding in respect of the latter allegation in view of the circumstances explained in paragraph 12.3.2 of the impugned order. Regarding the first charge, the Adjudicating Officer proceeded on the premise that in its order dated 12.1.2006 regarding the IPO of Infrastructure Development Finance Corporation (IDFC), the Board had issued a directive to the appellant to monitor the flow of securities into the account of Biren Kantilal Shah and recorded a finding that the appellant had failed to do so in violation of the Board's directive. We have perused the Board's orders of 12.1.2006 and 27.4.2006 and find that the Board had not issued any directive whatever to the effect that the flow of securities into the account of Biren Kantilal Shah should be monitored or regulated. The clear and unambiguous direction issued by the Board was that Biren Kantilal Shah should not be permitted to enter into any transactions involving shares of IDFC and any other ensuing IPOs and there is no allegation against the appellant that it had allowed any such prohibited transaction. Thus, the charge in the show cause notice as well as the finding in respect thereof both are based on a wrong premise and cannot be sustained.

Appeal No.69 of 2007

13. In the show cause notice dated November 23, 2006 issued to CDSL, the charges are as under:

- CDSL facilitated the Depository Participants to open beneficial owner accounts without following the prescribed procedure.

- CDSL failed to put in place adequate mechanism for the purpose of reviewing, monitoring and evaluating the controls, systems, procedure and safeguards.
- CDSL failed to enter into agreements with the clearing houses of stock exchanges.

In its reply to the show cause notice, CDSL pointed out that in fact agreements had been entered into between CDSL and clearing corporations/clearing houses of stock exchanges and the conclusion arrived at in the iSec report largely on the basis of which the charges have been framed in this regard was erroneous. This reply seems to have been accepted by the Adjudicating Officer and there is no adverse finding recorded on this charge. We need not therefore deal with this aspect of the matter.

14. The impugned order has recorded very strong findings on the first charge against CDSL that the latter facilitated opening of fictitious/benami demat accounts without following the prescribed procedure. The Adjudicating Officer has considered the provision for the second address or the correspondence address in the account opening forms to be primarily responsible for opening of the large number of fictitious/benami accounts and has held CDSL responsible for that. The learned counsel for CDSL, however, pointed out that it is not correct to hold, as the Adjudicating Officer has done, that CDSL had included the column for correspondence address without the Board's approval. The provisions for correspondence address, in addition to the permanent address, has been a part of CDSL's system since inception and this always had the approval of the Board. Besides, the learned counsel for CDSL pointed out that contrary to what has been recorded in paragraph 5.3 of the impugned order, CDSL has not withdrawn the provision for correspondence address in the demat account opening forms as this provision is considered to be absolutely necessary in the interest of investors. Similar facility exists in the account opening forms in banks, in the applications forms for allotment of permanent account number by the Income Tax department, in the form

of application for passport etc. Mere existence of the provision for correspondence address cannot be held responsible for the so called IPO scam. The Adjudicating Officer has noted that a very large number of accounts had been opened on a few specific dates in different names but with the same correspondence address and has held that CDSL ought to have been able to detect this phenomenon. This finding has been based on the stipulation in the Board's circular dated August 4, 2000 quoted by us in paragraph 6 supra but the logic that is being followed by the Adjudicating Officer in this case for holding CDSL responsible for the failures of DPs does not appeal to us.. In the aforesaid circular, the responsibility for verification of an applicant's identity has been placed squarely on the DP and to shift the burden to the Depositories on the ground that a DP is an agent of the Depository is not at all justified. In the scheme of the regulatory process that exists in the securities market, the role of each intermediary has been specifically delineated and the Depositories cannot be saddled with the specific responsibility for any failure by the DPs. The DPs are also market intermediaries registered with the Board and, in terms of chapter VI of the DP Regulations, the Board has the responsibility of periodically inspecting them. Therefore, by the same logic that the Adjudicating Officer seems to be relying upon in this case, the Board itself can be held responsible for the alleged failures of the DPs and hence, indirectly, for the IPO scam. However, considering the fact that there is nothing intrinsically wrong in having a second address of the applicants for opening demat accounts and that there is no bar on opening multiple demat accounts by a single individual with the same DP or with different DPs, the entire basis for the finding by the Adjudicating Officer is wrong, as has been found by us in case of NSDL.

15. In the case of CDSL, however, there is yet another aspect of this charge. It has been alleged that in order to facilitate the process of IPO allotments, CDSL distributed identification numbers of beneficial owners in advance to its DPs even before the latter completed the application forms and submitted the same to CDSL.

This, according to the Adjudicating Officer, is in violation of bye laws 13.3.4, 13.3.5 and 13.3.6 of CDSL's bye laws which read as under:

> "13.3.4 The Beneficial Owner will have to make an application for this purpose to the participant in the format specified in the operating instructions issued by CDSL.
> 13.3.5 The Beneficial Owner will be required to enter into an agreement with the participant as per form at Annexure "C" to these Byelaws.
> 13.3.6 Once the application has been accepted by the participant, the applicant will be issued a Beneficial Owner account number."

It is also alleged by the Board that distribution of 29,848 identification numbers (ids for short) of beneficial owners (BO for short) in advance to the DPs indicated lack of due diligence on the part of CDSL and its failure to follow the prescribed procedures and safeguards resulting in violation of Regulation 34 of the DP Regulations. We do not think so. Bye laws 13.3.4 to 13.3.6 require that the BO id has to be given only after an application is accepted by the DPs and it is not necessary for the latter to upload those particulars to the CDSL system before giving the client a BO id. The BO ids were provided to the DPs in advance on their request since typically, before a popular IPO opens for subscription, a large number of applications are received at the last moment and enough time may not be available for processing them and verifying the KYC norms before sending the applications to the issuer companies. On the other hand, it is mandatory to provide a BO id before sending the applications to the issuer companies as otherwise the applications would be rejected by the latter. It was under these circumstances that the DPs requested CDSL to provide BO ids in advance which CDSL did in the interest of the investors as well as its own business. It is pertinent to mention that these ids given by the Depository in advance were system generated and even if the DP had uploaded the applications to the CDSL system after completing the KYC norms, the same id numbers would be generated. In such an event, the DP has to upload the applications to the CDSL system in exactly the same order in which BO ids had been provided earlier. This procedure has apparently been followed quite successfully by the DPs of CDSL without causing any harm either to the investors or to the market. As already observed, this helps the investors

to apply for allotment at the last moment and in the process the DPs also increase their business. We do not think that any culpable irregularities were committed in this process for which it was necessary to take action against the Depository. In the impugned order, the Adjudicating Officer has recorded a finding that advance allotment of BO id facilitated the account opening process "without adherence to prior verification and scrutiny of documents". In paragraph 6.4 (6.4.0 to 6.4.5) of the order which deals with this particular allegation, there is absolutely no discussion on or explanation of what irregularity is involved and how such irregularity facilitated opening of the afferent accounts. We are, therefore, unable to accept the finding. Incidentally, as mentioned by the learned counsel for CDSL repeatedly, only one out of 29,848 alleged cases in which BO ids were given in advance was an afferent account (i.e. a fictitious/benami account as found by the Board during the investigations) which shows that such advance action did not facilitate opening of the fictitious/benami accounts. Even in respect of that one account, furnishing of the BO id in advance had nothing to do with making that account fictitious/ benami.

16. The next charge against CDSL is that of failure to put in place adequate mechanisms for the purpose of reviewing, monitoring and evaluating the controls, systems, procedures and safeguards. In the impugned order, the finding against CDSL on this charge has been based on two strands of argument both of which are fallacious. The first is that if effective control measures had existed along with a proper system for monitoring and evaluating such control measures it "could have prompted CDSL in checking creation of large number of afferent accounts". We do not think that this would have been possible in a system which permits opening of any number of accounts by a single individual with any number of DPs. Apart from making a bald statement in the impugned order, the Adjudicating Officer has not explained as to how it would have been possible. During the course of arguments, we repeatedly asked the learned counsel for CDSL as to how it would have been possible in the kind of system that we have and we got no satisfactory explanation. The second argument is that the bye laws that CDSL has framed for the

purpose are not adequate. We do not think it is open to the Board to first approve certain bye laws and then form an opinion (possibly with the benefit of hindsight) that these are not adequate and then penalise the framers of the bye laws for the perceived inadequacy. If there was any inadequacy, it was incumbent upon the Board to have pointed out the same to CDSL and to have advised it to remove the same by amending the bye laws suitably.

17. The only other adverse finding against CDSL is that it failed to verify the infrastructural facilities of the DPs. This charge also fails for the same reasons as in the case of NSDL which we have dealt with in paragraph 10 supra.

18. We have considered above the specific charges levelled against the two Depositories by the Board and find that in the facts and circumstances of these cases, none of the charges can be said to have been established. Some of the charges, however, have very major implications for the securities market and deserve further discussion. Much has been made by the Board about the column for the second address that has been provided in the form for opening demat accounts. Honestly, we are unable to see what is wrong with this form. A client may very well have a permanent address and a correspondence address that is different. From the point of view of communication, it would be the correspondence address which will be the most important. However, is it not necessary for the DP to know also the permanent address of the client? After all, the object is to know one's client and knowing both the addresses is certainly a better KYC norm. Interestingly, though the Adjudicating Officer has held that the provision for the second address has facilitated the opening of fictitious demat accounts, we understand that the provision for both addresses continues till now and the Board has not issued any orders to discontinue this practice. Clearly, the Board also finds this provision to be necessary and useful. If so, we do not find any rationale behind the Board's insistence on penalising the Depositories for having the provision for two addresses. Admittedly, certain unscrupulous elements have misused this facility for the purpose of cornering shares

in certain IPOs but the responsibility for the abuse or misuse of the facility cannot certainly be laid at the door of the Depositories.

19. The charge of improper maintenance of data on the part of NSDL and its data integrity being suspect also has very grave ramifications. NSDL and CDSL together maintain the demat accounts of all investors in public limited companies in the entire country and if the data integrity of either of them is suspect, the consequences could be disastrous for the whole market. Such a charge ought not to be levelled lightly and, if proved, should result in much more drastic action than the mere imposition of a monetary penalty. Even if one were to assume that the use of certain default values in a few fields in the database was not correct, but can it be concluded on that basis alone that the data integrity of the Depository as such is suspect? The answer has to be in the negative. Since NSDL contends that its systems are perfect and have the approval of the Board, it was necessary to permit it to cross examine the author(s) of the iSec report upon which the Adjudicating Officer has solely relied for recording a finding against the former, so that the deficiency if any, in the system could be identified. Another aspect of the matter also needs to be kept in view. If some defect either in the design or in the operation of the computerised data bases of the Depositories is detected, one would expect the primary concern of the market regulator to be to find a way to rectify the defect. Considering the supreme importance of the Depository data bases for the integrity of the market and its smooth operation, this has to be the first priority. Of course, NSDL has taken the stand that there is absolutely no defect or deficiency or irregularity in the maintenance or operation of its data base but the Board has neither accepted that stand nor taken steps to remove the perceived deficiency and restore data integrity by asking NSDL to take any specific steps. Given the scale of operations of the two Depositories, even the success of the Board's action to regulate the securities market properly is dependent on the proper functioning of the two Depositories including the integrity of their data bases. In fact, the Board and the two Depositories have to work together in tandem to secure the interests of the investors and the securities market. The Depositories are

also very important and responsible market intermediaries and they are not expected to work at cross purposes with the Board. In the case of IPO scam too, the immediate remedy and the further follow up action ought to be decided by the Board and the two Depositories together rather than through the Board's punitive action against the former. Most of the data on the basis of which the Board has conducted investigations into the IPO scam and fixed responsibilities on the key operators and the financiers has emanated from the data bases of the two Depositories. Having relied upon and utilised such data gleaned from the two Depositories without having any doubts about its integrity, we do not think it is open for the Board to allege lack of data integrity in respect of NSDL.

For the reasons recorded above, the charges against both the appellants fail and their appeals succeed. The impugned orders are set aside leaving the parties to bear their own costs.

Sd/-
Justice N.K. Sodhi
Presiding Officer

Sd/-
Utpal Bhattacharya
Member

14.1.2009
RHN/PMB