

SECURITIES AND EXCHANGE BOARD OF INDIA

ORDER

DIRECTIONS UNDER SECTIONS 11(1), 11(4) AND 11B OF THE SECURITIES AND EXCHANGE BOARD OF INDIA ACT, 1992 IN THE MATTER OF SOCIETE GENERALE

1. Regulation 20A of the Securities and Exchange Board of India (Foreign Institutional Investors) Regulations 1995 (hereinafter referred to as FII Regulations) casts responsibility on Foreign Institutional Investors (hereinafter referred to as FIIs) to provide information about Offshore Derivative Instruments (ODIs)/Participatory Notes (PNs) to Securities and Exchange Board of India (hereinafter referred to as SEBI) in the prescribed manner and format. ODIs/PNs are used interchangeably for the purposes of this Order. Regulation 20A of the FII Regulations is reproduced hereinbelow:

“20A. Foreign Institutional Investors shall fully disclose information concerning the terms of and parties to off-shore derivative instruments such as Participatory Notes, Equity Linked Notes or any other such instruments, by whatever names they are called, entered into by it or its sub-accounts or affiliates relating to any securities listed or proposed to be listed in any stock exchange in India, as and when and in such form as the Board may require.”

2. As per Regulation 7A of the FII Regulations, FIIs are required to adhere to the Code of Conduct specified in Schedule III thereof. Clause 6 of the Code of Conduct *inter alia* prohibits an FII to make any untrue statement. Clause 6 is reproduced hereinbelow:

"6. A Foreign Institutional Investor shall not make any untrue statement or suppress any material fact in any documents, reports or information furnished to the Board"

3. The ODI activities of FIIs are *inter alia* subject to the provisions of Regulation 15A of the FII Regulations. Regulation 15A are quoted hereinbelow:

Regulation 15A as on February 3, 2004:-

*"15A. (1) A Foreign Institutional Investor or sub account may issue, deal in or hold, off-shore derivative instruments such as Participatory Notes, Equity Linked Notes or any other similar instruments against underlying securities, listed or proposed to be listed on any stock exchange in India, only in favour of those entities which are regulated by any relevant regulatory authority in the countries of their incorporation or establishment, **subject to compliance of "know your client" requirement:** (emphasis supplied)*

.....

Regulation 15A as on May 22, 2008:

"(1) No foreign institutional investor may issue, or otherwise deal in offshore derivative instruments, directly or indirectly, unless the following conditions are satisfied:
(a) such offshore derivative instruments are issued only to persons who are regulated by an appropriate foreign regulatory authority;
*(b) such offshore derivative instruments **are issued after compliance with 'know your client' norms:** (emphasis supplied)*

.....

4. SEBI issued circulars under Section 11 of the Securities and Exchange Board of India Act, 1992 (hereinafter referred to as SEBI Act) read with Regulation 20A of the FII Regulations, specifying the format for the periodical submission of the information by all registered entities about their ODIs/PNs activity. SEBI, vide Circular dated February 19, 2004 carried out certain modifications in the reporting format prescribed earlier (vide Circular dated August 8, 2003) and accordingly, all FIIs were mandated to provide the following information on investors to whom ODIs/PNs are issued:-

	A	B	B1	C
Sr. No.	Name and Location of the person to whom the Offshore Derivative Instruments are issued.	Name and Location of other person in case back to back Offshore Derivative Instruments has been issued against the instrument mentioned in A	Name and jurisdiction of the Regulator by whom the person holding the Offshore Derivatives Instruments, is regulated in terms of Regulation 15 A FII Regulations	Type of the investor (e.g. hedge funds , corporate, individual, pension fund, trust etc) This information should be given for column 'B', in case column 'B' information is Nil furnish information for column 'A'

The said modification (insertion of a new column B1) was consequential to the insertion of Regulation 15 A in the FII Regulations and was for the purpose of ascertaining the end beneficiary of the PNs.

5. Therefore, it follows that the provisions of the FII Regulations (Regulation 15A and 20A) and the Circulars issued thereunder, as stated above unequivocally mandates the following:

- i. FIIs have to abide by the requirements on disclosures and provide a complete and correct picture of its activity to SEBI and more particularly about its ODI issuances.
- ii. FIIs can issue ODIs only to regulated entities.
- iii. FIIs have to observe “Know Your Client” (KYC) norms diligently, this being a key responsibility of any regulated entity.

6. Under this regulatory regime, from the reports submitted by Societe Generale, Foreign Institutional Investor Registration No. IN-FR-FA-0481-98 (hereinafter referred to as SG), during the period January 2006 and January 2008, it was observed that SG had issued certain ODIs/PNs to Hythe Securities Limited (hereinafter referred to as Hythe), with Reliance Communications Limited as the underlying.

7. In order to obtain more information regarding Hythe, SEBI, vide electronic mail (hereinafter referred to as e-mail) dated December 15, 2009 required SG to provide the following details of all the instruments issued by it to Hythe:

- i. *The regulatory status of Hythe*
- ii. *To confirm whether the beneficial owner is Hythe and if the ODIs/PNs are onward issued, then the regulatory status and the beneficial ownership details of that entity as described hereunder:-*
 - a) *details of shareholders*
 1. *name*
 2. *nature of constitution*
 3. *percentage of holding*
 4. *domicile status*
 - b) *Document of incorporation (in case of a corporation)*
 - c) *Articles/ memorandum of association or any other like document*
 - d) *Registered address*
 - e) *Correspondence address*
 - f) *Contact person*
 1. *name*
 2. *e-mail address*
 3. *contact telephone/fax*

Besides, SG was also advised to provide documents in support of the transactions with Hythe and any onward issuance of ODIs/PNs.

8. SG, replied vide e-mail dated December 24, 2009 informing that Hythe is regulated and registered with Financial Services Authority (United Kingdom). While providing details of all the ODIs/PNs entered into with Hythe, SG stated and acknowledged that there had been errors in its reporting to SEBI of the transactions with Hythe. According to it, fourteen such transactions with Hythe were wrongly reported to SEBI. As per the monthly reports filed by SG with SEBI till date, it was seen that SG had forty eight transactions with Hythe out of which it admitted having misreported in respect of fourteen of these transactions.

9. SEBI sought confirmation from SG that the ODIs/PNs issued to Hythe were solely to it as the beneficial owner. It was also advised to inform the details of the end beneficial owner and the regulatory status of the entity, if the ODIs/PNs were onward issued. In reply, SG stated that it had established relationship with Hythe on the basis for dealing on 'principal' basis. While restating that the ODIs/PNs were issued to Hythe, it had requested further time to "retrieve" the documents sought by SEBI and that it was "still in the process of verifying the information" and further that it would

inform SEBI “in case there is a discrepancy”. SG further stated that, though Hythe had mentioned the word ‘client’ during one of its conversations, it did not indicate the ultimate beneficial owner and the said transaction took place in the same manner as other transactions with Hythe.

10. SG in its e-mail dated December 24, 2009, further sought direction from SEBI so that it could request Hythe to provide a confirmation to SEBI that the ODIs/PNs issued by it to Hythe were indeed in the principal capacity and if not, to provide the end beneficial owner details. SG was further advised vide SEBI e-mail dated December 29, 2009 to explain the due diligence undertaken by it to ensure that Hythe was the final beneficiary owner of the ODIs/PNs issued by it.

11. In response, SG, vide e-mail dated December 30, 2009 while providing supporting documents, stated that as per its relationship with Hythe, the latter was required to inform about the proposed beneficiary owner/client. It further contended that based on the dealing, booking instruction and settlement of Hythe, it had concluded that Hythe was acting as a principal and the beneficiary owner of the transactions. In its e-mail, it also informed SEBI that they “*will dispatch the request via e-mail today to Hythe to provide directly to SEBI to preserve Hythe’s client confidentiality (we will provide your email address to the Compliance Department of Hythe)*

- *confirmation that Hythe is the end beneficiary of all the above transactions, and*
- *to the extent that Hythe is not the end beneficiary owner of any such transactions, the details of end beneficiary owners of such transactions...*”

In order to ascertain the correctness of the contention of SG, SEBI advised it to provide documents in support of its relationship with Hythe and the order booking instructions. In this regard, SG was also advised to provide the Euroclear statement of all settlements of all trades executed for the particular ISINs reference no. XS0287844574 and XS0347364563, vide SEBI e-mail dated January 1, 2010.

12. Pursuant to the same, SG, vide e-mail dated January 5, 2010 submitted certain documents purporting to show its relationship with Hythe. One such document was a letter from SG to Hythe dated May 26, 2005 titled "SG Securities (HK) Limited Regulatory Documentation". In the said letter, SG dealt with three issues- status of Hythe as a professional investor, compliance of Hythe with the client identity rule and restrictions placed on short selling in the Hong Kong jurisdiction. It had also provided another document dated March 8, 2006 addressed to Hythe containing certain acknowledgements, representations, warranties and undertakings in respect of the ODIs/PNs. One of the clauses of the said document was the specific clause quoted herein below:-

"Upon our request, you will promptly provide us or procure such information as is requested or required by the Issuer and/or any statutory or regulatory authority directly or indirectly connected with the issue, offer , sell, transfer, assignment, novation or otherwise creating any economic interest against the Products either by you and/or your affiliates and/or your associates (including pursuant to the securities laws or regulations as may be applicable)"

13. Subsequently, Hythe, vide e-mail dated January 7, 2010 informed SEBI to confirm the veracity of request for information on ODIs/PNs and also confirm that it is a "compelled regulatory request". Thereafter, Hythe vide another e-mail dated January 11, 2010 confirmed that it had acted as broker in those transactions. It was observed that those ODIs/PNs had been onward issued to Opportunite S.A. (Registered FII: IN-FR-FD-1387-06) and further to "designations" by the name of Pluri Emerging Co PPC Cell E, Pluri Cell E, or just Cell E. Thus, for these PNs, reporting Hythe as the end beneficiary is not true. Further, Regulation 15A of the FII Regulations lays emphasis on the fact that an FII or sub account can issue ODIs/PNs to regulated entities only after compliance with 'know your client' norms. As described above, SG has failed to adhere to this norm as it has little or no relevant knowledge of the ultimate beneficiary of the ODIs issued by it.

14. As regards the onward issuance of ODIs/PNs, SG has stated that the agreements signed by it with Hythe provided an ability to it to seek information on the end beneficiary owner of the ODIs/PNs, so issued. However, when SG was advised to provide the end beneficiary details it was unable to do so SG vide e-mail dated January 12, 2010 acknowledged that it was unable to obtain the details of beneficial owners stating *“Hythe is not willing to provide such information to us. They would rather provide you (SEBI) the details directly.”*

15. It is abundantly clear, from the reporting stipulations on PNs, that FIIs issuing the ODIs/PNs are required to provide the name of the investor in case the same (ODIs/PNs) are issued onward to any other entity as a back to back instrument. The responsibility for identifying and the accountability for reporting the end beneficial owners rests entirely with the issuer, the FII.

16. On the contrary, from the submissions and the documents provided by SG, it appears that it had shirked its responsibility cast on it under the regulations, and has left it to its subscriber- Hythe, which is not registered and regulated by SEBI, to furnish the necessary information. SEBI has permitted issuance of ODIs/PNs by FIIs with an explicit obligation that the issuance of ODIs/PNs comes with an inalienable responsibility to maintain complete audit trail of onward issuances of ODIs/PNs right up to the end beneficiary. FIIs shall also bear the responsibility of reporting the same to SEBI in their monthly reports. In view of the above, SEBI, vide e-mail dated January 7, 2010 informed SG that the onus is on SG to abide by the provisions of the FII Regulations and stipulations thereof. Leaving the responsibility of making the disclosures on ODI issuances mandated under the said statutory obligations to its clients is certainly no compliance at all.

17. From the above response, it is evident that SG has failed to satisfy the basic tenet of “know your client” compliance when it issued ODIs. SG was not only unaware of the end beneficial owner but also did not have any mechanism in place to ensure that it can know the end beneficial owner as clearly demonstrated by the e-

mail response where it stated that its client was not willing to provide such a response.

18. I note that such information should have been well in the possession with SG itself in the first instance. As a registered entity that has been permitted to issue ODIs, it cannot throw up its hands in sheer helplessness and put forward a plea that it is unable to furnish the required information, because its client is unwilling to part with the same. Not only is such a stand clearly unacceptable, but it indeed makes a mockery of the regulatory requirements put in place by SEBI, in this regard. Furthermore, this clearly indicates that SG has not been able to maintain any meaningful control over its processes/systems for identifying the ultimate beneficial owners, in compliance with the stipulations imposed under law thus demonstrating complete disregard for the regulatory compliance expected from SG in its capacity as FII and an issuer of ODIs/PNs.

19. From the information submitted by SG and Hythe, it is evident that the ODIs/PNs which were issued by SG to Hythe (as reported to SEBI), were in fact subsequently issued downstream to Opportunite S.A and then to Pluri. It is also pertinent to note that the ODIs/PNs were issued afresh overlooking the regulatory requirements as specified in Regulation 15A of the FII Regulations since February 2004. FII Regulations casts responsibility on an FII to ensure that any downstream issuance of ODIs/PNs is reported to SEBI. In the facts and circumstances including the submissions made by SG, it is evident that it had failed to report the ultimate beneficiaries. It further continued to misrepresent that the ODIs/PNs were not issued "back to back" to any other entity. It is a major lapse on the part of SG as it was not able to identify the beneficial owners even after the continuous advise/requests by SEBI and instead wrongly reported to SEBI that Hythe was the true beneficiary, which was contrary to facts. The Code of Conduct prescribed for FIIs, advise FIIs to uphold the highest standards of probity and they cannot make any untrue statement or suppress any material fact in any document, reports and information furnished to

SEBI. In the present case SG had to completely rely upon Hythe for the details of the ultimate beneficiaries when it had a statutory duty to maintain the same by itself.

20. One of the pivotal criteria on which SEBI grants the certificate of registration to FIIs is that an FII has to be necessarily regulated by an appropriate foreign regulatory authority as provided in Regulation 6(1)(b) of FII Regulations. It tacitly implies that SEBI recognises an equivalence and comparability of the rigour of compliance required of the entity in its jurisdiction. It also implies that that an FII would *inter-alia* put systems and processes to ensure compliance with 'know your client' norms. Thus, abiding by 'know your client' requirement is an integral duty cast on a regulated entity. SG was not only unaware but was also unable to ascertain whether the ODIs/PNs were onward/ downstream issued to an unregulated entity. It failed to comply with the provisions of FII Regulations governing ODIs/PNs and provide correct and true picture of the ODIs/PNs issued by it, signifying callous disregard for the regulatory compliance required under the FII regulations for an ODIs/PNs issuer.

21. I am therefore of the opinion that:

- a. SG has failed to provide true, fair and complete details of the ODIs/PNs activity undertaken by it but also *prima facie* violated the provisions of FII Regulations by furnishing false and incorrect information to SEBI.
- b. It *prima facie*, has not even been able to ascertain whether the entity to which ODIs were issued onward are themselves regulated.
- c. It has failed in its due diligence expected in the observance of 'know your client' norms.

22. Full and fair disclosures, form the cornerstone of any disclosure requirements stipulated by SEBI. As the source of funds available with an FII comes from offshore, by its very nature, SEBI has no direct access to verify the source and nature of the funds or whether the funds are misused for the purpose of market manipulation or for perpetrating any type of fraud in the securities market. The very essence of the

amendments to the FII Regulations in Regulations 15A and 20A reflects this pressing regulatory concern. In other words, SEBI places almost absolute faith and unqualified reliance on the ability of an FII to carry out the basic regulatory and prudential oversight. Therefore, SEBI as a regulator requires fair, true and correct information for assessing and monitoring FII activity in the securities market. When a registration is granted to an FII, SEBI presupposes that the FII has the capacity to ensure the proper compliance of the provisions of the FII Regulations and the integrity and accuracy of the data it provides to SEBI. It appears that, from the facts discussed above, SG has been non compliant with the provisions of the FII Regulations and shown disregard to the regulatory responsibility cast on the FII as an issuer of ODIs/PNs. Further, SG completely failed in obtaining correct and complete information from the counterparties it deals with. SEBI, as a regulator cannot allow such an entity to continue with any activity in respect of the issuing and dealing with ODIs/PNs. Such acts of SG is prima facie in contravention of Regulations 7A read with Clauses 1, 5 and 6 of the Code of Conduct prescribed for FIIs, Regulation 15A and Regulation 20A read with SEBI Circular dated February 19, 2004. After due consideration of the facts and circumstances of this case, I am of the view that SG needs to be restrained in its activity in dealing with ODIs/PNs till such time SEBI is satisfied that it has the organizational resolve and capability demonstrable vide systems, processes and controls to provide true, accurate and complete picture of its ODIs/PNs transactions as envisaged under the FII Regulations and the reporting requirements therein. Therefore, I find it necessary, in order to protect the interest of the investors and for the orderly development of the securities market to take preventive measures and issue urgent directions in this regard to ensure that such kind of violations do not continue or get repeated.

23. Accordingly, in exercise of the powers conferred upon me under Sections 11(1), 11(4) and 11B of the Securities and Exchange Board of India Act, 1992, I hereby direct Societe Generale, Foreign Institutional Investor (Registration No. IN-FR-FA-0481-98) not to issue/subscribe or otherwise transact in any fresh/new

Offshore Derivative Instrument till such time it provides a true and correct reporting of its Offshore Derivative Instruments/Participatory Notes transactions, to the Securities and Exchange Board of India.

24. Furthermore, given the aforesaid *prima facie* violations discussed above, Societe Generale is required to show cause as to why appropriate proceedings including cancellation of its certificate of registration as a Foreign Institutional Investor should not be initiated.

25. Societe Generale may file its objections/reply, if any, to this Order, within thirty days.

26. This order shall come into force with immediate effect.

**DR. K. M. ABRAHAM
WHOLE TIME MEMBER
SECURITIES AND EXCHANGE BOARD OF INDIA**

**PLACE: MUMBAI
DATE: JANUARY 15, 2010**