

# THE GAZETTE OF INDIA

EXTRAORDINARY

PART - III - SECTION IV

PUBLISHED BY AUTHORITY

## SECURITIES AND EXCHANGE BOARD OF INDIA

NOTIFICATION

Mumbai, the 4<sup>th</sup> day of December, 2003

**IN THE MATTER OF SUPERSEDING THE COMMITTEE OF THE CALCUTTA STOCK EXCHANGE ASSOCIATION LIMITED UNDER SECTION 11 OF THE SECURITIES CONTRACTS (REGULATION) ACT, 1956.**

Serial No. 199 - The Calcutta Stock Exchange Association Limited (hereinafter referred to as the CSE) is a company limited by shares and was granted recognition as a stock exchange on October 10, 1957.

1.0 The Securities and Exchange Board of India (hereinafter referred to as the SEBI) conducted a special inspection of the CSE on May 2001 consequent to the payment crises in the CSE during March 2001. Thereafter SEBI advised the CSE to take immediate corrective action in the area of surveillance and risk management and advised that the responsibility be fixed on the concerned officials for deficiencies and violations brought out during the course of inspection. SEBI further advised CSE to thoroughly revise the existing surveillance and risk management function as also overhaul and strengthen it and conduct an audit of the systems of the CSE by an independent group of computer system auditors to ensure that the

system is secure and free from bugs. SEBI also advised CSE in June 2001 to get an audit done of its computer systems.

1.1 Only after repeated follow-up by SEBI, CSE initiated the exercise in August 2002 and got the system audit done by M/s Ernst & Young. However, its surveillance systems were left out. Thereafter M/s Ernst & Young submitted a draft report in October 2002 to the CSE, but the findings therein were not communicated to SEBI. The details of this report came to the knowledge of SEBI only in February 2003 when the inspection of the CSE was carried out.

1.2 In the said report, M/s Ernst & Young pointed out several deficiencies in the risk management system of the CSE which were not rectified by the CSE and also revealed serious shortcomings in the computer systems of the exchange, some of which are given below:

a. The slot timings during which marked-to-market limits, gross exposure were calculated were too high, as a result of which it was possible for any member to exceed such thresholds several times over during the slot given.

b. Various modules in the package were not tightly integrated. For example, it was found that a member was actually given a turnover limit 100 times that of the eligible amount in TWS, but surveillance module showed the eligible amount only.

c. Critical data such as margin, securities, physical lot clearing house, was maintained on FoxPro based applications, where the data security is always suspect.

d. The various codes and IDs were not serially generated by the system. The members IDs, company codes, etc were manually entered by the user creating the master.

e. Facilities provided in the system could lead to violation of regulatory guidelines, for example the 'PO Leverage' option, allowed a trader to exceed his laid down turnover limit by another 20%.

f. There was a large amount of manual intervention in the entire process. For example, the pay in / pay out files were transferred between the Systems Operations department and the

Market Operation department (MOP), via floppy disks. At the MOP, the pay in / pay out files were renamed manually. The funds shortfall file was manually prepared at the MOP. Margin related information was transferred between Systems Operations and Margin departments via floppy disks.

- g. Lots of commands were entered by the CMC Systems Operations personnel from the 'Operations Menu' on both Sun & Bruno servers. In the absence of any documentation the significance of such commands were unknown to the CSE management.
- h. The exchange did not have an independent specific security committee or administration for IT Security functions. No formal comprehensive IT security policy or procedures existed.
- i. The exchange had not configured "safeguard" system for its C-Star system, which is a basic security feature.
- j. There were no formal password standards defined for the exchange. A user could even choose to have a password only one character long.
- k. There were no policies and formal procedures for access authorization.
- l. There were no documented procedures to ensure that all change requests for system amendment were considered for amendment and that all approved requests were appropriately implemented on a timely basis.
- m. No user, technical and system documentation had been prepared for the C-Star application. There were no systems and programs specifications. It may not have been possible to effectively maintain and use the application system.
- n. Users of the exchange shared their passwords; as a result accountability could not be maintained in the system.
- o. Any exchange user could effect any change in the system, which could lead to erroneous financial statements and improper decision making. Access should be provided on a 'need to do' basis.

- p. Back up and restoration policy were not defined. Back up tapes were not stored at an off-side location.
  
- q. Antivirus software installed on the server/work stations was outdated.
  
- r. There was no audit trail in the system to indicate the user entering the transactions together with date and time.

1.3 Thereafter, SEBI called for a meeting on February 19, 2003 on the issue of system audit, which was attended by the representatives of CSE and Computer Maintenance Corporation Ltd. (CMC), the software service provider. SEBI advised CSE and CMC to rectify all the deficiencies in the computer systems of the exchange by March 31, 2003. The minutes of the meeting were also forwarded to CSE vide letter dated March 03, 2003 and CSE was once again advised to ensure rectification of deficiencies by March 31, 2003. On non-receipt of confirmation regarding the same, SEBI vide letter dated April 23, 2003, advised CSE to confirm rectification of all the deficiencies by way of an undertaking by April 28, 2003. CSE was also advised to initiate compliance audit exercise and complete the same within 45 days, i.e., by June 7, 2003. Although another reminder dated June 23, 2003 was sent by SEBI to CSE to submit the said undertaking by June 30, 2003, CSE failed to do so and instead vide its letter dated June 30, 2003 stated that confirmation of rectification of deficiencies would be forwarded only after completion of compliance audit exercise by July 15, 2003.

1.4 However the CSE failed to confirm the rectification of the deficiencies noticed in the computer systems inspite of receiving repeated directives from SEBI, although the inadequacies in the computer systems, which were pointed out in the systems audit report, had the effect of making the risk management system ineffective.

1.5 CSE also failed to initiate the process of enquiry, fix responsibility and take appropriate action for the removal of deficiencies and also failed to initiate systems audit exercise for its surveillance systems although it was advised to submit the compliance report to SEBI by March 17, 2003 which date, was time and again extended by SEBI. CSE vide its letter dated March 13, 2003 discounted any laxity at their end. However, SEBI vide its letters

dated April 23, 2003 and June 23, 2003 advised CSE to fix accountability and inform SEBI by July 15, 2003. Once again CSE vide letter dated June 30, 2003 reiterated that there was no pronounced laxity at the end of CSE and submitted that since the deficiencies pointed out by the auditors had been in existence for a number of years, it was not possible to conduct a meaningful enquiry for fixation of responsibility. Thus despite repeated follow up, CSE failed to comply with SEBI's directions to fix responsibility.

1.6 The computer system of the CSE was also encountering problems in its CSTAR and settlement server. Members of CSE reported multiple forced logout from the CSTAR server in April 2003. It was also found that a number of foreign packets were present in network in the system and it was not possible to locate the exact sources as these packets were transient in nature. During August 2003, it was noted that the CSE was unable to complete the securities and funds pay out due to technical problems in the exchange settlement server.

1.7 As stated above, the draft report of M/s Ernst & Young which was received by the CSE in October 2002 highlighted several serious deficiencies in the risk management and surveillance system. However the same came to the knowledge of SEBI only in February 2003 when SEBI once again conducted an inspection of the CSE in order to assess the situation with regard to its management and risk management and surveillance aspects. On perusal of the said report, it was noted that none of the deficiencies pointed out by M/s Ernst & Young had been rectified by the CSE even by February 2003 and that no time-bound action plan for rectification of these deficiencies had been finalized by the CSE till the time of the said inspection. The inspection also pointed out several other deficiencies on the risk management and surveillance system.

1.8 In view of the then prevailing situation, SEBI advised CSE vide its letter dated February 14, 2003 to take all possible measures to rectify the deficiencies in the exchange's trading, surveillance and risk management system by March 04, 2003.

1.9 It was also noted that SEBI has been regularly writing to the CSE regarding compliance of its directives which were issued with a view to bring down the pendency of a large number of investigation cases. However, there has been no compliance with the said directions/observations of the special inspection report/inspection report, systems audit, compliance audit, or the deficiencies in C-Star System pointed by Ernst and Young.

1.10 In fact the inspection report was sent to CSE vide SEBI letter dated March 25, 2003 for rectification of the deficiencies pointed out in the report. In reply to the same, the exchange submitted its compliance report, vide letter dated July 16, 2003, which was found to be unsatisfactory in as much as CSE was found to have failed to take up the issue of removal of deficiencies from its systems with the required seriousness and had also failed to comply with all the directives of SEBI

2.0 The Articles of Association of the CSE provide that the Committee shall comprise of 19 Directors, out of which 9 shall be Elected Member Directors, 3 SEBI Nominee Directors, 6 Public Representative Directors and an Executive Director. In accordance with the SEBI order dated April 20, 1993 issued under Section 8 of the Securities Contracts (Regulation) Act, 1956 (hereinafter referred to as SCRA) the ratio of elected members and SEBI/Public Nominees should be in the ratio of 50:50 in the Committee. However, during the inspection conducted by SEBI in February 2003, it was found that the Committee had 15 Directors, comprising of 9 Elected Member Directors and 6 SEBI/ Public Nominees while the Executive Director had submitted his resignation. There were reports of the public representative directors expressing their desire to resign/discontinue from the Committee, as they did not find a conducive environment to perform and carry out their duties at the Committee, due to the unwarranted interference and obstruction from the members. There were reports that the elected broker directors were not playing a constructive role on the Committee and that the same was causing an impediment in decision making at the level of the Committee.

2.1 The quality of deliberations at Committee level was also found to have deteriorated considerably, often marked by irresponsible allegations and acrimonious and discourteous behavior on the part of some of the members. The lack of decorum at the Committee, and the fact that the Committee was not functioning, in the way it should be functioning was marked by several unsavory events. On one occasion, a meeting of the Committee was convened on August 12, 2003 mainly for calling the extraordinary general meeting of the shareholders and to comply with SEBI decision to obtain the shareholders approval by the first week of September, 2003 on the issue of the Scheme of Demutualisation earlier submitted by the CSE. As the elected members did not agree and continued to agitate and eventually staged a walk out, despite the repeated requests of the President and others not to do so and as the remaining members present at the meeting did not form the necessary quorum as per the relevant provisions of the Articles of Association of the CSE, the meeting had to be adjourned. Consequently, the notice for the proposed extra ordinary general meeting could not be issued. This event

was brought to the notice of the SEBI by CSE vide its letter dated August 13, 2003.

2.2 Thus the Committee was unable to discharge its duty towards the exchange and the investors, and appeared to lack the required focus and direction to improve the functioning of the exchange. The fact that the Committee was not functioning effectively, was further gauged by the fact that since March 2003, 5 members of the Committee i.e. 2 SEBI/ Public Representative Directors, 2 elected Directors and the Executive Director of the exchange resigned without completing their term in the Committee. Surprisingly, even the elected Directors were expressing unwillingness to continue in the Committee. Thus as the functioning of the Committee had created uncertainty and ambiguity even amongst the members of the Committee and insecurity amongst the investors, the situation warranted immediate action to stop the further deterioration of the functioning of the Committee.

2.3 It was also learnt that consequent upon the resignation of Shri P. K. Sarkar, former Executive Director on February 28, 2003, CSE had formed a Committee of Executives, which consisted of Shri Gautam Bhattacharjee, GM, IT Dept., a computer professional who had limited experience in managing the day to day affairs of the exchange, Shri P. K. Ray, Secretary (about whose fitness there were serious doubts) and a couple of other junior executives. The Management at the operational level was consequently left in a lurch which potentially impaired the surveillance and risk management capabilities of the exchange.

2.4 Instances were observed wherein the reply / reports pertaining to surveillance activities, furnished by the CSE were incomplete or misleading or submitted after considerable delay. In order to elicit information / report from the exchange, SEBI was sending reminders on a regular basis. The monthly reports on surveillance / investigations were not reaching SEBI within the prescribed time. Earlier, although the CSE had vide its letter dated January 20, 2003, assured SEBI that the monthly reports from December 2002 onwards, would be submitted on time, it failed to do so despite further reminders of SEBI dated February 18, 2003, April 11, 2003 and April 24, 2003. SEBI also informed these observations to CSE vide its letter dated June 10, 2003. SEBI was also not kept informed by the CSE as regards the important decisions taken by the Committee in its Monthly Development Report in a prescribed format.

2.5 The financial condition of the exchange was also found to be very weak.

The accounts for the year 2001-02 were not adopted by the CSE which made a net loss of Rs 4.10 crores in 2001-02 and continued to make further losses. A loss of Rs 2.02 crores was incurred by it in the 9 month period ending 31/12/2002. The CSE was also unable to recoup / replenish the shortfall/losses of its funds particularly, the settlement guarantee fund (hereinafter referred to as the SGF). The past depletion of its SGF added to its financial vulnerability of the CSE which reached a stage where the Committee was unable to perform effectively and provide guidance and direction to CSE. The factors of an operational management which was weak if not virtually absent, and other shortcomings such as the critical deficiencies of the basic systems of the CSE, which exposed the system to continuous misuse and yet remained unrectified, warranted immediate action to stop the further deterioration of the functioning of the Committee.

2.6 Further the Joint Parliamentary Committee constituted to look into the Stock Market Scam and Matters relating thereto, in its report presented to the Parliament on 19<sup>th</sup> December, 2002 had inter alia observed that CSE had failed miserably in enforcing its own rules concerning the trading and carry forward limits, and that there had been deliberate failure to initiate steps for rectification of the collection of gross exposure margin by CSE, an absence for a medium for monitoring margin, dereliction of duties in the affairs of the exchange, errors in software system etc.

2.7 In view of the above facts, SEBI issued a notice dated August 27, 2003 under Section 11 of the SCRA to the Committee of the CSE advising them to show cause as to why the Committee should not be superseded in view of the above mentioned instances of mismanagement and irregularities in the functioning of the Committee of the CSE and called upon them to submit their reply to the show cause notice within 15 days from the date of the receipt of the notice and indicate a preference for a personal hearing, if they so desired. The following documents were annexed to the notice.

- a. Letter no. SMD/CSE/SR/3641/03 dated February 14, 2003 of SEBI directing CSE to take all measures possible to rectify the deficiencies in the trading, surveillance and risk management system by March 4, 2003.
- b. Letter no. IES/MSD/SR/DM/3816/2003 dated February 18, 2003 of SEBI informing CSE about the incomplete periodical reports and recurring delay in sending the same.
- c. Letter no. SMDI/PJ/4671/2003 dated March 03, 2003 of SEBI advising CSE to ensure rectification of deficiencies by March 31, 2003.
- d. Letter No. SMDID/INSP/6111/2003 dated March 25, 2003 of SEBI forwarding the report on special inspection conducted during February 2003.



- e. Letter no. SMD/PJ/6735/2003 dated April 04, 2003 of SEBI advising CSE to submit its report without any further delay.
- f. Letter no. IES/MSD/SR/K/7373/2003 dated April 11, 2003 of SEBI advising CSE to submit its monthly reports for the months of February and March, 2003.
- g. Letter no. SMDID/INSP-COMP/7711/03 dated April 23, 2003 of SEBI informing CSE that it did not find the reply of CSE satisfactory and advising CSE to fix responsibility within 15 days.
- h. Letter no. IES/MSD/SR/K/7896/03 dated April 24, 2003 of SEBI regarding the monthly report of CSE for March 2003.
- i. Letter no. IES/MSD/SR/K/1129/03 dated June 10, 2003 of SEBI advising CSE to ensure that the reports / information submitted to it are correct and complete in all respects.
- j. Letter no. SMDID/INSP-COMP/12054/2003 dated June 23, 2003 of SEBI once again advising CSE to fix accountability and inform SEBI by July 15, 2003.

2.8 After the issuance of the notice, four public representative directors including the President and one SEBI nominee director tendered their resignation from the Committee. Thereupon the CSE vide its letter dated September 15, 2003 forwarded the reply of the Committee of CSE dated September 12, 2003 along with compilation of minutes to SEBI in response to the show cause notice in which the following submissions were inter-alia made out: -

- a. System audit :- The Committee did not offer any comments on the charge of CSE not having initiated the system audit to be done by M/s Ernst & Young after receiving several reminders from SEBI in August 2002 and that too leaving out its surveillance systems, and the fact that the draft report submitted by M/s Ernst & Young in October 2002 was not brought to the notice of SEBI.
- b. Non-rectification of deficiencies - system audit:-With reference to the non-rectification of deficiencies in the system audit pointed out by M/s Ernst & Young, the Committee did not offer their comments.
- c. The Committee did not give their comments, as to the shortcomings in the computer systems, reported by M/s Ernst & Young, and the fact that despite the repeated insistence by SEBI, CSE failed to confirm rectification of deficiencies in the computer systems which had the effect of making the risk management system ineffective.
- d. The Committee did not give any comment to the issue of CSE failing to conduct a formal enquiry, fix responsibility and take appropriate action

for serious deficiencies in the computer systems.

- e. The Committee did not offer any comment upon the recent problems encountered in its CSTAR and settlement server in April 2003 and in August 2003.
- f. The Committee also failed to offer any comment on the failure on the part of CSE to satisfactorily rectify the deficiencies as pointed out in the inspection report.
- g. With reference to the ineffectiveness of the Committee of CSE, such that CSE was unable to recoup / replenish the shortfall/losses of its funds particularly SGF, which compelled the public representative directors to resign/discontinue from the Committee and the fact that a meeting such as EGM of the shareholders for the Scheme of Demutualisation on August 12, 2003 could not be conducted, the Committee made the following submissions :-

#### Appointment of Elected Directors.

None of the elected members ever held any office having managerial powers or had access to the day to day functioning of the exchange and /or the day to day management and control over the staff members of the exchange, in due adherence to circular no. SMDRP/Policy/42702/2001 dated December 28, 2001 issued by SEBI, which inter alia held that no broker member should be an office bearer of the exchange i.e. hold the position of President, Vice President, Treasurer, etc.

#### Board Meetings.

The Board Meetings were held at the whims and desire of the exchange officials and nobody bothered to take responsibility for the same. There was no fixed schedule for holding of such Board Meetings and no procedure was laid down for the agenda even though Board Meetings were required to be convened once in a fortnight to enable the elected directors to be aware of the developments relating to the Exchange. Any suggestions made during the Board Meeting were never recorded. Reference was made to a letter dated July 14, 2003 written by one of the elected directors Shri Shankarlal Agarwal in which the said points had been raised earlier by the said directors.

#### Demutualisation.

The elected directors were dedicated to complete the process of demutualization within six months in terms of the directive of SEBI issued vide notice dated December 16, 2002. When one of the elected directors, Shri Shankarlal Agarwala requested for details on the discussion of the Kania Committee's recommendation and an emergency meeting on the same, although the demutualization issue was discussed in each and every Board Meeting, the Chairman felt that it was difficult to finalise the issue in the absence of the Executive Director. Any suggestion made by an elected director to the effect that in principle approval of brokers member be obtained for demutualization, was negated by the Officer on Special Duty, Shri T.K. Das on the ground that the members were only required to submit the draft scheme of the demutualization and not obtain the consent of the general members. When a request was made by the elected directors to hold a brokers meet for the said purpose, a notice was published on July 18, 2003 in the official quotation of the CSE with the following remark:

*"Without any obligation and or commitment from the Exchange..."*

Despite the above notification, the brokers along with the elected directors met on July 22, 2003 in the trading hall of the exchange and after convincing the members, circulated and unanimously approved a draft summary of demutualization.

Direction for holding E G M

Notwithstanding the direction of SEBI to hold an EGM and obtain the shareholders mandate for demutualization, the Management Sub Committee in particular and the Chairman and Shri T.K. Das advised that the draft notice on holding of the EGM be approved by the Solicitor of the Exchange which has caused a delay on the finalization of the issue. The matter was undecided till date under the pretext of obtaining a fresh approval from the Solicitor.

- h. With reference to the charge that the committee of CSE did not act in compliance with SEBI directives such that a large number of cases of investigation were left pending and there was no improvement in the said matter and that there was no compliance with the observations of the special inspection report/inspection report, systems audit, compliance audit, and fixing accountability with regard to deficiencies in C-Star System pointed by Ernst and Young etc., the Committee submitted that even for a small issue, a member of the exchange had to wait for 8 to 10 days for seeking approvals regarding transfer of securities / funds and consequently the attitude of the CSE had

caused mental agony and unnecessary harassment to the members of the exchange.

- i. As regards the worsening financial condition of the CSE, the Committee commented that due to the effort of the elected members in the shifting of the contingency pool of the exchange, discontinuance of vendor services and reduction in general expenses like telephone, electricity, etc. the CSE had saved a lot of money. It was stated that none of the elected directors ever used any facilities at the cost of the exchange such as mobile phones, etc. further contributing to the annual savings on cost reduction to a great extent.
- j. With reference to the inaction against defaulters, it was stated that the Management Sub Committee under one pretext or the other, avoided and ignored suggestions made for the recovery of money from the defaulters that was due to the exchange. As such the elected directors were forced to move a resolution signed by 135 members of the CSE with a request to hold an extraordinary general meeting for that purpose. A copy of the same was enclosed for perusal. It was submitted that the most confidential information relating to the recovery of money from the defaulters was leaked to the relevant persons to help them indirectly to vitiate the process of the recovery.
- k. Liquidation of impounded securities of Old Defaulter Members. It was stated that since certain brokers had been declared as defaulters from time to time from 1990 onwards, the elected directors had made a suggestion for the sale of securities lying with the exchange on the account of such defaulter members, in order to recover the money due to the exchange. However, the said suggestion was never attended to by the Management Sub Committee and any details asked for in relation thereto was submitted only after a lot of persuasion and the decision for liquidation was never taken till date. It was stated that they had been told that there was a mismatch in the records since certain securities which should have been with the exchange on such defaulter member's account were not traceable. On further enquiry, it was reported that a few members had obtained duplicate certificates from the respective companies. It was stated that despite knowing the factual position no effort was taken to trace the securities and /or fix the responsibility on the concerned person.
- l. Replenishment of Settlement Guarantee Fund. It was submitted that during the scam in March 2001, the securities of the members lying with the exchange was dislocated to such an extent that it could not be reconciled till date and the deposits of the members lying with the exchange apart from the money drawn from the SGF was used to meet the payment crisis. The exchange authorities were not in a position to fix up the member-wise liability for that purpose and it was only at the behest of the elected directors in several Board Meetings that the decision was taken to the effect that an audit of the SGF be carried out separately strictly in compliance with the SGF rules so that the entire

issue was resolved. Thereafter an informal committee under the then Executive Director was formed and a Chartered Accountant firm was appointed to carry out the same. Subsequent to the said date, the elected directors were never informed about any further development which was within the knowledge of the Management Sub Committee. It was stated that the issue was still pending. Elaborating on the developments of the meeting held on August 12, 2003 which was brought to the knowledge of SEBI, it was stated that on the said day, the elected directors insisted that the draft report received by the Chairman be tabled for discussions. However, the Chairman and the Executive Director declined to discuss the subject and stated that the same would be taken up in the next meeting causing delay in the finalization of the process of replenishment of SGF. It was stated that consequently the elected members were not in a position to know their liability to the SGF and during the last eight months despite the suggestions of the elected directors that the issue of audit of SGF be finalized, the same was kept pending. It was stated that in terms of the amendment in the Companies Act, 1956, the authorized capital of the company is required to be increased beyond a minimum amount of Rs.5 Lacs. Although a notice from the department of CLB has been served on the exchange, the exchange officials including the SEBI nominee director, Shri L. M. Gupta remain silent despite receiving repeated reminders from the elected directors and the final decision on the said issue has been kept pending for reasons best known to the outgoing Chairman and Officer on Special Duty.

m. Development of Business

(i) Membership of NSE through subsidiary Route.

Despite draft schemes being prepared, several discussions being held, including one with Shri G.N.Bajpai, Chairman, SEBI in the meeting with the elected director on November 12, 2002 at Mumbai, for the exchange to obtain membership of NSE through the subsidiary route, nothing materialized.

(ii) Depository Participation.

The suggestion of the elected directors to have its own depository service was never taken up although an assurance was given from time to time.

(iii) Efforts of Sub Committee (SEBI action taken Sub Committee)

The compliance to SEBI directives were abnormally delayed without the knowledge of the elected directors.

n. Arbitration Sub Committee.

No arbitration cases were pending with the exchange.

o. Action against illegal NSE Terminal.

Although a memorandum was submitted by one of the elected directors Shri Sultan Usman for action against illegal NSE Terminals, no action was initiated. Copy of the same was enclosed.

p. Resignation of Chairman and Public Representative.

It was stated that the notice for supercession of the committee issued by SEBI was received on August 28, 2003 and immediately thereafter, instead of replying to the show cause notice, the public representatives including the Chairman sought to avoid the accountability and fixation of accountability and resigned. It was stated that a person who did not discharge his duty and ran away at the time of crisis could not be considered a competent administrator and the appointment of these persons was never approved by the Board but was initiated solely at SEBI's discretion.

q. Appointment of New Chairman.

It was stated that on September 09, 2003 an emergency meeting was called for, without any agenda to discuss the matter, and in just one minute, a new Chairman was appointed, which was indicative of the efficiency levels of the elected directors and a proof of their sincerity and honesty for reviving the exchange at the time of crisis.

2.9 While denying all the allegations made in the show cause notice except those on record, reference was made to the attendance for the meeting held on August 12, 2003. It was stated that as the said day was Raksha Bandhan, it was practically impossible to attend a meeting in the evening and in any case, two elected directors were not present with the prior information to the management while the remaining directors attended the meeting. It was submitted that the matter relating to the SGF audit became an issue because the Chairman was not interested to discuss the SGF audit. It was further contended that a show cause notice was brought to the knowledge of the elected directors only by the evening of September 09, 2003 by which time it was practically impossible to collect the relevant data, records and/ or to reconcile the figures in the absence of any cooperation from the exchange officials. As such the present reply

was being made simply to comply with the SEBI directives to reply to the show cause notice and hence the Committee requested that before a final decision was taken in the matter, a personal hearing be granted to them.

2.10 Accordingly, the Committee was advised to appear before me on October 9, 2003. On the said date, six elected directors of CSE i.e. Shri Suresh kumar Kaushik., Shri Harish Kumar Singhanian, Shri B.J. Agarwal, Shri Sultan Usman, Shri Shankarlal Agarwal and Shri Shree Nath Kapur, appeared before me and reiterated the written submissions made earlier and also submitted certain documents to support their contentions viz. written submissions dated October 09, 2003, letter dated September 02, 2003 issued by the CSE to Shri Sultan Usman, letter of CSE dated July 03, 2003 addressed to Shri Shankarlal Agarwal, letter of CSE dated January 03, 2003 addressed to Shri Sultan Usman and the notice of requisition dated November 21, 2002 calling for the EGM under Section 169 of the Companies Act. Upon the conclusion of the hearing, upon their request, the directors were granted seven days to file the written submissions if any. Subsequently, the written submissions were forwarded to SEBI vide letter dated October 14, 2003.

3.0 In the letter dated October 09, 2003, it was submitted that as the earlier reply to the notice made vide letter dated September 12, 2003 to SEBI had been hurriedly drafted and certain important facts had been omitted, the same were being now submitted. The elected directors stated that the report on the basis of which the show cause notice had been sent by SEBI, was not disclosed anywhere and consequently they had been denied their right of effectively dealing with the issues raised therein. Referring to the strength of the CSE, it was stated that the Board of Directors of CSE comprised of 19 members out of which, 10 members in the post of Directors were appointed and approved by SEBI who held the reins of the administration and management of the CSE, and the remaining 9 members, who served in an advisory capacity were elected by the members of the CSE. It was contended by the elected directors that the key post of the CSE was held by the SEBI appointed persons as per the SEBI direction contained in circular no.SMDRP/POLICY/42702 /2001 dated December 28, 2001. According to the elected directors, these key post holders were the real executives and the actual wrong doers, although the other 9 elected directors had to bear the brunt for their inaction by virtue of the proposed supersession.

3.1 The elected directors submitted that when SEBI issued the show cause notice, the directors appointed and approved by SEBI chose to resign one after the other without assigning any reasons, thereby obviously

shunning their responsibility and accountability. Consequently, in view of the mismanagement of the exchange by the non-elected directors of the exchange, no tangible case could be made against the elected directors. While expressing apprehension regarding the deliberate misreporting against them, the directors stated that the CSE held movable and immovable property which was more than Rs. 125 crores worth and that it was due to their resistance that the said property was not wasted at the hands of certain persons with vested interests. It was submitted that in case they were removed by the supercession of the Board, the non-elected directors would be accountable to no one and there would be nobody to protect the interest of the members of the CSE.

3.2 While drawing attention to some of the wrongdoings of such members, it was pointed out that the defaulting members of the CSE had offered for settlement i.e. 50% of the amount payable by them although they were capable of paying the full amount. It was stated that although the said offer was received at the office of the CSE two months back, the same was not mentioned in the agenda of the Board Meeting, and it was not clear at whose instance the said offer had been made.

3.3 It was stated that some key officials of the CSE were not co-operating with the Calcutta Police investigating into the CSE Scam of 2001, thus sabotaging the revival of the CSE. No action had been taken against these non-cooperating officials although, the matter had been raised at the Board Meeting on several occasions, leading one to conclude that it was perhaps easier for the authority to supercede the Board of Directors, particularly the elected directors rather than punish the offenders. It was submitted that these facts indicated a lack of impartiality and transparency, as seen in the case of the discrepancies noted in the security account of an old defaulter member M/s Bajranglal Mahavir Prasad which were never addressed inspite of repeated requests, for reasons best known to the management sub committee. It was stated that the request for reconciliation and disposal of the securities held by the CSE in the old defaulter members accounts including those above mentioned, was never addressed.

3.4 It was pointed out by the elected directors that the details and approval relating to the fixed deposits made by the exchange with the State Bank of Saurashtra was never made known to the Board and when the then Executive Director P.K. Sarkar, under whose guidance the CSE had shown great signs of improvement, stepped down in February 2003, Mr.T.K. Das was appointed by SEBI as the officer on special duty, where after the problems in the exchange commenced.



- 3.5 It was reiterated that the initiation of the process of demutualization was well accepted at CSE and the draft scheme thereof was approved instantly in the very first meeting by the elected directors, but for reasons best known to the then Chairman and the Officer on special duty, the scheme was not accepted or approved consecutively on two Board Meetings, for one reason or the other, even though the approval of the general members was obtained by the elected members on July 22, 2003.
- 3.6. While referring to the press release dated September 11, 2003 issued by the secretary of the CSE, it was stated that instead of explaining the real position of the CSE, the SEBI appointed directors, had chosen to resign and remain silent on the said issues. It was stated that everywhere in the world including in the NSE, the participation of the brokers at the level of decision making was considered crucial for the exchange and the act of superceding the Committee, would injure the confidence of the participants of the capital market.
- 3.7 On the issue of system audit report, risk management system, fixing responsibility, inspection of exchange, it was submitted by the elected directors that the management of the exchange with specific reference to functioning of different departments was totally and directly under the control of Management Sub-Committee as constituted by the Chairman at his sole discretion and consisting of only non-elected directors. Further, it was also submitted that elected directors had only advisory role restricted to Board Meeting and the meeting was restricted to Agenda items prepared by the Secretary under direct control of the Chairman.
- 3.8 On the issue of ineffectiveness of the Committee, it was submitted by the elected directors that the requirement of fulfilling the vacancies of public and several nominee directors lies exclusively in the hands of Management sub-committee. The resignation of two elected directors was circumstantial.
- 3.9 Further, it was contended that the depletion of SGF was not during the tenure of present elected directors. The elected directors efforts to recover the money from defaulters remained unattended. The observation by the Hon'ble JPC was for the period before their becoming their directors. These present directors should not be subjected to any action whatsoever. Apart from this, the annexed letters with the notice were

addressed to the persons responsible for Management of the exchange.

3.10 Thereafter vide letter October 09, 2003, Shri Shankarlal Agarwal, one of the elected directors of CSE inter-alia contended that although CSE being a limited company, CSE was supposed to be managed by the directors of the said company, it was, as per the SEBI Act, compelled to follow the SEBI Guidelines. It was contended that as per the SEBI Guidelines and Article 81 of the CSE, out of 19 Managing Authorities/Directors, 3 were to be nominated by SEBI authority, 6 were to be nominated by SEBI from the public representatives, One Executive Director was to be duly approved by SEBI, while the remaining 9 directors were to be appointed by the members of the CSE. Further the President, Vice President and Treasurer were required to be appointed out of the directors nominated by SEBI in terms of the circular dated December 28, 2001 i.e. SMDRP/POLICY/42702/2001. Despite the same, SEBI appointed only two instead of three nominated directors, out of which one attended the meetings very occasionally and only for a few minutes without taking part in the deliberations, while the other director never attended a single meeting since December 2002. It was stated that the then Chairman / President had intentionally ignored these irregularities and consequently, the remaining nominated directors were also not observing attendance as laid down in Article 86 of the CSE. It was stated that as per SEBI guidelines, the nominated directors of SEBI and /or public representatives and the Executive directors alone had the power to take policy making decisions and act in the company's day to day affairs. Apart from advising the nominated directors and executive directors, the elected directors had no role to play in the committee of the CSE and even a simple suggestion made by them was not accepted and /or considered by the nominated directors and executive directors. It was stated that these grievances were recorded in the minutes book and the copies of the letters issued in this regard dated June 25, 2003 and July 14, 2003 were forwarded for perusal.

4.1 Shri Agarwal further contended that despite the repeated requests of the elected directors, the nominated directors refused to consider the JPC report dated December 19, 2002 and take steps in terms of the suggestions contained therein. It was stated that being aware of the irregularities committed by them, these nominated directors who were appointed by SEBI from the public representatives as well as the Executive directors, resigned from their post ignoring the directives and reminders of SEBI. Yet the then President failed to fill up the vacancy. It was stated that since the scam took place in the CSE in 2001, none of the letters sent by SEBI was placed in the meeting for consideration, for fixing responsibility and accountability.

4.2 Even a notice containing important information was not disclosed to the broker directors in compliance to the directions of SEBI although the same was reported to the press by the secretary of CSE. It was stated that the system audit report prepared by M/s Ernst and Young was not placed before the Board and the rectification of deficiencies advised by the auditors was never allowed to be discussed in the meeting with the elected directors. It was submitted that although one Mr. P.K. Bhattacharjee, who was appointed by the Board of Directors on April 12, 2002 for opining on the organizational study of the CSE, submitted his report dated December 05, 2002, the said report was never discussed but kept pending. It was stated that upon the direction of the nominated directors, the then executive director and Officer on special duty, without consulting the elected directors and the secretary of the CSE, conducted the matter of fixing responsibility and the elected directors were unaware about any recent problem in the computer system. The entire responsibility lay with the ITD and Surveillance under the supervision of the nominated directors, executive directors and the Officer on special duty.

4.3 It was submitted that one of the elected directors highlighted the misuse of the C Star, by the officers of the CSE vide letter dated October 9, 2002 and requested for appropriate action and also highlighted the problem in pay in /pay out vide his letters dated July 9, 2003 and July 10, 2003 but the same were ignored. It was stated that the matter of inspection was never placed before the Board of directors and the elected directors were prevented from taking any effective step in the policymaking decisions, except advising the existing nominated directors. It was submitted that the nominated directors had appointed Khaitan & Company as their solicitors of CSE, fully being aware that the said solicitors were holding the brief for the other side as well as they had been warned of the same by the elected directors. It was stated that despite repeated requests made in writing, with the latest made on January 8, 2003, the circulars and directives of SEBI were never placed before the meeting for perusal of the directors, under the instructions of the nominated directors and the Officer on special duty. As such the nominated directors were responsible for the mismanagement and inadequacies of the surveillance system and financially adverse condition of the CSE and in the absence of proper control of the SEBI over its own nominated directors and the inefficiency of these directors, the CSE was prevented from reviving its present condition. Under those circumstances, it was prayed that appropriate action be initiated against the nominated directors. Subsequently another elected director of the CSE, Shri Shreenath Kapoor vide his letter dated October 14, 2003, reiterated the submissions made earlier by Shri Aggarwal.

4.4 I have taken into consideration the facts and circumstances of the case

and the material available on record which includes the show cause notice, reply and the documents submitted by the elected directors as well as the submissions made before me during the personal hearing.

4.5 I have noted that based on the findings of the inspection report and the systems audit report of M/s Ernst & Young, various issues were raised by SEBI viz. such as initiating the process of enquiry, fixing responsibility and taking appropriate action for the removal of the deficiencies noted during the inspection. However I have noted that apart from these issues although other deficiencies as pointed out in the systems audit report of M/s Ernst & Young had the effect of making the risk management system of the CSE ineffective, the Committee of the CSE failed to initiate adequate steps to rectify these defects as well as initiate systems audit exercise for its surveillance systems. On the contrary, it appears from oral and written submission by the Committee, that the Committee of the CSE discounted any laxity at their end and reiterated that there was no pronounced laxity at their end. They stated that as the deficiencies pointed out by the system auditor had been in existence for a number of years, it was difficult for them to conduct a meaningful enquiry for fixation of responsibility. The endeavor of the Committee members who represented before me appeared to be more focused on shifting the blame of failure to rectify deficiencies, rather than a healthy constructive approach towards the rectification of the deficiencies and rejuvenating the working of the exchange. This attitude is reflective of the laid back and callous manner of functioning of the Committee of the CSE, which is further substantiated by the fact that although the draft report of M/s Ernst & Young was received by the CSE in October 2002, highlighting serious deficiencies in the risk management and surveillance system of the exchange, no corrective action was initiated to rectify the deficiencies. Further the report came to the knowledge of SEBI only in February 2003 when SEBI once again conducted an inspection of the CSE in order to assess the situation with regard to its management and risk management and surveillance aspects. It is clear that, the Committee of the CSE did not think it fit to bring the contents of the system audit report therein to the notice of SEBI although the same should have been their primary responsibility, apart from rectifying the deficiencies pointed out in the said report by M/s Ernst & Young. Moreover corrective action was not initiated even by February 2003 and the Committee of the CSE did not even think it proper to finalize any time-bound action plan for rectification of the deficiencies till the time of the said inspection. Although the SEBI inspection pointed out several other deficiencies on the risk management and surveillance system, and brought the same to the notice of CSE vide SEBI letter dated March 25, 2003 for rectification of these deficiencies, the Committee of the CSE submitted its compliance report, only after reminders and by July 16, 2003, which was also unsatisfactory in as much as they had failed to take up the issue of removal of deficiencies from its systems with the required seriousness and also failed to comply with all

the directives of SEBI. Admittedly the Committee of the CSE is guilty of having failed to ensure that the CSE send its monthly reports and settlement reports of the exchange on time. I have noted that although vide its letter dated January 20, 2003, CSE assured SEBI that the monthly reports on the progress of the surveillance activities and investigation cases from December 2002 onwards would be submitted on time, the CSE failed to do so, despite further reminders from SEBI vide letters dated February 18, 2003, April 11, 2003, April 24, 2003 and June 10, 2003. I have taken note of the fact that the Committee of the CSE did not think it fit to keep SEBI informed as regards the important decisions taken by it in its Monthly Development Reports.

4.6 Even the issues raised in the show cause notice as regards rectification of deficiencies in the systems, fixing responsibility or taking action or the progress of the investigation cases etc have not been properly addressed by the elected directors in their replies to SEBI. On the contrary, the Committee members were more engaged raising several frivolous issues, which in my opinion, are not relevant to the context of the subject under discussion. These issues, in any case were only raised by them, subsequent to the receipt of the show cause notice from SEBI. The fact remains that from the material available on record, including the various letters addressed by the elected directors of CSE to SEBI, there have been an admitted lapse on the part of the Committee to maintain systems and procedures in accordance with the statutory requirements. There has clearly been a failure on the part of the Committee of the CSE to take proper review of the management to ensure that the circulars / directives/ instructions issued by SEBI were being complied with. The non rectification of the various deficiencies in the exchange computer system which encountered various problems in its trading and settlement server, consequently affected the completion of the securities and funds payout on time. These problems had the effect of rendering the exchange ineffective and wrought havoc in the securities market. That being the case, the issues raised by these members at this juncture seem to have been made with an intent to divert the consideration of the main issue i.e. effectiveness of the Committee, and discharging its duty effectively towards the exchange and the investors.

4.7 It is to be noted that the corporatisation and demutualization initiative had been undertaken so as to strengthen the management and the organization of the stock exchanges in India. The walk out by the elected members in the Committee meeting in the CSE to consider and approve the notice for calling an EGM of the shareholders for the Scheme of Demutualization is clearly indicative of the defiance and non-compliance with the SEBI directive/decision and has the potential to debilitate the exercise of corporatisation and demutualization. I have examined the reasoning given by the elected directors in this behalf and do not find any

grounds for their having thus acted. Moreover, the incident was adversely commented upon in the major newspapers like Telegraph and Business Standard. This attitude of the members is certainly not conducive to the interest of the exchange and also not in the interest of investors.

4.8 I have noted that the public representatives, among other SEBI nominated directors have resigned from the Committee of CSE due to the unconducive environment prevailing in the CSE and also the complaint against the elected broker directors, not playing a constructive role on the Committee of CSE. I have taken cognizance of the reported instances of unwarranted interference and obstruction from the members and the quality of deliberations at the Committee as well as the allegations of both the elected and non elected directors acting in a manner that is far from desirable. The fact remains that the lack of decorum at the Committee, while conducting meetings and the issue of the Committee not functioning in the way it should be, is a matter of great concern and cannot be ignored. Such can not be an approach of any responsible member of the Committee, and no Committee can function effectively with elected directors acting in this manner. Any acrimonious behaviour especially on the part of responsible members of the Committee is likely to lead to severe imperilment at the decision making at the level of the Committee. The fact remains that at the time of the personal hearing held before me, the elected directors admitted that they were not playing participative role on the Committee and were ineffective in playing a positive role in the Committee and running of the CSE.

4.9 In this regard, I would like to quote the decision of the Supreme Court in the case of the Official Liquidator vs. P.A. Tendolkar, reported in (1973) 43 Com Cases 382 : AIR 1973 SC 1104. In the said case it was interalia stated that *".....while observing that it is a question of fact to be determined on the evidence in each case, a director may be shown to be so placed and to have been so closely and so long associated personally with the management of the company that he will be deemed to be not merely cognizant of, but liable for fraud in the conduct of the business of the company even though no specific act of dishonesty is proved against him personally. He cannot shut his eyes to what must be obvious to everyone who examines the affairs of the company even superficially. If he does so, he could be held liable for dereliction of duties..... even if he is not shown to be guilty of participating in the commission of fraud"*.

4.10 I have taken note of the fact that apart from the serious irregularities noted in the running of the CSE, the lapses in the surveillance functions and non initiation of effective steps for the general functioning and administration of the exchange in terms of the provisions of SCRA and the rules made there under, there has also been a non compliance of the

various circulars /directives/instructions issued by SEBI time and again and also an apparent disregard for complying with the same as mentioned in previous paras. I believe that it is imperative that an exchange should not only comply with the SEBI's directives and the provisions of law, but also ensure that in the smooth functioning of the exchange, the risk management should be carried out smoothly in accordance with law and in tune with the securities market. However in the case of CSE, there are reports of deficiencies in the systems audit, mis-management, committee's lack of functioning, adverse financial condition of the exchange etc. which are just some of the indicators of a stock exchange functioning in a manner against the interest of the members, the investors and the public at large.

5.0 Admittedly, the operational management is weak, if not virtually absent. The financial position of the CSE is weakening day by day and the past depletion of its Settlement Guarantee Fund has added to the financial vulnerability of the CSE. I have also noted that the CSE is unable to recoup / replenish the shortfall/losses of its funds particularly, the Settlement Guarantee Fund. Topping the above shortcomings are the extremely critical deficiencies of the basic systems of the CSE which continue to expose the system to be abused. CSE has done little to rectify these shortcomings. An exchange with such vulnerabilities can pose a systemic threat to the entire securities market and to the investors.

5.1 When the activities of the exchange are carried out contrary to the interest of the investing public and in a manner which is adverse to the interest of the investors, members and the public; the same is bound to injure and damage the interest of the investors. Moreover, the failure of the Committee of CSE to ensure proper governance and implementation of the provisions of the SCRA, Bye-Laws of the Exchange and the SEBI directives, could erode the confidence of the investors. The reported instances of unruly behavior on the part of the elected directors and brokers in the day-today functioning of CSE are bound to make it arduous for any exchange to function in accordance with its Byelaws of the exchange and the SEBI directives. It is evident that the Committee has failed to put a proper system to ensure the smooth functioning of the various activities of the stock exchange. The functioning of the Committee has created uncertainty and ambiguity even amongst its own members as well as insecurity amongst the investors, and hence the situation warrants immediate action to stop the further deterioration of the functioning of the Committee.

5.2 I have also observed certain observations made by the Joint Parliamentary Committee to the effect that the CSE failed miserably in enforcing its own

rules concerning the trading and carry forward limits, and that there was a deliberate failure to initiate steps for rectification of that collection of gross exposure margin by the CSE. An absence of medium for monitoring margin, dereliction of duties in the affairs of the exchange and errors in the software system were also some deficiencies, among several others highlighted by the Joint Parliamentary Committee.

5.3 On a cumulative analysis of the facts abovementioned, I am of the opinion that the Committee of CSE is unable to perform effectively and provide guidance and direction to the CSE.

5.4 SEBI is mandated to ensure that the systems and the procedures on an exchange are such that transactions are carried on in a lawful manner, without adversely affecting the interest of investors. In order to ensure that such systemic improvements take place on the CSE, the persons who have prevented the smooth day to day operations of the exchange from being carried on in a lawful manner need to be excluded from the governance of the exchange. Further, in order to ensure that systemic improvements take place on the exchange, it is necessary that independent and impartial persons are appointed.

5.5 After taking into consideration all the above, and the gravity and seriousness of the problem, I am of the prima facie opinion that if the present Committee of CSE is allowed to further continue, it may expose the securities market to systemic risks. Therefore, it is essential that immediate measures are adopted to ensure the safety and integrity of the stock exchange and ensure that the transactions on the exchange are carried out as per the regulatory framework and that the interests of the investors are not further jeopardized.

5.6 Accordingly, in view of the above, and in exercise of the powers conferred upon me under Section 19 of the Securities and Exchange Board of India Act, 1992, read with Section 11 of the Securities Contracts (Regulation) Act, 1956 read with the Government of India Notification number SO 573 dated July 30, 1992, I hereby order that the Committee of the Calcutta Stock Exchange Association Limited be superseded with effect from December 04 , 2003 and Shri Tushar Kanti Das (IAS Retd) be appointed as an Administrator for a period of one year to exercise and perform all the powers and duties of the Committee of the Calcutta Stock Exchange Association Limited.



**A. K. BATRA**

**WHOLE TIME MEMBER**

**SECURITIES AND EXCHANGE BOARD OF INDIA**