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**Task Order No. 004
Securities Exchange Board of India (SEBI)**

**Review of the Enforcement Plan of
the Securities Exchange Board of India
November, 1995**

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Price Waterhouse
FIRE Project



November 28, 1995

Mr. D.R.Mehta
Chairman
Securities Exchange Board of India
Mittal Court
Nariman Point
Bombay 400 021

Dear Mr. Mehta,

Re: Review of Surveillance and Enforcement plan of SEBI

At your request and as a part of our contract with USAID, Mr. Clifford Kennedy, Attorney at Law, Consultant to Price Waterhouse Capital Markets and a former Philadelphia District Director of the U.S. SEC, has completed the first part of our activity under the sub section B of Task Order No.4, towards assisting the Securities Exchange Board of India in improving its surveillance and compliance capabilities and presenting a workshop on securities market enforcement issues and techniques.

Purpose of Activity

The purpose of this activity was to review the enforcement plan of SEBI in light of the regulatory framework under which SEBI operates and recommend thrust areas for SEBI to improve its effectiveness as a regulator, and present a workshop on enforcement

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issues and self regulation to officials of SEBI and the stock exchanges.

Scope of Review

We reviewed all issues involved in SEBI's enforcement program, including the authority granted to SEBI under the SEBI Act (as amended), the regulations framed by SEBI for defining insider trading, market manipulation and other violations and inspections carried out by SEBI's investigations department and other enforcement actions taken by SEBI in the past. We also reviewed the functioning of SEBI as an enforcement authority, regulating the markets and simultaneously facilitating the development of the self regulatory framework in the Indian capital markets.

The review also included the effectiveness of SEBI's enforcement activities and recommends ways in which this can be strengthened. The role that Indian stock exchanges are currently playing with regard to enforcement was also reviewed and the weaknesses examined.

Approach to work

This assignment was carried out by Mr. Clifford Kennedy who has more than 25 years of experience in bringing enforcement actions for the Securities and Exchange Commission of the United States. Mr. Kennedy had extensive discussions with the enforcement staff of SEBI and that of the National Stock Exchange, OTC Exchange of India and other stock exchanges. Two full day workshops were conducted by Mr. Clifford Kennedy at the end of the review. One full day workshop (on September 28, 1995) was with officials of SEBI and the second workshop (on September 29, 1995) was with the enforcement officials of stock exchanges including the Bombay Stock Exchange, NSE and the OTCEI.

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Findings and Conclusion

This report presents the findings of the review of SEBI's enforcement plans and the existing methodology and techniques of enforcement. **The Indian securities markets have on the whole a low level of enforcement.** Enforcement awareness has really started building up with the advent of SEBI and SEBI's obtaining of the required authority to enforce. The market surveillance programs of Indian stock exchanges are also in the initial stages of development.

In this scenario SEBI has to take it upon itself to play a much larger role in enforcing its rules and regulations. SEBI has to strengthen its own methodology for detection of violations and directly bring enforcement actions against violators. SEBI should simultaneously make effort to develop the stock exchanges as credible self regulatory organizations. For this SEBI also needs to set minimum standards for SROs and enforce adherence to these standards by the SROs.

SEBI has currently only 8 professionals working to detect and investigate securities law violations. This needs to be strengthened so that SEBI is able to cover a larger part of the market and is able to do thorough investigations, if preliminary findings detect any violations. Besides augmenting the resources being used for detection and enforcement, SEBI has to determine priorities for enforcement to be able to concentrate available resources into more significant areas.

Enforcement staff has to be recruited and trained intensively in analysis of trading records and investigation methodology and techniques. Detailed rules related to investigations need to be drafted and an enforcement manual needs to be prepared for the staff.

SEBI also needs to draft amendments to the securities laws to augment its own authority and also to the rules and regulations drafted by it. The penalty provisions need to be strengthened to make them of a more deterrent nature. SEBI has to bring all the market participants under its preview and has to set and enforce minimum standards and uniform accounting practices for all market participants.

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An effective disciplinary mechanism needs to be put in place. This system has to be efficient and should afford an adequate due process to respondents including an appellate mechanism.

Next Steps

We suggest that we at the Price Waterhouse FIRE Project, work with you to strengthen the detection and enforcement activities of SEBI. We suggest the following activities, as a follow up essentially arising out of this review.

- ▶ Training of your staff in rule making and assistance in drafting amendments to the existing rules and regulations of SEBI.
- ▶ Training of your enforcement staff in the analysis of market trading records to establish violations such as market manipulation and insider trading.
- ▶ Training to your staff in investigation methodology and techniques.
- ▶ Assistance to your enforcement staff in the development of an enforcement manual.
- ▶ Assistance in the development of a disciplinary process.

We would like to discuss the above with you in detail so that specific activities can be included in our work plan for USAID approval. On November 20, 1995 we initiated follow up action by the secondment of Price Waterhouse Capital Markets Legal and Regulatory Consultant Mr. Terence O'Malley, Attorney at Law and a former U.S. SEC enforcement attorney to your surveillance and enforcement division.

For the success of this project the participation and full cooperation of the top management and the commitment of your staff is essential.

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We would like to thank you and your colleagues at SEBI for the time, courtesy and cooperation extended to us during the course of our review.

Please get in touch with us for any clarifications that you may require.

Yours Sincerely,

A handwritten signature in black ink, appearing to read "W. Dennis Grubb". The signature is written in a cursive style with a large, sweeping initial "W" and a distinct "G" at the end.

(W. Dennis Grubb)

Securities Exchange Board of India

Review of the Enforcement Plan of the Securities Exchange Board of India

U.S. Agency for International Development / India
Price Waterhouse / Financial Institutions Reform and Expansion (FIRE) Project

Bombay
November, 1995

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I. INTRODUCTION

A. Background

This task is part of the Financial Institutions Reform and Expansion (FIRE) Project and arises from a request made by the Securities Exchange Board of India (SEBI). The scope of this study was to review the enforcement program of SEBI in light of the regulatory framework under which SEBI operates and recommend thrust areas for this consultancy to increase SEBI's effectiveness as a market regulator.

B. Methodology

In conducting the review, the consultant Mr. Clifford Kennedy visited Bombay from September 11, 1995 to September 30, 1995. Mr. Kennedy met a number of senior officials and other staff members of SEBI, the Stockholding Corporation of India (SHCIL), and stock exchanges like the National Stock Exchange (NSE) and the OTC Exchange of India (OTCEI) and had discussions regarding surveillance, inspections and enforcement, among other things. The persons interviewed included the Chairman of SEBI, the Senior Executive Director in charge of surveillance along with other officials of his department, the Managing Director of SHCIL and OTCEI and the deputy Managing Director and Vice President of NSE. The list of persons interviewed is appended as Attachment A.

All relevant securities laws including the SEBI Act, 1992 as amended on 24/3/95 were reviewed. The various SEBI regulations regarding Insider Trading, stock brokers and sub brokers, merchant bankers, portfolio managers, mutual funds, registrars and transfer agents, underwriters, substantial acquisition of shares and takeovers, guidelines for investor protection and disclosures etc. were also reviewed. Investigations carried out by the SEBI investigations department and enforcement actions taken were also reviewed. The list of documents reviewed is appended as Attachment B.

A two day workshop was held at the conclusion of the consultancy. The first day of the workshop was attended by 22 SEBI officials, and on the second day both SEBI officials and enforcement executives from 12 stock exchanges participated including the BSE, NSE and OTCEI.

The discussion papers presented at these workshops are appended as Attachments C and D.

II. EXECUTIVE SUMMARY

The SEBI enforcement program has been operating for a very short time and with limited resources. The enforcement staff is hardworking, dedicated and anxious to learn. SEBI has separated its staff by function and assigned 8 professionals to detect and investigate possible violations of India's securities laws.

The market surveillance programs of Indian stock exchanges are also in very early stages of development and are not yet effective in detection of potential abuses such as insider trading, price rigging or market manipulation. Therefore, SEBI must strengthen its own methodology for detecting trading-market abuses, once SEBI determines that stock exchanges are best positioned and suited to conduct effective market surveillance, then SEBI must set minimum standards and enforce compliance by all stock exchanges.

SEBI staff believes, that investigative powers and available remedies need to be strengthened, they understand that SEBI must proceed aggressively now to ensure the efficient functioning of the markets and to establish investor confidence.

Summary of Recommendations

It is recommended that the following action steps be initiated by SEBI :

- ▶ SEBI should review its staffing needs and establish enforcement priorities. Priorities should include detection and enforcement, market manipulation and insider trading violations. Additional priorities should include mutual fund related matters and financial disclosure violations by issuers.

- ▶ Once priorities are established, sufficient enforcement staff should be recruited and then trained.

- ▶ Intensive training should be provided to enforcement staff in the analysis of market trading records to establish market manipulation and insider trading violations.

- ▶ Intensive training should also be provided in investigation methodology for establishing various violations of Indian securities laws including document production and taking of testimony.

- ▶ SEBI should draft detailed rules relating to investigations.

- ▶ SEBI should conduct a review of remedies and of pleading techniques in enforcement cases. Additional relief and remedies need to be identified and new remedy provisions should be drafted.

- ▶ An enforcement manual should be developed for SEBI enforcement investigations. This manual should serve as guide to SEBI staff on such subjects as taking of testimony and rules relating to investigations.

- ▶ Amendments should be drafted to securities laws, rules and regulations that increase SEBI's authority to conduct investigations and bring a full range of enforcement actions, increase penalty provisions and require uniform reporting requirements with minimum standards for all market participants.

- ▶ SEBI should develop a formal coordination mechanism with other governmental agencies and establish procedures for referral of criminal matters for prosecution.

III. SEBI ENFORCEMENT PROGRAM

A. General

The SEBI enforcement program has only been operating for a very short time and with very limited resources. The enforcement program is an essential element in the overall regulatory responsibilities of SEBI. Its goals are to raise the general standards of conduct in the Indian securities industry and to protect public investors. The enforcement staff is hardworking, dedicated and anxious to learn.

B. SEBI Enforcement staff

SEBI has separated its staff by functions, including enforcement, which allows them too focus attention to developing expertise regarding the Indian securities markets and to use limited resources to address particular enforcement problems that are occurring, such as price rigging, insider trading and manipulation. SEBI has assigned a staff of 8 professionals to detect and investigate possible violations of India's securities laws, rules and regulations. A division chief and two staff are assigned to market surveillance; five staff including a division chief, two lawyers and two analysts are assigned to investigations and enforcement proceedings. The enforcement staff also conducts inspections of market participants.

SEBI enforcement staff must be able to detect fraudulent activity early enough to prevent investor losses and bring enforcement actions that stop fraud and sanction the violations. Although progress is being made, a number of steps, discussed later in this report, should be taken to establish SEBI as a securities regulator with effective monitoring, investigation and enforcement capabilities and to increase the capacity of its staff.

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C. Detection and Surveillance

Market surveillance programs at the Indian stock exchanges are in very early stages of development and are not yet effective in detection of potential abuses such as insider trading, price rigging or market manipulation. The BSE, NSE and OTCEI appear to be making progress on initiating surveillance in their respective trading markets, but much remains to be done. Since the exchanges still lack surveillance capabilities, SEBI must improve its own methodology for detecting market abuses. Therefore, SEBI must strengthen its own methodology for detecting trading market abuses. Once SEBI determines that stock exchanges are best suited and positioned to conduct effective market surveillance, then SEBI must set minimum standards and enforce compliance by all stock exchanges.

Detection efforts by SEBI must include monitoring the compliance of reporting by issuers, broker-dealers, mutual funds and other market participants as well as surveillance of trading on exchanges. Trading records and brokerage and customer account information should be reviewed by SEBI staff on a routine basis and unusual trading practices analyzed. For example, SEBI staff must look for unusual concentrations and buying and selling of shares in accounts and should routinely review trades before and after major announcements by issuers and after sudden increases and decreases in the market price of shares. SEBI must require that exchanges and market participants maintain records that enable SEBI staff to review trading activity promptly.

Presently, exchanges delay supplying requested records to SEBI. The current practice of suspending trading of securities in the event of a sudden price increase on exchanges is not sufficient to detect or prevent manipulation in the Indian trading markets. Any trading suspension should be followed by an inquiry into the trading activity to determine if any violations occurred.

D. Need for Enforcement Actions

SEBI staff indicates, that several price rigging and insider investigations are near completion and that appropriate enforcement proceedings shall be brought soon. Although SEBI staff believe that their investigative powers and available remedies need to be strengthened, they understand

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that SEBI must conduct inquiries and proceedings aggressively now, and enforce the existing rules and regulations to ensure the efficient functioning of the markets and to establish investor confidence. These investigations must be concluded and appropriate proceedings initiated as soon as possible and given maximum publicity by SEBI.

E. Availability of Information

1. Trading Information supplied by exchanges to SEBI

The ability to effectively monitor the behavior of the market participants requires both periodic and event driven reporting to SEBI staff or indirectly through stock exchanges. At the present time, market surveillance of the Indian securities markets is ineffective. However, the securities exchanges of India must become major contributors in monitoring trading activity, since they are responsible for monitoring the activities of their members and for the disclosure and reporting activities of issuers whose shares are listed on their stock exchanges. Both the Bombay Stock Exchange (BSE) and the NSE will begin providing trading information directly to SEBI via computer link in late October. Consideration should be given to requiring all exchanges to furnish SEBI with current trading information.

2. Market Information provided by Issuers

Timely filing of financial and other information by issuers whose shares are publicly traded is essential to the maintenance of orderly trading markets. Presently, periodic and annual reports of issuers are only provided to exchanges and are not filed or reviewed at SEBI. Issuers should be required to file their reports at SEBI as well as with exchanges. Also, there are no uniform requirements or minimum disclosure standards in effect with respect to reports. Uniform requirements and minimum disclosure standards must be established by SEBI.

F. SEBI's Enforcement Authority

SEBI's authority to inspect, investigate and bring enforcement actions is contained in the SEBI Act, 1992, as amended and in rules and regulations published by SEBI since 1992. Generally SEBI is empowered to call for information, undertake inspections and conduct inquiries and audits of stock exchanges, mutual funds, market intermediaries and associated persons and self-regulatory organizations.

With respect to investigation authority, the 1995 securities law amendments provide SEBI with increased powers and are the same as those vested in civil courts under the Indian Code of Civil Procedure for discovery and production of books and documents, summoning and enforcing attendance of persons, examining them under oath, and inspecting books, registers and other documents of any regulated entity and associated persons. However, new rules and regulations must be drafted and approved by SEBI before these amendments are effective and available to enforcement staff. Even with these new discovery and investigation powers, SEBI is limited to only reaching documents, records and testimony of regulated or licensed entities and associated persons. As a result bank or telephone records still cannot be reached.

G. Need for Additional Investigation Authority

In order to conduct thorough, competent and objective inspections and investigations, SEBI will need broader statutory authority to reach crucial documents and witnesses that are now unavailable to SEBI under its existing rules and regulations. Such documents as bank records, financial statements, contracts and telephone records can be critical in market manipulation and insider trading investigations, but are not available to SEBI under the current regulations, except on a voluntary basis. The Indian securities law must explicitly empower SEBI to obtain any and all documents, records and testimony it requires to enforce the rules and regulations and to be able to respond quickly to apparent ongoing violations. In the meantime, effective use of the 1995 securities law and amendments pertaining to discovery and production when implemented, will enhance SEBI's investigation efforts.

Although the March 1995 amendments constitute an improvement in the authority that SEBI has to conduct inspections and investigations, additional enhancements are required in order for SEBI to handle its responsibilities of enforcing the Indian securities laws.

If it is necessary to compel testimony and production of documents from any person or entity, SEBI should have the statutory authority to do so and to apply to a court for compliance. If a witness refuses to comply, he should be subject to a possible contempt and penalties.

H. Enforcement Action - Authority and Remedies

At the conclusion of an investigation, SEBI should have the authority to institute prompt enforcement action. However, under existing rules and regulations, SEBI has to first consider a number of procedures and notice requirements before initiating an action and can only include licensed market participants, associated persons and insider trades as defendants.

Likewise, fines may only be applied against licensed market participants and insider traders.

SEBI requires expanded remedy alternatives, including the recovery of illicit profits and imposition of substantial penalties, to assist its law enforcing efforts. Violations of the Indian Securities Laws should warrant civil and administrative enforcement actions and where violations are very serious, criminal sanctions against any person or entity.

IV. ACTION STEPS

Active and effective market surveillance and enforcement efforts at SEBI are critical to eliminating and preventing many abuses that can damage the reputation of Indian securities markets. A number of activities and steps are discussed below that should be taken in order to strengthen the SEBI market surveillance and enforcement programs.

- ▶ SEBI should review its staffing needs and establish enforcement priorities, including detection and investigation approaches to primary abuses in Indian securities trading markets. Priorities should include market manipulation and insider trading detection and enforcement. Additional priorities should include mutual fund related matters and financial disclosure violations by issuers.

- ▶ Once priorities are established sufficient enforcement staff should be recruited and properly to be trained.

- ▶ Intensive training should be provided to enforcement staff in the analysis of market trading records to establish market manipulation and insider trading violations. It is important that SEBI enforcement staff fully understand the market and its potential problems. Early detection of both manipulation and insider trading violations requires the review and analysis of many records in order to establish and prove these cases.

- ▶ Intensive training should also be provided in investigation methodology including document production and taking of testimony. There are a varying different types of investigative procedures and techniques that must be applied to the development of various securities law violations.

- ▶ SEBI should draft detailed rules relating to investigations.

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- ▶ SEBI should conduct a review of remedies and of pleading techniques in enforcement cases. Administrative and civil relief should be reviewed under Indian law. Additional relief and remedies need to be identified and new remedy provisions should be drafted.

- ▶ An enforcement manual should be developed for SEBI enforcement investigations. This manual should serve as guide to SEBI staff on such subjects as taking of testimony and rules relating to investigations.

- ▶ Amendments should be drafted to securities laws, rules and regulations that increase SEBI's authority to:
 - i. conduct investigations and bring a full range of enforcement actions;
 - ii. increase penalty provisions;
 - iii. require uniform reporting requirements and minimum standards for issuers, broker dealers, mutual funds and other market participants; and
 - iv. reach non - licensed market participants.

- ▶ SEBI should develop a formal coordination mechanism with other governmental agencies and establish procedures for referral of criminal matters for prosecution.

V. CONCLUSION

SEBI has made considerable progress in developing rules and regulations for the Indian securities markets in the few years of its existence. But a lot more needs to be done to create a well regulated and efficient market.

SEBI now has to review its enforcement priorities and the approach it needs to take to make its surveillance and enforcement efforts more effective. These priorities have to be based on the existing level of different kinds of violations prevalent in the Indian securities markets. Once the enforcement priorities are established, SEBI needs to recruit sufficient staff and train them in their specific areas of concentration. To have an efficient and effective enforcement program, a highly professional and thoroughly trained staff is essential. Training should be given in investigation methodology including document production, analysis of trading records, testimony taking and other investigative procedures and techniques. Detailed rules and procedures of investigations have to be drafted in the form of an enforcement manual. SEBI also needs to draft changes in securities laws and rules which shall augment SEBI's authority to conduct investigations and impose visible and penal sanctions on violators.

In addition to establishing rules SEBI has to establish and continuously strengthen a system to ensure compliance with the established rules and other laws and regulations governing the securities industry. For this, it must have an enforcement mechanism. This function would include (in addition to the automated market surveillance system), routine "on site" examinations and "cause" examinations of member firms' operations. By these efforts, SEBI shall also be able to determine if the SROs are efficiently regulating their members, and if any changes need to be suggested in the SRO surveillance mechanism.

Findings of non compliance would result in disciplinary proceedings being pursued against the violator and, where wrongdoing is found, sanctions imposed. To impose sanctions on wrongdoers an effective disciplinary mechanism must be in place. Such a system should be structured for efficiency and should afford respondents adequate due process. It should therefore provide for notification of the charges brought, the opportunity to respond, the right to hearing and the right to representation by counsel. The system should also include an appeal mechanism.

Rules alone do not make a well-regulated market. There also must be a process in place which enforces those rules and which is able to identify and sanction those who do not follow them. A market that is not well regulated is not a credible market place, and without credibility a market place has little to offer. On the other hand, a well regulated market, one not operated for the primary benefit of its members, will have a better chance of attaining high credibility and international acceptance.

APPENDICES

- A. List of persons interviewed**
- B. List of documents reviewed**
- C. Discussion Papers for Workshops conducted for SEBI and Stock Exchange officials**
- D. Concept paper on Self Regulation**

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APPENDIX - A

PERSONS INTERVIEWED

SEBI

1. Mr. D. R. Mehta, Chairman
2. Mr. L.K.Singhvi, Senior Executive Director
3. Mr. M.D. Patel, Executive Director
4. Mr. R.V. Nabar, Division Chief
5. Mr. A. Kacher, Chief of Investigations
6. Mr. A. Alam, Division Chief
7. Mr. P.C.Singh, Deputy General Counsel
8. Mr. R.C.Gupta
9. Mr. M. Natrajan, Officer, Trading and Surveillance Section
10. Mr. R. Suresh, Officer, Trading and Surveillance Section
11. Mr. S. Dharamraj, Officer, Trading and Surveillance Section

OTC Exchange of India

1. Mr. Ajeet Prasad, Managing Director
2. Mr. S. Nambiar, Regional Manager
3. Mr. G. Shetty, Manager
4. Ms. S. Mathur, Manager
5. Mr. J. Bharat

National Stock Exchange

1. Mr. Ravi Narain, Deputy Managing Director
2. Ms. C. Ramakrishna, Vice President

Stock Holding Corporation of India

1. Mr. R. Chandrasekharan, Managing Director
2. Mr. M. Borkar, Company Secretary

APPENDIX - B

LIST OF DOCUMENTS REVIEWED

1. SEBI Act of 1992 as amended in March 1995
2. SEBI Merchant Bankers Rules and Regulations, 1992
3. SEBI Stock brokers and sub brokers , Rules and Regulations, 1992
4. SEBI Insider Trading Regulations, 1992
5. SEBI Portfolio Management Services, Rules and Regulations, 1993
6. SEBI Consolidated Guidelines on Disclosure and Investment Protection
7. SEBI Mutual Funds Regulations 1993
8. SEBI Registrars to Issue and Share Transfer Agents, Rules and Regulations, 1993
9. SEBI Underwriters Rules and Regulations, 1993
10. SEBI Debenture Trustees Rules and Regulations, 1993
11. SEBI Bankers to Issue Rules and Regulations, 1993
12. SEBI Substantial Acquisition of Shares & Takeovers Rules and Regulations, 1994
13. Inspections carried out by the SEBI Investigations Department
14. Enforcement actions taken by SEBI
15. SEBI Indian Securities Markets, Agenda for Development and Reform, 1994

APPENDIX - C

**Discussion Papers for workshops conducted for SEBI and Stock Exchange officials on
September 28-29, 1995**

APPENDIX - C

At the conclusion of the study two full day workshops were held at SEBI for officials of SEBI and 12 stock exchanges including the Bombay Stock Exchange, National Stock Exchange and the OTC Exchange of India.

The discussion on the two days centered around the role of the SEBI as the Chief regulator of the Indian securities markets and the exchanges as Self Regulatory Organizations in enforcement and compliance taking the U.S. experience of market regulation as a guide. The philosophy of self regulation including the reasons for its evolution as a widely accepted system of regulation were discussed as also the role of the supervisory body in oversight of the SROs.

Participants from exchanges brought up issues related to limited powers of the SROs in India, with respect to obtaining vital trading information from sub brokers and investors and also the inability to penalize issuers for violations beyond suspension of trading. The need for augmenting the authority of SEBI as well as that of the SROs to improve access to information and records and sanctioning the violators as well as improving inter exchange coordination was emphasized.

The discussion papers for the workshops are enclosed.

DISCUSSION OUTLINE

Regulation of a Securities Market

There are different ways to structure regulation for a securities market.

- a. In India a broker-dealer must become a member of an exchange and abide by the Code of Conduct.
- b. In the UK the Securities and Investment Board, an SRO is wholly separate from the London Stock Exchange.
- c. In the US much of the direct regulation of the securities business is done by private organizations, under the oversight of the SEC. When Congress created the SEC in 1934, stock exchanges, which are private associations, were already regulating their members. Congress left this system of self-regulation intact, merely adding the SEC as an additional level of regulation.
- d. The US now has a three-tiered approach.

1. Broker-dealers have statutory obligation to belong to an SRO and supervise employees and enforce compliance with statutory obligations.

Every broker-dealer must be member of either the NASD or an exchange.

2. SRO - regulates members and enforces compliance with statutory obligations and the rules of the SRO in order to protect investors.

The SRO has a market surveillance program to monitor activities and securities traded for potential abuses.

The SRO regulatory program includes broker- dealer examinations, investigation of customer complaints, financial surveillance of member firms and disciplinary actions.

3. SEC - oversees the broker-dealers and the SRO's to ensure compliance with statutory obligations and directly regulates when necessary. The SEC establishes minimum standards.

- a. SEC has responsibility to ensure that SROs require their members to comply with the federal securities laws and rules of the SROs. The SEC carries out this responsibility by periodically conducting routine oversight inspections of (1) programs administered by the SROs, (2) the SROs' market surveillance programs and clearing operations, (3) the regulatory and arbitration programs administered by the SROs.
- b. The inspection process consists of four phases: pre-inspection planning, on-site review, report, and implementation and follow-up, prepares a list of specific materials and case files for the SRO to produce for staff review during the on-site visit. The on-site review, involves direct investigation, observation and collection of facts and information regarding specific SRO program and work product. Upon completion of the on-site review, the staff compiles an inspection report, taking into consideration the adequacy of the SRO's procedures, whether the SRO follows prescribed procedures, and whether the SRO meets its desired objectives.
- c. Each inspection report includes a letter to the SRO, which contains the results of the inspection and recommends action to address program deficiencies noted in the report, and requests that the SRO respond within a prescribed time period setting forth and remedial action taken or planned to address any deficiencies cited in the report, including a time frame for the implementation of recommended action.
- d. The staff reviews the SRO response letters to evaluate the adequacy of any proposed action, notifies the SRO if additional information or action is required, and confirms that appropriate remedial action has been implemented by the SRO during subsequent inspections of the SRO or by conducting special follow-up inspections where warranted.

SELF REGULATION PHILOSOPHY AND GENERAL REQUIREMENTS

- A. Selective rule making, monitoring and review by government, with responsibility on the part of self regulatory organizations to establish, review for compliance and enforce standards of conduct for members.

- B. Basic standards established by Regulatory Authority; private sector participants establish more detailed requirements and monitor behavior of their members subject to Regulatory Authority oversight.
- C. Principal reasons for self regulation
 - 1. Persons involved in market often have superior knowledge and expertise.
 - 2. Limited governmental resources.
 - 3. primary deficiencies-possible reluctance to enforce rules on members.
- D. Principal self regulatory organizations.
 - 1. Exchanges
 - 2. Clearances, settlement and depository organizations
 - 3. Associations of broker-dealers or other market participants
- E. Oversight of self regulatory organizations
 - 1. SRO must be licensed by Regulatory Authority; all rules and changes to rules must be approved by the Regulatory Authority.
 - 2. Regulatory Authority conducts compliance inspections and may censure or limit activities of SRO, revoke registration, remove officers and directors, suspend or expel members or persons from being associated with members.
 - 3. SRO must have capacity to carry out purposes of laws, enforce compliance by members.
 - 4. SRO must accept all qualified persons meetings capital and competency requirements.
 - 5. SRO rules must provide for fair representation of members in governing structure.
 - 6. SRO must allocate fees, dues and other charges equitably.
 - 7. SRO rules must be designed to prevent fraudulent and manipulative practices.

8. SRO is required to enforce rules and sanction violators.
9. SRO rules must provide fair disciplinary procedures.
10. SRO rules must not impose unnecessary burden on competition.

MONITORING AND OVERSIGHT

A securities law should give the Regulatory Authority broad powers to monitor the behavior of market participants. In order to monitor such activities, the Authority must require both periodic and event-driven reporting. It must conduct inspections, it must investigate complaints, and it must conduct constant surveillance. The Authority powers to monitor the market may be exercised directly, with its own staff, or indirectly through bodies such as securities exchanges and other market participants and include the following.

- a. Annual and for cause inspections to assure self regulatory mechanism is working.
- b. Monitoring of business plans, finances and operations.
- c. Assuring capability of management.
- d. Assuring representation of interests of members, issuers and investing public.
- e. Requiring written program for monitoring activities of the exchange's members, with records of inspections and actions taken.
- f. Requiring comparable programs for monitoring listed companies and trading activities.
- g. Directly performing inspections of a small number of broker-dealers and company results with inspections made by securities exchange.
- h. Maintaining investors' service facility to receive complaints and comments.
- i. Conducting ongoing research into matters related to fairness, orderliness and efficiency of exchanges.

Securities Exchanges should be major contributors in monitoring securities market activities because they are responsible for monitoring the activities of their members and for the disclosure and reporting activities of companies whose securities are listed on their exchange. Monitoring the quality of securities exchange self-regulation should be accomplished through Authority annual inspections of exchanges and inspections of exchange members to verify the effectiveness of the self-regulation by the exchange.

SEC Enforcement Overview

The Securities and Exchange Commission was created in 1934. The five original members of the Commission were appointed by the President on June 30, 1934. The commission was charged, in its first year, with administering the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"). The Securities Act and Exchange Act were the first enacted in what was to become a comprehensive program for the protection of investors in the securities markets within the United States. Various other statutes, which the Commission is charged with administering, were subsequently enacted; including the Investment Company Act of 1940; and the Investment Advisers Act of 1940.

The Commission has organized itself into program areas designed to carry out its responsibility of protecting the investing public by administering the federal securities laws. There are four primary programs; one designed to provide full disclosure to investors; another to regulate the securities industry; the third to prevent fraud in the securities markets; and the fourth involving investment advisers and investment companies. The various division's within the Commission have been assigned responsibilities regarding these programs.

The Division of Corporation Finance administers the full disclosure programs - it has primary responsibility for processing registration statements under the Securities Act and Exchange Act, proxy statements, as well as periodic reports of issuers filed under the Securities Act and Exchange Act. The Division of Market Regulation regulates the securities industry, specifically broker-dealers and exchanges. The Division of Investment Management oversees investment companies and investment advisers. The Enforcement Division has responsibility for preventing fraud in the securities markets as well as enforcing virtually all aspects of the securities laws where compliance is not voluntary. As is evident from the following brief synopsis of each of the statutes administered by the Commission, the Divisions of Market Regulation, Corporation Finance, and Investment Management find their responsibilities under specific securities statutes; the Division of Enforcement's responsibilities extend to each of the securities acts.

Statutes Administered By SEC.

Our discussion will mostly involve the following statutes.

The Securities Act basically requires disclosure to investors of material facts concerning securities publicly offered for sale where the mails or instrumentalities of interstate commerce are used. Such disclosure is required by the issuing company, by any control persons of the issuing company, and by any individuals or entities involved in the distribution of these securities to the public. Such disclosures are made through the registration statement. The issuer and underwriter have primary responsibility for disclosures for the registration statement.

The Exchange Act sets up a system of registration and regulation of securities exchanges, securities listed on such exchanges, and brokers and dealers of such securities and is designed to maintain fair and honest markets in securities transactions.

The Investment Company Act of 1940 provides for registration and regulation of companies whose primary business is investing, reinvesting, owning, holding or trading in securities.

The Investment Advisers Act of 1940 created a system of regulation of investment advisers basically similar to that of the Exchange Act for broker-dealers. The act requires that persons engaged in the business of advising others, for compensation, as to securities, register and adhere to certain statutory and regulatory standards. With rare exception an investment adviser may not share in profits resulting from his management of client funds.

The Insider Trading Sanctions Act of 1984, the Insider Trading and Securities Fraud Enforcement Act of 1988 and the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 are also discussed below.

These Acts charge the Commission with maintaining and enforcing a regulatory scheme that affords investors certain minimum protections, primarily through disclosure of material information, prevention of fraudulent representations (or omissions), and maintenance of fair and honest securities markets. The underlying theme of the federal securities laws is full disclosure; the federal regulatory scheme does not in any way constitute a merit review program.

Enforcement Program - and Remedies

The Division of Enforcement is the largest activity at the Commission, budget-wise. The Commission's enforcement program is aggressive and seeks to preserve the integrity, efficiency and fairness of the federal securities markets. The intended result is maintenance of investor confidence in the securities markets. The securities laws provide civil and administrative remedies designed to rectify past violations and prevent future violations. The vast majority of enforcement actions are brought under the Securities Act and Exchange Act, although an increasing number are brought under the Investment Advisers Act, and a lesser number under the Investment Company Act.

The goals of the Commission's enforcement program are to prevent illegal distributions of unregistered securities, fraud and manipulation in the purchase, sale and trading of securities, as well as the myriad of conduct otherwise unlawful. The Commission cannot represent claims of individual investors; the Commission represents the public at large. However, ancillary relief, such as disgorgement of ill-gotten gains, may accrue to the benefit of investors.

Enforcement actions can be brought by the Division of Enforcement as well as each of the Regional Offices located throughout the United States. Prior to instituting any enforcement action an investigation must be performed and an appropriate recommendation made to the Commission regarding the proposed enforcement action. The enforcement staff must obtain the Commission's specific approval for each enforcement action, including proposed defendants to be named as well as statutory violations to be alleged. Enforcement actions are generally either a civil injunctive action filed in the appropriate U.S. District Court, or an administrative proceeding brought before an administrative law judge.

Other appropriate enforcement responses where there appears a possibility of criminal misconduct include referral of cases to the Department of Justice. Additionally, referrals for appropriate disposition may be made to a self regulatory organization, such as the NASD or the New York Stock Exchange.

The federal court injunction is the primary civil remedy pursued. An injunction directs a defendant to stop violating the law and/to comply with the law in the future. A violation of an injunction can result in contempt of court proceedings that may result in imprisonment or imposition of fines. Civil injunctive actions may be filed against any appropriate defendant, whether subject to regulation by the SEC or not. Such potential defendants can include issuers, broker-dealers, salesmen, corporations, individuals, investment managers, or any of the other entities or individuals capable of violating the federal securities laws.

In civil injunctive actions, various forms of ancillary relief have been obtained, including the appointment of receivers and special officers, disgorgement of illicit profits, freezing of assets, bank accounts and, the adoption of procedures to prevent recurrence of violations, and imposition of restrictions on specified business activities and fines. The Insider Trading Act of 1984 authorized the SEC to obtain civil penalties of up to three times the profit made as a result of insider trading. Beginning in 1990, federal courts were authorized to impose civil penalties for virtually any violation and bar or suspend persons who commit fraud from serving as officers or directors of public companies.

Administrative proceedings may be brought against regulated entities including exchanges, broker-dealers, investment companies and investment advisers, and their associated persons. Administrative proceedings may result in censure, imposition of limitation on activities, or suspension or revocation of registration and a fine. Remedies against associated persons include censure, suspension from association, and a fine.

In 1990, legislation expanded remedies available to the SEC in administrative proceedings. The SEC can enter cease-and-desist orders for any violation of the securities laws and require the disgorgement of profits, the rendering of accounting and impose civil fines against regulated entities and associated persons

Issuers of securities are subject to administrative proceedings for failure to comply with the disclosure requirements and certain other provisions of the Exchange Act. A proceeding can be brought to compel issuers and others to correct deficient filings.

Administrative proceedings can also be brought under Rule 2(e) of the Commission's Rules of Practice against attorneys, accountants and other professionals. The primary sanction in a Rule 2(e) proceeding is to limit the practice of such professionals before the Commission. This can include a permanent bar.

Enforcement Program Priorities

The SEC redefines its enforcement priorities year to year to address current major abuses, chronic violators, or to facilitate the anticipation and solution of problems before they arise or before they become major securities frauds. In recent years the Commission's program areas have addressed the following.

Corporate Reporting and Accounting. This area involves financial disclosure, in annual and periodic reports filed with the Commission. Abuses in such financial disclosure can involve employees of the reporting company or of the accounting firms performing audits. Cases in this program area can involve delinquent filings, improper valuation of assets, failure to comply with standard accounting practices, or simply making material misstatements or omissions regarding corporate operations, remuneration of corporate officers, or disposition of offering proceeds.

Insider Trading. Insider trading generally consists of the purchase or sale of securities by persons in possession of material nonpublic information, relating to such securities, in violation of a fiduciary duty or other relationship of trust and confidence. Insider trading is prohibited by the general antifraud provisions of the securities laws. These practices undermine the expectation of fairness and honesty that is the basis of investor confidence in the securities markets. Trading of option contracts, coupled with tender offers and other acquisitions, has increased opportunities for inside traders to reap large profits. Examples of material non-public information include planned acquisitions, gains or declines in profits and tender offers. Defendant inside traders have included employees of law firms representing corporations, officers or directors of corporations, broker-dealers and their employees, and a variety of tippees of these persons.

Securities Offering Violations. Issuers of securities sometimes fail to register public offerings where registration is required. Exemptions are frequently claimed as a defense to such registration violations, but the exemptions usually are inapplicable. Additionally, violation of the antifraud provisions is also frequently found in cases involving unregistered distributions.

Regulated Entities and Associated Persons. Regulated entities include broker-dealers, investment companies, and investment managers. Broker-dealers and underwriters who engage in questionable or improper sales practices are subject to enforcement proceedings. Firms employing such individuals may be charged with failure to reasonably supervise employees in connection with employee misconduct. Broker-dealer firms are also sometimes charged with violations of the financial responsibility, bookkeeping and financial reporting requirements.

Market Manipulation. The Commission, the securities exchanges and the NASD engage in surveillance of trading on the national securities exchanges and the over-the-counter markets to ensure their integrity. Market manipulations can include schemes to artificially increase the market price of a corporation's securities. Such artificial influence on the market can result from false press releases, false purchases and sales of shares in the market, or any variety of other manipulative activity.

Changes in Corporate Control. Proxy solicitations and the filing of persons or groups who make a tender offer or acquire beneficial ownership of more than 5% of a class of equity securities registered with the Commission. The requirements are intended to insure that investors have the material information needed to make informed investment or voting decisions concerning potential changes in the control of a corporation.

Enforcement Investigations

The SEC enforcement program is administered by the Division of Enforcement and the Regional Offices, which generally organized into two functional areas: investigation and litigation. Because the Division has more staff than the regions, it has some specialization of branches. The regional offices conduct investigations and litigate cases involving the full range of securities violations.

Investigations are conducted by the enforcement staff which, based on the results of investigations, makes recommendations to the Commission for enforcement action (i.e., injunctive action, administrative proceeding). The investigations are fact finding in nature. Investigations need not be based on probable cause; a mere suspicion that the laws have been or are about to be violated is sufficient. In fact, an investigation may be conducted for the sole purpose of finding out if there is a violation. Information regarding possible violations can be received from a variety of sources, including investors complaints, inspections of the books and records of regulated entities, market surveillance, and referrals from federal, state or local law enforcement authorities. Once information is received and analyzed the enforcement staff must decide whether to pursue the matter.

APPENDIX - D

Concept Paper on Self Regulation

SELF REGULATION IN THE SECURITIES INDUSTRY

A. THE CONCEPT

A fundamental premise in the concept of self regulation is protection of the public interest. Inherent in this premise is that a self regulatory organization cannot operate for the primary benefit of the members of the organization. Its thrust, therefore, and its guiding principle must be the public interest and the protection of investors.

For self regulation to be successful it must have the total support of the government hopefully evidenced by a statutory grant of authority, or regulatory mandate, which also specifically delineates the responsibilities and obligations of the self regulatory organization or organizations and mandates that all securities organizations doing business with the public be members thereof.

Important in the successful implementation of the self regulatory concept is close government oversight effectively, efficiently and fairly administered, but not direct government involvement in the self regulatory organization as this could stifle initiative and creative thinking. In some countries, including India, government representation on the governing Board of a self regulatory organization is either required or authorized. Long term this is not advisable and is antithetical the concept of self regulation. However, in certain transitional situations, it may serve a short term good.

In addition, self regulation in the generally accepted international context embodies the premise that members of the industry set standards for their business conduct for the purpose of enhancing their industry's professionalism and stature in the eyes of the public. It also embodies the enforcement of those standards and other provisions of law on members of the industry by their peers. Standards established by self regulatory organizations often go beyond the illegal and establish ethical norms which must be observed. Significant, however, is that these rules and other standards adopted are for the most part formulated by professionals knowledgeable in the nuances of the securities business, presumably experts in the subject area, though government approval is required in most countries. Sanctions imposed can, depending upon the severity of the violation, bar a firm from further involvement in the securities industry. Important here is that peers of the accused, who are schooled in the ways of the market, sit in judgment.

As stated, for the effectiveness of the self regulatory concept to be maximized, it should have a legal framework established by a statute or regulatory sanction which establishes and defines the functions, authority and limitations of its regulatory authority and lays out the relationship between the SRO and the government regulatory authority. It is most important, however, that there be government oversight of self regulatory organizations, not only to add to their credibility but also, and importantly, to guard against self interest in the discharge by them of their regulatory responsibilities. The regulatory activities of the government and the self regulators should in many ways complement each other and they should work together in a spirit of cooperation.

Self regulatory organizations may be organizations which are both regulators and market operators (the United States mode) or those whose purpose and function is only regulation (the United Kingdom mode). The former are usually exchanges or operators of organized markets. The latter are sometimes called securities associations. Either concept is viable and has worked successfully in those countries. Even when the functions are separated, market operators are still self regulatory organizations in respect to the operation of their market places. This is the case in the U.K. where market operators are not self regulatory organizations but they have the indicia of such in overseeing their markets.

B. RULES OF SELF REGULATORY ORGANIZATIONS

Generally, rules of self regulatory organizations are divided into admission rules, marketplace rules, conduct rules and procedural rules.

Admission Rules

Admission rules govern the entry of persons or firms into the securities business and many times involve the passage of written qualification examinations to insure professional fitness before a person is permitted to conduct a securities business. These are sometimes tailored to the function which the individual wishes to pursue in the industry, that is, salesman, trader, principal of a firm, among others. The self regulatory organization determines the content of the qualification tests and to insure that the content is in keeping with the times, test modules are routinely updated. Admission standards could also impose educational, age, experience or other requirements generally, or on certain categories of employees, or create additional standards for firms.

For securities firms, admission and continuing qualification standards for firms often involve capital and books and record keeping and maintenance requirements set by the government or the self regulatory organization. Even when set by the government they are often enforced by the self regulator. The self regulator may even wish to set stricter capital standards for firms engaged in certain kinds of more risky business or for other reasons.

Marketplace Rules

Marketplace rules govern the operation of exchanges or organized markets and are usually divided into listing rules including continuing compliance standards, trading rules (including requirements relating to customers such as time stamping orders when received and the sending of confirmations as to each order), rules insuring transparency in the market, and clearance and settlement requirements. Also, there are often rules governing the primary offerings of securities.

Listing rules vary with the marketplace and may establish different standards for a main board and a second board. Continuous disclosure requirements mandate the disclosure by listed

companies of certain information on a periodic and other basis after listing. This includes periodic reports and reports concerning material events. Trading rules govern trading on the market. These are important to the price discovery and trade execution process and to protect against manipulation and other improper trading practices.

Systems are maintained for disseminating quotations and last sale data and for processing transactions. This insures transparency in the marketplace for the benefit of the public and investors. Marketplaces also normally have rules governing clearing and settlement practices. Some SRO's operate their own clearance and settlement systems. Others do it in coordination with outside organizations such as clearing corporations, often owned by one or more self regulatory organizations or banks.

Marketplaces should have in place an effective, automated market surveillance system. These systems, usually referred to as stock watch systems, are designed to monitor the market for unusual price or volume movements. Their purpose is to raise red flags as to the possibility of insider trading, manipulation or other improper trading activity such as frontrunning and marking the close. They also provide an audit trail of activity of all securities in the market. These systems are considered extremely important to have in place in advanced markets and are considered an essential element of effective regulation. Their operation is based upon the input of quotation, transaction and other information required by trading and other rules governing the marketplace. In evaluating "red flags" that are raised, this information is analyzed in combination with other company specific and market information to determine if an investigation should be pursued.

Conduct Rules

Conduct rules establish generally acceptable business practices for firms and their employees in dealing with their customers, securities firms and other organizations. These involve standards relating to suitability, best execution, churning, fairness of markups/markdowns and commissions, unauthorized transactions, disclosure of interest in certain situations, prohibitions on guarantees against loss, communications to the public, customer priority when a dealer is dealing in the same security and supervision practices of firms, among other things. More egregious practices are also covered such as false trading and rigging transactions, manipulations, false or misleading statements, fraudulently inducing persons to deal in securities, use of manipulative and deceptive devices, dissemination of information about illegal transactions and insider trading, among others. Many times certain of these practices are direct violations of law and in many countries violations of criminal law.

Self regulatory organizations often have requirements that its member firms have internal procedures to insure proper supervision of the activities of their employees, in particular those dealing with the public. This often includes a requirement that firms have a Compliance Director who is responsible for the proper implementation of these procedures.

Procedural Rules

Procedural rules can be of several types, the most common of which are surveillance and disciplinary procedures, arbitration procedures and procedures for the operation of systems which the self regulatory organization may have in place. Surveillance, disciplinary and arbitration procedures are discussed below.

C. SURVEILLANCE AND DISCIPLINARY MECHANISMS

Surveillance Mechanism

In addition to the establishment of rules, a self regulatory organization must establish a system to surveil for compliance with the rules established and other laws and regulations governing the securities industry. Thus, it must have an enforcement mechanism. This function involves, in addition to an automated market surveillance system, routine on site and cause examinations of member firms' operations. Routine examinations are conducted pursuant to a prescribed format, perhaps modular in nature, and cover all aspects of a firm's operations including compliance with financial and books and records rules, trading rules, conduct rules, supervision rules of the organization and the rules established by the government regulatory authority. Any other area of the member firm's business considered pertinent would also be reviewed. Routine examinations would be periodic, perhaps no less frequent than once per year. Cause examinations would be conducted as necessary as a result of complaints or other indications of improper activities coming to the attention of the self regulatory organization, perhaps as a result of the operation of the market surveillance system.

Findings of noncompliance would result in disciplinary procedures being pursued against the violator and in cases where wrongdoing is found, sanctions imposed. The important point to stress here is that rules alone do not make for a well regulated market. There must also be a process in place which enforces those rules and which is able to identify and sanction those who do not follow them. A market that is not well regulated is not a credible marketplace, and without credibility a marketplace has little to offer. On the other hand, a well regulated market, one not operated for the primary benefit of its members, will have a better chance of attaining high credibility and international acceptance.

Disciplinary Mechanism

To impose sanctions on wrongdoers, an effective disciplinary mechanism must be in place. Such a system should be structured for efficiency and afford respondents adequate due process. Thus, it would provide for notification of the charges brought, the opportunity to respond.

the right to a hearing and the right to representation by counsel. Some kind of appeal mechanism should also be provided for respondents dissatisfied with the findings of the body with original jurisdiction.

To have efficient and effective enforcement and disciplinary mechanisms a highly professional, thoroughly trained staff is essential. Training should be obtained in countries that routinely perform these functions and are highly experienced in their operation. This cannot be emphasized too strongly.

D. ARBITRATION PROCEDURE

The establishment of a fair dispute resolution system is an important complementary process to the regulatory function of a self regulatory organization. An arbitration procedure is designed to adjudicate finally disputes between members and the public, and between members and other members, without the necessity of going to court. Arbitration programs have worked very effectively at self regulatory organizations in advanced markets and are considered an important service to members. Important here is that the arbitration system be available not only to members of the self regulatory organization but also to customers who may have grievances against the firm or person with whom they have done business. The procedures established must also be fair, allow public representation on an arbitration panel in cases of customer arbitration and permit representation by counsel. Determinations should be final with little or no opportunity for appeal absent some egregious situation such as demonstrable fraud on the part of the arbitrators. In this connection, the arbitration code adopted should be consistent with the Arbitration Law of the country of domicile

E. CODE OF CONDUCT

A self regulatory organization has a special responsibility to have an established internal code of conduct governing the activities of its employees. The necessity for such is emphasized by the nature of their activities which are often sensitive in nature and involve the handling of confidential or market sensitive information.

It has been said that the rules pertaining to employees of self regulatory organizations must go beyond those of the regulated in order that the integrity and credibility of the organization as well as its reputation for fair dealing is not compromised. In this connection, it is important that employees maintain exceptionally high standards of honesty, integrity and impartiality in their conduct. It is also important that they have a conscious awareness of the need to avoid situations which could result in actual misconduct or conflicts of interest or those most likely to raise an appearance of impropriety, and to conduct themselves in their professional and personal relationships in a manner which commands the respect and confidence of both the securities industry and the public.

To avoid even the perception of unfairness in the discharge of their activities, therefore, internal standards should detail what is expected of employees in a variety of areas, such as, conflicts of interest, confidentiality of information, business dealings with others especially those

in the industry, securities transactions, outside or private employment, the acceptance of gifts or gratuities, and other activities.