

RECENT AUDIT ISSUES FOR STOCK BROKERS & DP



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COVERAGE

- ❑ Internal Audit & Its Scope
- ❑ Opportunity in Capital Market
- ❑ Audit Methodology
- ❑ Audit Periodicity
- ❑ Issues in Stock Broking
- ❑ Scope in System Audit
- ❑ Issues in DP Operations
- ❑ Accounting
- ❑ Policies
- ❑ Report Submission
- ❑ Challenges
- ❑ Penalties

WHAT IS INTERNAL AUDIT?

- ❑ Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations.
- ❑ It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.
- ❑ Internal Audit of Stock brokers emphasizes more on Compliances & therefore it is more of Compliance Audit & less of Financial Audit

SCOPE / PURPOSE OF INTERNAL AUDIT

- ❑ Member has complied with the provisions of the SEBI Act, 1992, SCRA, 1956, SCR Rules, 1957, SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992, the Depositories Act, 1996, SEBI (Depositories & Participants) Regulations, 1996, Other Rules & Regulations from SEBI / Stock Exchange / Depository, notices / circulars / communiques, press releases, etc. of SEBI / Stock Exchange / Depository.
- ❑ The conduct of the Member is in overall interest of market and fair dealing with investors.
- ❑ The purpose of Audit is to examine that the processes, procedures followed and the operations carried out by the Trading Member / Clearing Member / DP are as per the requirements of the regulators

SCOPE / PURPOSE OF INTERNAL AUDIT (Cont...)

- ❑ To ensure that the required internal controls, checks and risk management procedures are in place.
- ❑ Appropriate risk management policy with internal control and exception reporting mechanism is in place.
- ❑ Proper books of accounts, records and documents, as per the regulatory requirement have been maintained by the member, so far as it appears from examination of the books.
- ❑ No material fraud by the Member has been observed during the course of this Audit.
- ❑ We do not have any direct / indirect interest in or relationship with the member or its share holders / directors / partners / proprietors / management and also confirm that we do not perceive any conflict of interest in such relationship / interest while conducting audit of the said member.

OPPORTUNITY IN CAPITAL MARKET

- ❑ Certify compliance as per the updated regulations
- ❑ Implementation of various circulars
- ❑ Heavy Penalties by SEBI / Stock Exchanges.
- ❑ Requirement of Regular Audit covering:
 - ❑ Internal Audit of the Stock Brokers
 - ❑ System Audit requirement on periodical basis – half yearly, annually or bi-annually
 - ❑ System Audit for starting any new trading software or for any modification of an existing trading software
 - ❑ Concurrent Audit of the Depository Operations
 - ❑ Internal Audit of the Depository Participants
- ❑ Internal Audit requirement for Commodity broker may be a reality in year/s to come.



AUDIT METHODOLOGY

- ❑ Knowledge of the Regulations & Circulars
- ❑ Collection of information about the Auditee's operation
- ❑ In-depth analysis of the information using auditing software / excel commands
- ❑ Discussion regarding the observations / non-compliances
- ❑ Corrective & Preventive actions for the corrections of the non-compliances
- ❑ Discussion of the report with the clients
- ❑ Signing & Submission of the final report



AUDIT PERIODICITY

- ❑ Circulars specify the format and minimum scope & sample size for audit.

- ❑ Stock Broking Operations Reporting
 - ❑ Exchanges – NSE/BSE/MSEI
 - ❑ Due Date - 30th June & 31st December

- ❑ System Audit Reporting
 - ❑ Exchanges – NSE/BSE/MSEI
 - ❑ Due Date – 30th November & 31st May (subject to change)

- ❑ Depository Operations Reporting
 - ❑ DP – CDSL / NSDL
 - ❑ Internal Audit Report - Due Date – 15th May & 15th November
 - ❑ Concurrent Audit Report - Due Date – 10th of the next month

STATUTORY AUDITOR BEING INTERNAL AUDITOR?

- ❑ Sec 141(3) of Companies Act, 2013 specifies internal audit as a specialized service and prohibits the statutory auditor from providing Internal Audit services.
- ❑ The board, management and independent directors seek increased comfort from an Internal Auditor as the internal auditor facilitates to comply with the responsibilities and legal duties which have been missed by their oversight.
- ❑ Corporate India is looking to their internal auditors to help deliver a more sustainable, efficient and effective audit function. One that fully aligns with the new governance needs and expectations.
- ❑ Internal auditor provide an independent third party view on the operations and processes of the Auditee.

COLLECTION OF INFORMATION

- ❑ Certification on 153 questions by proper audit and analysis
- ❑ Sample Size to be reported, earlier only in MSEI. Additional time for collating the figures.
- ❑ Requirement list / Checklist of information requirements covering list of active clients, branch / sub-broker / dealing office information, Associated enterprises, etc
- ❑ Complaint register, Investor grievance & verify with Exchange / Depository websites
- ❑ Software functionalities
- ❑ Hardware hurdles – speed, data analysis competency, etc
- ❑ Prior approval / Post facto information to exchanges for various changes:
 - ❑ officials appointment – Principal officer, Compliance officer, Authorized signatory, etc.
 - ❑ Director / shareholders – Designated / Dominant Promoter

CLIENT REGISTRATION

- ❑ Documents
 - ❑ Contradictory clauses in the Non-mandatory documents.
 - ❑ Running account consent from client. As per SEBI guidelines / Revocation clause not incorporated.
 - ❑ Non-uploading of UCC.
 - ❑ In Person Verification (IPV)
 - ❑ Verification of Original Document
 - ❑ Delivery of copy of complete set of KYC not maintained.
- ❑ KRA
 - ❑ Status verification & uploading in case KRA shows MF-Verified
 - ❑ Existing client not registered in KRA or data not fetched from KRA system.
 - ❑ Non-uploading of KRA within 10 days of Account opening.
 - ❑ Follow-up in case of KRA with Hold status
 - ❑ Difference in Correspondence OR Permanent address as per KRA
- ❑ PAN no. wrong updated in back office or Exchange data.

PREVENTION OF MONEY LAUNDERING ACT

- ❑ System for periodical updation of financial information / address / client database.
- ❑ Creation of FIU login on finnet for various SEBI registrations.
- ❑ Appointment of Principal Officer, Designated Director & Intimation to FIU, Delhi along with updated PMLA Policy.
- ❑ Client Due Diligence (CDD) Process
 - ✓ Elements of Customer Due Diligence
 - ✓ Policy for acceptance of clients
 - ✓ Risk Assessment & Classification
 - ✓ Clients of special category (CSC)
- ❑ Client identification procedure
- ❑ Financial details to be reviewed on periodic basis.
- ❑ The policy / document in relation to CDD will be reviewed within a defined period.

PMLA

- ❑ Monitoring of transactions
- ❑ Off Market transaction to reviewed at the time of punching the details – Value of off mkt txn.
- ❑ BLNG File to be reviewed on fortnightly basis.
- ❑ Suspicious Transaction Monitoring & In case any suspicious transaction, the same has been reported to the FIU Delhi through finnet gateway and the same to be intimated to the CDSL.
- ❑ Review of Valuation of stock on half yearly / Yearly and compare with previous period
- ❑ Employees' Hiring / Employee's Training / Investor Education

TRANSACTION RELATED

- ❑ Contract note & DMS
 - ❑ Contract note & Daily margin statements – Electronic / Physical within 24 hours
 - ❑ Digital signature of contract note
 - ❑ Proof of dispatch of Contract note sent.
 - ❑ Change in Email ids
 - ❑ Bounced ECN
- ❑ Contract note Format not as per Exchange guidelines / Updation of the contract note format.
- ❑ Client code change / Trade modification in the Back-office.
- ❑ Modification of client code only on exchange platform
- ❑ Use of ERROR account in case of trade errors

DEALING WITH CLIENTS

- ❑ Banking & Demat
 - ❑ Banking and Demat account
 - ❑ Mode of payment & delivery
 - ❑ Receipt of funds in the form of Pre-funded instruments / Electronic fund transfer
 - ❑ Actual Settlement of Client Funds & Securities on monthly / quarterly basis
 - ❑ Statement of Accounts for fund & securities & Retention report
- ❑ Non-maintenance of separate bank & demat account for client funds and own funds.
- ❑ Misutilisation of client funds / securities
- ❑ Non-segregations of Clients funds and securities OR Pay in / payout not received from / delivered to respective clients.
- ❑ Financing of securities transactions & transfer of securities & funds

MARGIN COLLECTION

- ❑ Collection Reporting of Margin in F&O segment:
 - ❑ Form of margin collection
 - ❑ Compliance when cheque received on T Day
 - ❑ Check bouncing of cheque, if any, re-uploading of the margin file
 - ❑ Application of Haircut / VAR file etc.
 - ❑ Calculation of margin reported
- ❑ Penalty in case of short reporting of margin charged on daily basis & same can be passed on to the client with proper documentation
- ❑ False reporting of margin
- ❑ Penalty for false reporting
 - ❑ 100% of falsely reported amount + suspension of trading for 1 day in respective segment

TERMINALS & USER ID

- ❑ Multiple connectivity, backups & frontend options.
- ❑ Terminal Operated by non-approved person.
 - ❑ Terminal code same at different locations.
 - ❑ TWS Branch code & Terminal ID is same.
 - ❑ One Terminal ID using more than Two Person.
 - ❑ Office status, Branch, Employee information properly entered.
 - ❑ Same employee shown at different locations
- ❑ NISM certificates expired in the CM, F&O & CD Segment.
- ❑ User List (Limit Setting files)

SCOPE OF SYSTEM AUDIT

- ❑ Under the Information Technology Act
- ❑ Following areas to checked and reported:
 - ❑ System controls and capabilities (IML terminals and servers)
 - ❑ Software Change Management
 - ❑ Risk Management Tools existing on the Admin terminal
 - ❑ Trading process
 - ❑ Segregation of Data and Processing facilities
 - ❑ Back office data
 - ❑ Order / Trade Limit Controls
 - ❑ Order Reconfirmation facility
 - ❑ Execution of Orders / Order Logic
 - ❑ Application Access Control



SCOPE OF SYSTEM AUDIT (...2)

- ❑ Following areas to checked and reported:
 - ❑ Password Security
 - ❑ Session Security
 - ❑ Database Security
 - ❑ Network Integrity
 - ❑ Encryption
 - ❑ Event logging and system monitoring facility
 - ❑ User Management system
 - ❑ Authentication mechanism
 - ❑ Physical Security
 - ❑ Systems backup capability
 - ❑ Business Continuity or Disaster Recovery or Incident Response process

DEPOSITORY AUDIT

- ❑ Client (BO) Registration
 - ❑ Sub-status of the account holder important
 - ❑ Procedure for demat account opened for illiterate / disabled person
 - ❑ Scanning of BO signature (special care in non-individual BO)
 - ❑ Types of Modification
 - ❑ Change in Name / Address / Signature / Bank details / Mobile no. / Email Id
 - ❑ EOD Modification file to be run in the back-office on daily basis.
 - ❑ DP account for partnership firm in name of partners
 - ❑ DP account not allowed in name of Proprietorship concerns
 - ❑ Return of welcome kits – An important point of concern.
 - ❑ POA account opening & requirement of SMART registration.
 - ❑ Nomination – **a great boon**

DEMATERIALISATION / DESTATEMENTIZATION

- ❑ Maintain inward of Demat request (DRF) / MF-DRF
- ❑ Keeping the physical securities under safe custody until dispatch
- ❑ Record of Dispatch of demat / destat to the Issuer / RTA / AMC within seven days from date of submission of BO.
- ❑ Securities lost in transit
- ❑ Rejected DRF's to be dispatched to the BO within 7 days of receipt
- ❑ Proof of dispatch

DELIVERY INSTRUCTION SLIP

Off-market, On-market, Inter-depository and Early Pay-in

- ❑ Inventory Control Mechanism
- ❑ Issuance of DIS Booklet to the BO's
 - ❑ 1st DIS Booklet
 - ❑ DIS Booklet on the basis of requisition slip
 - ❑ DIS booklet without requisition slip – supporting documents
- ❑ Issue of Loose DIS and limit thereon
- ❑ Acceptance of DIS
- ❑ Punching the DIS
- ❑ Maker Checker and Verification of DIS
- ❑ High Value Verification
- ❑ Confirmation in case of Dormant account DIS
- ❑ Scanning and uploading of DIS to the DP

ACCOUNT CLOSURE AND OTHER AREA

- ❑ Account closure request
 - ❑ Sending transaction statement with the words “Account Closed/ Marked for Closure”.
 - ❑ Procedure for account closed by the BO
 - ❑ Procedure for account closed by the DP
- ❑ Rematerialisation
- ❑ Freeze/ Unfreeze
- ❑ Pledge / Unpledge
- ❑ Printing & Dispatch of Transaction & Holding Statements

OTHER POINTS

- ❑ PMLA Policy
- ❑ System Requirements
- ❑ Back-up of data
- ❑ Concurrent Audit of Risk Prone Areas
- ❑ Inspection by Regulators on annual basis conducted
- ❑ Easiest login in month
- ❑ Risk Based Approach.
- ❑ Visit to Service Centre.
- ❑ Permanent Address to be modified in KRA site.

ACCOUNTING

- ❑ Document informing the debiting of clients account for Delayed payment charges, Penalties, etc
- ❑ General Ledger Scrutiny – statutory collections are not more than the amount payable/paid to the regulators / exchanges, Exchange Transaction charges, STT, SEBI Turnover fees, Service tax, etc.
- ❑ Advertisement
- ❑ Client Dividend ledger for transfer of dividend within reasonable time, etc.
- ❑ Collection of debtors of the DP / Stock broker



MISCELLANEOUS

- ❑ Maintenance of records
- ❑ Display of details by Stock Broker / Notice Board /
- ❑ Compliance at Sub-broker/Branch location
- ❑ Brokerage sharing with Sub-broker/Branch/AP
- ❑ Annual Inspection of Sub-broker/Branch/AP
- ❑ NISM Series VIII (EDS) & III(A) (CO) certification,
- ❑ All associated person not having valid NISM series VII certification – SORM.
- ❑ Periodical Compliances:-
 1. Risk Based Approach / Supervision
 2. Quarterly Compliance Certificate
 3. 1% Holding of (TMH) – Not Applicable for MSEI
 4. Funding report
 5. Investor grievance

POLICIES

- ❑ Updated Policies with the details of acceptance of the same by the Board of Directors. Main policies being:
 1. PMLA
 2. RMS
 3. Internal control
 4. Acceptance of Prefunded instruments.
 5. Outsourcing of only non-core areas.
 6. Insider Trading
 7. Research Regulations
 8. Prevention of circulation of unauthenticated news by SEBI Registered Intermediaries through various modes of communication
 9. Surveillance policy
 10. Policy for Conflict of Interest

REPORT SUBMISSION

- ❑ Stock Broking Internal Audit / System Audit
 - ❑ NSE – login creation, Electronic uploading of the report on ENIT, Non-compliant points to be substantiated, digital signing of the report by the auditor, management to input the management comments, submission of the same to the exchange
 - ❑ BSE – signed report to be provided to the auditee, scanned pdf submission of the report to be done to the exchange electronically by the auditee.
 - ❑ MSEI - signed report to be provided to the auditee, auditee to submit the hard copy of the same to the exchange
- ❑ DP Audit
 - ❑ Concurrent Audit report only to the management
 - ❑ Internal Audit report in hard / soft form to the DP

CHALLENGES

- ❑ Updation with the circulars
- ❑ Viability of audits a concern as articles not found.
- ❑ Cost benefit analysis to be Broker / DP & Chartered (considering the competition & reducing income)
- ❑ Maintaining the continuity of the staff considering periodical requirement of reporting
- ❑ Specialised understanding
- ❑ Strong excel working skill
- ❑ DP an manual area of checking as the regulator specifies the scope to be 100 % and not sample based.
- ❑ Compliances getting stringent. Non revenue generating area so audit fees shrinking day by day.

PENALTIES – INTERNAL AUDIT OBSERVATIONS

Stock Broking

- ❑ Rs. 1000 for various violations (penalties are indicative in nature and could undergo change in specific cases depending on frequency and gravity of violations)
- ❑ If same violations/non compliances are observed by the internal auditor in the subsequent internal audit reports, the penalty/fine shall be escalated by 50% as may be decided by the relevant authority



PENALTIES – INSPECTION OBSERVATIONS

- ❑ Penalty for non-availability of KYC – Rs. 10,000 per client per segment
- ❑ Penalty for non-issue of contract note upto 25% - Rs. 50,000
- ❑ Penalty for dealing with unregistered intermediaries – Rs. 1,00,000/- per unregistered intermediary
- ❑ Unauthorized extension terminal – Rs. 50,000/
- ❑ Error in upload of CTCL / IML details – Rs. 5,000 per terminal (for excess of more than 5 terminals)
- ❑ In case of false reporting of margin - 100% of falsely reported amount + suspension of trading for 1 day in respective segment

REPEATITIVE VIOLATION WILL LEAD TO INCREMENTAL PENALTY STRUCTURE.

ADDITIONAL RESPONSIBILITIES

- ❑ Stock Broking Audit
 - ❑ Members feedback for the non-compliance
 - ❑ Certification from the auditor for compliance of the non-compliance (as required)
- ❑ System Audit
 - ❑ Action taken report for the various non-compliances
- ❑ DP
 - ❑ Compliance report submission counter signed by the auditor
- ❑ Commodity Broking
 - ❑ Submission of Annual Compliance Report to the exchanges by 30th June



Question Hour

THANK YOU

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