

# SEMINAR ON INTERNAL AUDIT OF STOCK BROKERS

## KYC, PMLA & POLICY ASPECTS

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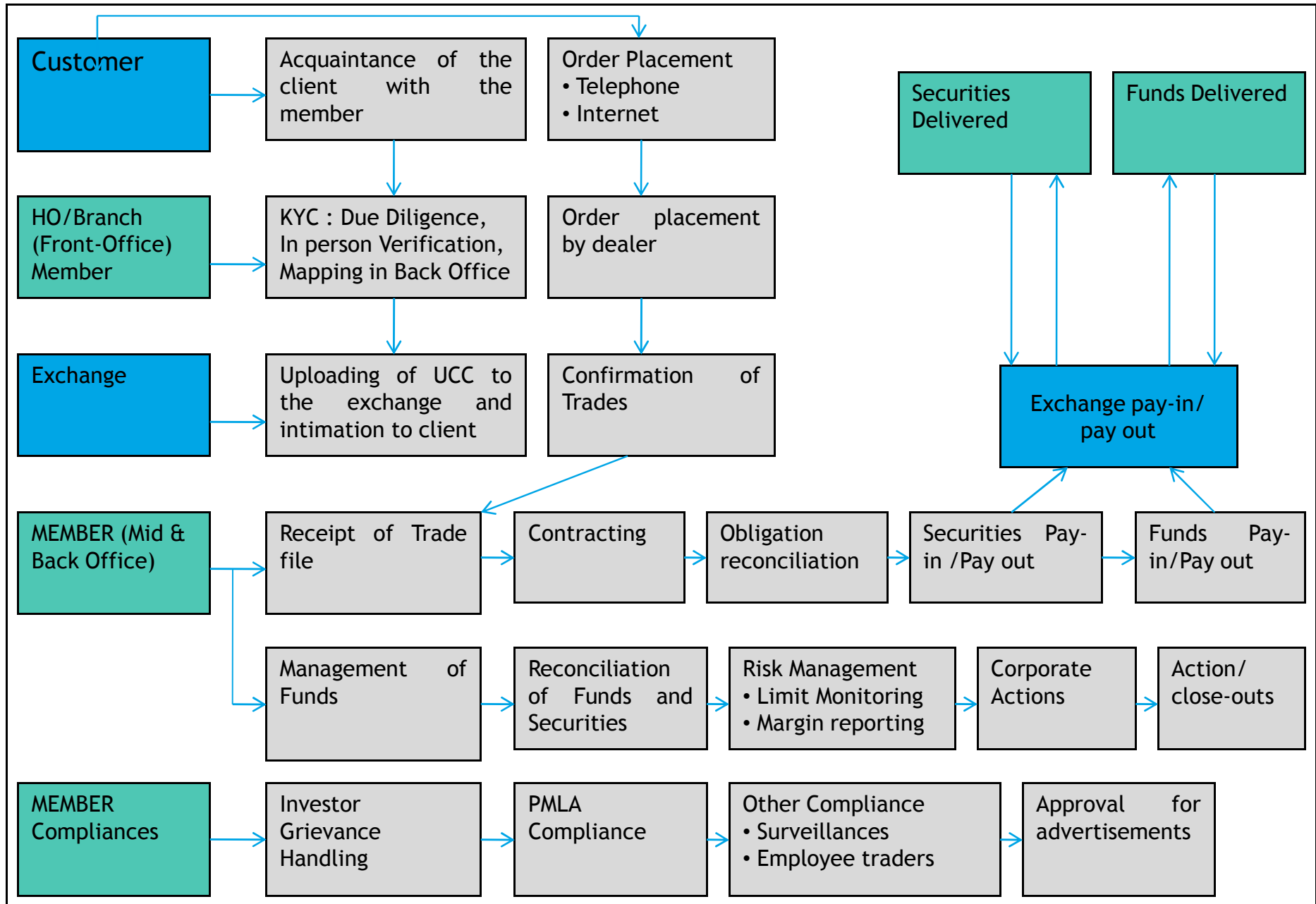


# GLOSSARY OF TERMS

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AML	Anti - Money Laundering	PEP	Politically Exposed Persons
CRF	Client Registration Form	PMLA	Prevention of Money Laundering Act, 2002
CTR	Cash Transaction Report	RDD	Risk Disclosure Document
FATF	Financial Action Task Force	SEBI	Securities and Exchange Board of India
FIU	Financial Intelligence Unit	STR	Suspicious Transaction Report
KYC	Know Your Client	TM	Trading Member
MCA	Member Client Agreement	UCC	Unique Client Code
PAN	Permanent Account Number	UIN	Unique Identification Number

Flow of activities for the stock broker is illustrated in the chart below:



# INTERNAL AUDIT OF STOCK BROKERS

Know Your Customers (KYC)

PMLA

POLICY ASPECTS

# INTERNAL AUDIT OF STOCK BROKERS

Know Your Customers (KYC)

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# BREIF OVERVIEW - WHAT IS KYC

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- It is a Customer identification process
  
- An effort to determine
  - ✓ True identity and beneficial ownership of accounts
  - ✓ Source of funds
  - ✓ Nature of customer's business
  - ✓ Reasonableness of operations, etc
  
- Objective of the KYC is to prevent a financial institution being used, intentionally or unintentionally by criminal elements for money laundering.
  
- Basic Components of KYC includes
  - ✓ Identity Verification and
  - ✓ Address Verification

# BREIF OVERVIEW - WHY KYC

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- KYC is increasingly becoming important to detect and prevent:
  - ✓ Financial fraud and risk,
  - ✓ Unusual and suspicious activity,
  - ✓ Money Laundering, and
  - ✓ Terrorist Financing.
  
- KYC enables to detect and prevent the misuse of world financial system for terrorism, extortion, drug trafficking, etc
  
- KYC enable financial institutions to know/understand their customers better and help them manage their risks prudently.



# BREIF OVERVIEW - KYC - BFSI Sector

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Banks, Financial Institutions and Intermediaries are required to follow certain minimum standards of KYC and AML (Anti - Money Laundering) as per The Prevention of Money Laundering Act, 2002 (PMLA).

Institutions	Regulators
Banks and Financial Institutions	Reserve Bank of India
AMCs, Funds, Brokers, DPs, Intermediaries, etc	Securities and Exchange Board of India (SEBI)
Insurance Companies	Insurance Regulatory and Development Authority (IRDA)
Housing Finance Companies	National Housing Bank

# BRIEF OVERVIEW - RISK BASED KYC

Due Diligence	Verification Process
Basic Due Diligence (Low Risk Profile Clients)	<ul style="list-style-type: none"><li>➤ Proof of identity</li><li>➤ Proof of address</li><li>➤ Latest photograph</li><li>➤ Other relevant documents based on legal constitution of customer</li></ul>
Enhanced Due Diligence (Medium or High Risk Profile Clients)	<ul style="list-style-type: none"><li>➤ Obtain additional information based on risk categorization (medium or high) on the following aspects:<ul style="list-style-type: none"><li>✓ Nature of transactions,</li><li>✓ Source of funds,</li><li>✓ Payments Modes, etc</li></ul></li></ul>

# BRIEF OVERVIEW - Key Challenges

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- Risk classification of clients based on parameters nature of client's transactions, sources of funds, modes of transactions, etc
- Challenges in retrieving correct information from clients
- Challenges in verifying certain information provided by clients
- Periodic information updates

# KYC - Stock Brokers

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- Brokers to assess the background, genuineness, financial soundness and investment objectives of the client.
- Proper introductory procedures to be followed.
- Client is personally known or has been introduced to him by a person known to him.
- A record of introduction of all clients should be kept by brokers.
- Agreements in prescribed format to be entered with the clients.
- Risk classification of clients into high, medium or low category.
- Enhances due diligence for high risk categories clients.
- Uniform Documents Requirements (Mandatory) viz., CRF, MCA, MTA - Broker, Sub Broker and Clients, RDD, Broker & Sub Broker Agreement.
- CRF may be waived for SEBI Registered institutions viz., FII, MFs, VCs, etc
- Non mandatory documents may be obtained at the discretion of members and clients.
- Separate dockets for mandatory and non mandatory (voluntary) documents.

# KYC - Stock Brokers

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- The trading member shall not have right or control over the bank account or ledger of the client except for transactions by members on behalf of clients (upfront margins)
- Client registration details to be reviewed and updated periodically.
- Monitoring of trading activities by the brokers.
- A copy of client registration documents to be delivered to the clients.
- **PAN - Sole Identification Number**
  - ✓ Compulsory to obtain PAN for all categories of the clients.
  - ✓ Brokers to verify PAN photocopy with originals and cross check with Income Tax website.
  - ✓ The PAN photocopy to be signed and stamped as as “verified with original”.
  - ✓ PAN photocopy should be legible.
- SEBI has prescribed the documents to be submitted by various categories of investors (SEBI Model KYC Documents)
- Additional documents may be obtained for better compliance and internal controls.
- Broker’s responsibility to provide client details as and when required by SEBI and stock exchanges.
- Remisier to act as introducer.

# KYC - Stock Brokers

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## ➤ In - Person Verification (IPV)

- ✓ To be carried by broker's own staff
- ✓ IPV cannot be outsourced
- ✓ Date of verification, name and signature of official to be and stamp to be affixed on CRF.
- ✓ In case of NRIs, the KYC documents to be attested by Notary, Court, Judge, Magistrate, etc.

# KYC - Stock Brokers

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## ➤ Inventory Controls

- ✓ Controls over blank KYC documents given to branches, sub brokers, clients and at HO.
- ✓ Periodic reconciliation of inventory.
- ✓ Inward/ Outward register to be maintained.
- ✓ KYC documents to be serially controlled.
- ✓ Proper storage of registered KYC documents to ensure fast and easy retrieval.
- ✓ To be kept in safe custody of authorized officials

# KYC - Stock Brokers

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## ➤ Unique Client Code (UCC):

- ✓ To be allotted to each of the client including sub broker's clients.
- ✓ Only one code to one client and same code not to be allotted to other clients.
- ✓ UCC is mandatory to enter orders on behalf of the clients.
- ✓ UCC details to be uploaded with the exchanges.
- ✓ Broker's to furnish particulars of UCC to exchange in such form, manner, at such interval and within such time as specified by exchange from time to time.
- ✓ Two trading client codes may be allotted for investors who cannot transact without adequate funds or securities to their credit before execution.
- ✓ Both these trading client codes should be mapped to client's UCC.



# KYC - Key Observations

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1	KYC documents not self attested by the client
2	Prescribed KYC documents not obtained
3	“Original Seen and Verified” (OSV) conducted post account opening
4	“OSV” incomplete w.r.t. employee code, signature, date, name, etc
5	Declaration obtained post account opening
6	POA executed post account opening
7	Erroneous details updated in the system
8	Prescribed details not updated in Account Opening Form (AOF)

# INTERNAL AUDIT OF STOCK BROKERS

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# OVERVIEW - MONEY LAUNDERING

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## Money Laundering - Meaning

- Money Laundering is a process of concealing sources of money.
- The process of creating the appearance that large amounts of money obtained from serious crimes, such as drug trafficking or terrorist activity, originated from a legitimate source.
- Money evidently gained through crime is "dirty" money, and money that has been "laundered" to appear as if it came from a legitimate source is "clean" money.

## Money Laundering - Steps

Money Laundering is generally conducted in the following 3 steps:

- **Placement** i.e., introducing cash obtained through illegal sources into the financial system by some means.
- **Layering** i.e., carrying out complex financial transactions to conceal the illegal source.
- **Integration** i.e., acquiring wealth generated from the transactions of the illicit funds.

As a result of the abovementioned process, the money obtained from illegal source appears to have been obtained from legitimate source.

# OVERVIEW - MONEY LAUNDERING

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## Money Laundering - Methods

- Smurfing/ Structuring whereby cash is broken into smaller deposits of money
- Bulk cash smuggling i.e., smuggling cash to another jurisdiction
- Cash-intensive businesses
- Trade-based laundering i.e., under or overvaluing invoices
- Shell companies and trusts to disguise the true owner of money
- Round Tripping i.e., routing money through tax heavens, etc

## Money Laundering - Risk

- Reputation Risk
- Business Risk
- Financial Risk
- Compliance Risk
- Legal Risk
- Fraud Risk
- Operations Risk, etc

# Regulatory Requirements: PMLA Act, 2002

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- Prevention of Money Laundering Act, 2002 (PMLA) was effective from July 1, 2005
- Objective was to prevent money laundering and to provide for confiscation of property derived from money-laundering
- Deal with the following aspects
  - ✓ Verification of records of the identity of clients
  - ✓ Maintenance of records of identity of clients & details of prescribed transactions
  - ✓ Reporting of transactions
  - ✓ Appointment of Principal Officer
- Transactions that need to be reported
  - ✓ Cash transactions of more than Rs. 10 lakhs or its equivalent in foreign currency
  - ✓ Series of integrally connected cash transactions
  - ✓ Cash transactions involving forged or counterfeit currency or any forgery of valuable security
  - ✓ All suspicious transactions

# Regulatory Requirements: SEBI Guidelines

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- SEBI has issued Guidelines on anti-money laundering vide its Circular No. ISD/CIR/RR/AML/1/06 dated January 18, 2006.
- All intermediaries are required to ensure that a proper policy framework is put into place within one month from the date of the circular.
- Important aspects of the guidelines are as under:
  - ✓ The Anti-Money Laundering (AML) program should be approved in writing by the senior management of member and reviewed at frequent intervals
  - ✓ Designation of a sufficiently senior person as 'Principal Officer'
  - ✓ Customer Due Diligence/KYC Standards
  - ✓ Monitoring of transactions for detecting suspicious transactions
  - ✓ Reporting of suspicious transactions
  - ✓ Ongoing training of employees
  - ✓ Audit/Testing of AML Program

# Regulatory Requirements: SEBI Guidelines

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- Risk classification of clients and enhanced due diligence for high risk clients.
- Customer and transaction records to be available on timely basis to investigating authorities.
- Records to be maintained for a period of 10 years from the date of cessation of transactions between client and the intermediary.
- Ongoing monitoring of the accounts
- Identification of apparently abnormal transactions
- Ascertaining whether new clients are to be categorized as Client of Special Category (CSC) i.e., NRI's, HNI's, Trust, Charities, Politically exposed persons (PEP), etc

# Regulatory Requirements: SEBI Guidelines

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## ➤ Illustrative list of Suspicious Transactions:

- ✓ Clients where identity verification seems difficult
- ✓ Substantial increase in activity
- ✓ Large number of accounts with common parameters
- ✓ Transactions with no business rationale
- ✓ Sudden activities in dormant accounts
- ✓ Doubtful sources of funds
- ✓ Large cash deposits
- ✓ Transfer to unrelated third parties
- ✓ Multiple transaction of value below the threshold reporting limit
- ✓ Business by shell companies, etc
- ✓ Clients in high risk jurisdiction
- ✓ Transfer of larger sums to or from overseas locations
- ✓ Suspicious off market transactions
- ✓ Large deals at prices away from the market
- ✓ Accounts used as “pass through”



# INTERNAL AUDIT OF STOCK BROKERS

Know Your Customers (KYC)

PMLA

**POLICY ASPECTS**

# POLICY ASPECTS

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- **KYC Policy to incorporate the following key elements:**
  - ✓ Customer Acceptance Policy
  - ✓ Customer Identification Procedures
  - ✓ Risk Management
  - ✓ Monitoring of Transactions and records maintenance
  
- **Important features of Customer Acceptance Policy**
  - ✓ To specify the criteria for acceptance of customers
  - ✓ Risk perception parameters
  - ✓ Documentation requirements
  - ✓ Due diligence measures
  - ✓ Customers checks before opening of new accounts to ensure customers are not from criminal background or banned entities
  
- Defined procedures for monitoring unusual large transactions
- Conducting on going due diligence and scrutiny of transactions
- Defined duties and responsibilities to ensure compliance
- Periodic training of staff with latest updates and guidelines

# POLICY ASPECTS

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- Anti Money Laundering Policy to incorporate the following key elements:
  - ✓ Customer Acceptance Policy - to identify a set of customers with whom the broker will / will not establish any relationship
  - ✓ Customer Identification Procedures i.e., procedures to identify each types of customers
  - ✓ Customer due diligence - to identify beneficial ownership and control of security accounts
  - ✓ Clients of Special Category (CSCs) i.e., NRI's, HNI's, Trusts, PEP's, etc  
Risk Management
  - ✓ Monitoring of transactions
  - ✓ Reporting of suspicious transactions to FIU - IND
  - ✓ Operation of accounts through POA
  - ✓ Maintenance of records and records retention
  - ✓ Employee Hiring, training and Investor education

# CASE STUDY - Operation Red Spider (Cobra Post)

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- A possible money laundering racket run by Banks and Insurance Companies.
- The investigation finds the banks and their managements systematically and deliberately violating several laws and regulations to boost deposits and thereby increasing their profits.
- A illustrative summary of the modus operandi to launder money is as under:
  - ✓ Accept huge amounts of unaccounted cash to invest in insurance products, and sometimes in gold as well.
  - ✓ Open an account to route the cash into various investment schemes of the bank or insurance arms.
  - ✓ Do it even without the mandatory PAN card or adhering to KYC norms.
  - ✓ Arrange forged PAN cards to facilitate investment of huge unaccounted cash.
  - ✓ Split the money into tranches, below the reporting threshold, to get it into the banking system without being detected.
  - ✓ Use accounts of other customers to channelize the black money into the system for a fee.

# CASE STUDY - Operation Red Spider (Cobra Post)

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- ✓ Get demand drafts made for the client either from their own banks or from other banks to facilitate investment without it showing up in the client's account.
- ✓ Keep the identity of the investor secret.
- ✓ Open multiple accounts to invest the unaccounted cash directly in cash-investment schemes.
- ✓ Buy as many policies as you can to accommodate the huge unaccounted cash.
- ✓ Open an account in some extension branch a couple of months before the investment matures, credit the returns in that account and close it as soon as you withdraw all your money. The point: Extension branches are seldom audited.
- ✓ Advise the investor to remain invested for a certain number of years, say, 7 years, to keep the taxman at bay.
- ✓ Allot as many lockers as the client needs for safekeeping the illegitimate cash.
- ✓ Use provisions like Form 61 to show the unaccounted cash as income from agriculture

# CASE STUDY - LATEST IN NEWS - NSEL

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- National Spot Exchange Ltd (NSEL), in the middle of a Rs 5,600-crore payment crisis, admitted several of its 24 borrowing members without proper compliance with know your customer (KYC) norms and failed in due diligence, a forensic auditor found.
- The refusal by these 24 members to pay their dues triggered the payment crisis in August 2013.
- During a forensic audit commissioned by the Forward Markets Commission (FMC), it emerged “25 buyers were introduced on the NSEL platform over the last four years. No due diligence of these buyers was done and buyers with very poor credentials had been introduced into the NSEL system.”
- These members account for about Rs 2,700 crores or nearly half of the total dues.

**OPEN FORUM**

# THANK YOU

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Disclaimer: The views expressed and presented are of the speaker and general in nature. The speaker is not responsible for any decision based on this information. Due professional advice must be sought on the matters.