UNIT 5 : AUDIT OF MEMBERS OF STOCK EXCHANGES

1. OVERVIEW

A stock exchange is an organized market for the purchase and sale of listed securities. The securities dealt in at a stock exchange include the shares and debentures of public limited companies, debentures, bonds and other such securities.

The Securities Contracts (Regulation) Act, 1956 defines a stock exchange as, “an association, organization or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling business in buying, selling and dealing in securities.”

Most of the trading in the Indian stock market takes place on its two stock exchanges: the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE).

2. FUNCTIONING OF STOCK EXCHANGES

It is important for auditor to understand adequate knowledge about important aspects of the functioning of stock exchanges and the manner in which the transactions are entered into by the members of stock exchanges.

2.1 Regulation of Stock Exchanges: The Securities and Exchange Board of India (SEBI) is the apex, statutory regulatory body for the securities market with the express mandate of investor protection and development and regulation of market under SEBI Act, 1992. Apart from SEBI, Securities Contracts (Regulation) Act, 1956 which provides for regulation of transactions in securities through control over stock exchanges, Depositories Act, 1996 which provides for electronic maintenance and transfer of ownership of demat securities, Public Debt Act, 1942, Companies Act, 2013, Banking Regulation Act, 1949 and Income Tax Act, 1961 also have a substantial bearing on the working of the securities market.

2.2 Securities and Exchange Board of India: SEBI has been given wide powers for the achievement of the objectives of the SEBI Act, 1992. SEBI’s main function is to regulate the business in securities market. SEBI, for the purposes of regulation of securities market, can issue directions to stock exchanges, companies, stock brokers or to any other person associated to the securities market.

SEBI Act, 1992 empowers SEBI to levy monetary fines and penalties on any person incurring a default under the Act in the following cases:

- failure to furnish any document, information, books, other documents, return or report called for by the Board;
**SPECIAL AUDIT ASSIGNMENTS**

<table>
<thead>
<tr>
<th>Failure/Action</th>
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<tbody>
<tr>
<td>Failure to maintain books of accounts and records;</td>
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<tr>
<td>Failure by an intermediary to enter into an agreement with his client, redress the grievances of investors;</td>
</tr>
<tr>
<td>Failure by a person sponsoring or carrying on any collective investment scheme, including mutual funds, without obtaining certificate of registration;</td>
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<tr>
<td>Failure by a stock broker to issue contract notes in the form and manner specified by the stock exchange, failure to deliver any security or failure to make payment of the amount due to the investor, charging of excess brokerage;</td>
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<tr>
<td>Any person dealing, communicating, counselling on the basis of some price sensitive information;</td>
</tr>
<tr>
<td>Failure by a person to disclose the aggregate of his shareholding in a body corporate before he acquires any shares of that body corporate and failure to make a public announcement to acquire shares at a minimum price in case of takeovers.</td>
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</table>

SEBI has also been provided with the power to suspend or cancel the certificate of registration of a stock-broker, sub-broker, share transfer agent, banker to an issue, trustee of a trust deed, registrar to an issue, merchant banker, underwriter, portfolio manager, investment adviser and such other intermediary who may be associated with securities market. This includes depository, depository participant, custodian of securities, foreign institutional investor and credit rating agency also.

The Securities Contract (Regulation) Act, 1956 empowers any recognised stock exchange, subject to the previous approval of the Securities and Exchange Board of India, to make bye-laws for the regulation and control of contracts.

It may be noted that since SEBI is the regulator of the securities market, the Securities Contract (Regulation) Act, 1956, through section 10, empowers SEBI to make or amend the byelaws of stock exchanges.

**2.3 Governing Body:** The Governing Body of a stock exchange can comprise of elected representatives of the members of stock exchange, nominated public representatives and/or professional directors. The Governing Body has powers, subject to SEBI approval, to make, amend and suspend the operation of the Rules, Bye-laws and Regulations of the stock exchange besides having jurisdiction over all its members. The Governing Body is specially empowered to admit or expel members and their subordinates.

**2.4 Membership:** Business at a stock exchange, can only be transacted by a member of the stock exchange. A member of NSE cannot transact business at BSE unless he is a member of BSE also. The members of stock exchanges are also called stock or share brokers. The members enter into transactions either on their own behalf or on account of their clients, including sub-brokers or authorised person.

There are several ways of placing an order with a member. It could be either directly or indirectly
through a sub-broker. Since the stock exchange operations involve considerable financial commitments on the part of its members, its membership is restricted to persons who are financially sound and possess adequate experience.

The Securities Contracts (Regulation) Act, 1956, the SEBI Act, 1992 and various rules, regulations, notifications, etc., lay down the requirements for becoming a member of a stock exchange.

Each stock exchange has its own SEBI approved rules and regulations regarding the admission of members. A stock exchange can have membership in multiple trading segments such as Capital Market Segment, Wholesale Debt Market Segment and Derivatives Segment.

The deposit / fee structure applicable to a member depends on the trading segments in which the member is admitted.

2.5 Classification of Securities Traded: A security (in common parlance also known as scrip) which is allowed to be traded on any Exchange can either be listed with the Exchange or be permitted to be traded without being listed on the Exchange. A listed company is bound by the listing agreement with the exchange.

2.6 Margins: There can be wide fluctuations at the time of settlement in the prices of securities since the closing rate of the earlier settlement. In order to restrict excessive speculation and also to safeguard the interests of the investors, members are required to keep certain deposits with the stock exchange authorities. These deposits are termed ‘margins’.

The members are required to collect the margin from their clients, wherever applicable, and deposit the amount collected with the Clearing House.

Margin is intended to protect the members by providing them with funds to cover anticipated fluctuations in prices of securities, particularly, if the client delays in paying the amount or is unable to meet his commitments.

Margins also help prevent excessive speculation as clients would be required to invest some funds and not indulge in speculation without adequate resources. A member is required to pay or deposit different margins such as Gross Exposure Margin, Mark to Market (MTM) Margin, Volatility Margin (VM), Additional Volatility Margin (AVM), Special Margin and Ad-hoc Margin.

The members are required to compute margin payable for all securities traded by them and make the margin payments on the due date to the Stock Exchange authorities. At times the margins are also required to pay upfront, without which the trade cannot take place.

Different types of margins are payable at stipulated time, as decided by the Exchange or Clearing House of the Exchange.
Three types of margins, viz., Mark-to-Market Margin, Volatility Margin and Gross Exposure Margins have been explained in the following paragraphs.

(i) **Mark to Market Margin**: MTM margin is the notional loss, which a member or his client would incur, if the net cumulative outstanding positions in all securities were closed out at the closing price of the relevant trading day, which is different from the price at which the transaction had been entered into. For each security, this is worked out by multiplying the difference between the closing price and the price at which the trade was executed by the cumulative buy and sell open position (for buy position the close price being lower than actual trade price and for sell position the close price being higher than actual trade price). The aggregate amount computed across all securities is MTM margin payable by a member. The mark-to-market margin is payable with reference to net position at client’s level.

(ii) **Volatility Margin**: Volatility margin is imposed to curb excessive volatility in the market and to act as a deterrent to building up of excessive outstanding positions. Price variations on account of calls, bonuses, rights, mergers, amalgamations and schemes of arrangements are adjusted for determining volatile securities and adjustments in prices is made for the purpose of computation of volatility, when securities are traded ex-benefits. Securities that attract volatility margin and the applicable margin rates are announced on the last day of the trading cycle and are applicable from the first day of the succeeding trading cycle. The volatility margin is levied on the net outstanding positions of the member, in each security, based on the respective margin rates.

(iii) **Gross Exposure Margin**: Gross exposure margin is computed on the aggregate of the net cumulative outstanding positions (purchases or sales) in each security. Each Exchange determines its own rates of Gross Exposure Margin and Additional Volatility Margin based on its own risk perception of the market and other risk containment measures such as deposits and collaterals in its possession.

A Stock Exchange may also collect the following margins -

(i) Special Margin in securities where price manipulation is suspected.

(ii) Adhoc Margin where it is felt that the margin cover vis-à-vis the exposure of the member is inadequate or a member has a concentrated position in some securities or has common clients along with other members.
2.7 Trading System: As stated earlier, a member can transact business at a stock exchange either on his own behalf or on behalf of his clients / sub-broker / Authorised person. Thus, a non-member can purchase or sell shares and other securities only through member or through their authorised and registered sub-broker / Authorised person.

The relationship between the client and the member is of a fiduciary nature. When, therefore, the member receives securities from his client for sale, he is obliged to sell the securities as per instructions and to remit the sale proceeds thereof, after deducting brokerage and other related expenses, to his client. This remittance of funds is also known as pay out of funds from share broker to client.
Similarly, when member buys securities for his client, he has to ensure that the shares/securities so purchased are delivered to the client after he has received from the client the payment for the same which includes the brokerage and other incidental expenses in connection therewith.

Thus, a member acts as a custodian and handles the securities of his clients on their behalf. The securities so purchased by a member on behalf of a client when given to client is known as payout of securities.

The procedures followed by various Stock Exchanges in the purchase and sale of securities vary. The following chart depicts the flow of purchase and sale transaction.

2.8 Trading on the National Stock Exchange: NSE operates on the 'National Exchange for Automated Trading' (NEAT) system, a fully computerised screen-based trading system. It enables members from across the country to trade simultaneously with enormous ease and efficiency by keying the order into the system. A single consolidated order book for each stock displays, on a real time basis, buy and sell orders originating from all over the country. The orders are executed only if the price-quantity conditions match.
### 2.9 Types of Market

The NEAT system has four main types of market. They are:

- **Normal Market**: All orders which are of regular lot size or multiples thereof are traded in the normal market. For shares which are traded in the compulsory dematerialised mode the market lot of these shares is one. Normal market consists of various book types wherein orders are segregated as regular lot orders, special term orders, negotiated trade orders and stop loss orders, depending on their order attributes.

- **Odd Lot Market**: An order is called an odd lot order if the order size is less than regular lot size; such orders are traded in the odd-lot market. These orders do not have any special terms or attributes attached to them. In an odd-lot market, both the price and quantity of both the orders (buy and sell) should exactly match for the trade to take place.

- **Spot Market**: Spot orders are similar to the normal market orders except that spot orders have different settlement periods vis-à-vis normal market. These orders do not have any special terms or attributes attached to them.

- **Auction Market**: In the auction market, auctions are initiated by the Exchange on behalf of trading members for completing the settlement process.

### 2.10 Order Books

The NSE trading system provides flexibility to members in the kind of orders that can be placed by them.

Every order has a distinctive order number and a unique time stamp on it. If a match is not found, then the orders are stored in different 'books' in price-time priority in the following sequence:

1. **Best Price**
2. **Within Price, by time priority**.

**Price priority** means that if two orders are entered into the system, the order having the best price gets the higher priority.

**Time priority** means if two orders having the same price are entered, the order that is entered first gets the higher priority.
The capital market segment has following types of books:

**Regular Lot Book** - The Regular Lot Book contains all regular lot orders that have none of the following attributes or conditions* attached to them.
- All or None (AON)
- Minimum Fill (MF)
- Stop Loss (SL)

**Special Terms Book** - The special terms book contains all orders that have either of the following attributes or conditions attached:
- All or None (AON)
- Minimum Fill (MF)

**Stop-Loss Book** - Stop loss orders are stored in this book till the trigger price specified in the order is reached or surpassed. When the trigger price is reached or surpassed, the order is released in the regular lot book.

| The stop loss condition is met under the following circumstances: |
|------------------|-------------------------------------------------|
| **Sell Order** - A sell order in the ‘stop loss book’ gets triggered when the last traded price in the normal market reaches or falls below the trigger price of the order. |
| **Buy Order** - A buy order in the ‘stop loss book’ gets triggered when the last traded price in the normal market reaches or exceeds the trigger price of the order. |

**Odd Lot Book** - The odd lot book contains all odd lot orders (orders with quantity less than marketable lot) in the system. The system attempts to match an active odd lot order against passive orders in the book. Currently, pursuant to a SEBI directive, the Odd Lot Market is being used for orders that have quantity less than or equal to 500 (Quantity more than the market lot) for trading. This is referred as the Limited Physical Market (LPM).

**Spot Book** - The Spot Lot Book contains all spot orders (orders having only the settlement period different) in the system. The system attempts to match an active spot lot order against the passive orders in the book.

**Auction Book** - This book contains orders that are entered for all auctions.

**2.11 Trading on The Stock Exchange, Mumbai (BSE):** The Exchange, which hitherto, had an open outcry trading system, switched over to a fully automated computerised mode of trading known as BOLT (BSE On Line Trading) System.

* Conditions are explained later in the Chapter.
It facilitates more efficient processing, automatic order matching and faster execution of trades. Above all, the system is more transparent for investors, while allowing members to keep their clients’ positions confidential as compared to the earlier regime where the counterparty was always known.

2.12 Depositories and Dematerialisation: The entire transaction of purchase or sale of securities can be said to be completed only after the buyer becomes the rightful owner of the securities and the seller gets the sale consideration.

Depositories Act, 1996 was enacted to provide for establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security by:

(a) making securities of public limited companies freely transferable subject to certain exceptions;
(b) dematerialising the securities in the depository mode; and
(c) providing for maintenance of ownership records in book entry form.

The Act made the securities of public limited companies freely transferable by restricting the company’s right to use discretion in effecting the transfer of securities, thus, dispensing with the transfer deed and other procedural requirements under the Companies Act.

In a depository system, securities are held in securities (depository) accounts; which are more or less similar to holding funds in bank accounts. Transfer of ownership of securities is done through simple account transfers.

**Advantages of Depository Services -**

(i) High liquidity of scrips due to immediate transfer and registration.
(ii) Receive bonus and right as direct credit to the account thereby eliminating the risk of loss in transit.
(iii) Much lower risk of bad deliveries.
(iv) Reduction in brokerage.
(v) Saving of stamp duty worth 1% of transaction price.
(vi) Saving of courier, notary charges.
(vii) Saving of expenses to be incurred on obtaining duplicate certificates as no threat of original shares getting mutilated or misplaced.

2.13 Depositories in India: National Securities Depository Limited (NSDL) and Central Depository Services Limited (CDSL) provide depository services to investors and clearing members through Depository Participants (DPs). They do not charge the investors and clearing members directly but charge their DPs, who are free to have their own charge structure for their clients. The charges for the investors are, therefore, market determined.
2.14 Clearing and Settlement Mechanism: When a trade has been executed, the shares and money should be transferred to the respective parties on settlement date. When an investor enters into a transaction with a broker, shares or funds, as the case may be, are delivered to the broker. In turn, the broker delivers these on settlement day to the settlement agent. In BSE, the settlement agent is known as ‘Clearing House (CH)’ whereas in NSE it is ‘National Securities Clearing Corporation Ltd. (NSCCL)’.

Settlement of trades transacted on an Exchange requires smooth, preferably instantaneous, movement of securities and funds in accordance with the prescribed schedule of pay-in/pay-out. Movement of securities has become almost instantaneous in the dematerialised environment. Two depositories, namely, National Securities Depository Limited and Central Depository Services Limited, are in place to provide electronic transfer of securities. All actively traded scrips are held, traded and settled in demat form. The securities pay-in obligations of members / custodians are downloaded by the clearing agency. The members / custodians make available the required securities in their pool accounts with Depository Participants (DPs) by the prescribed pay-in time for securities. The depository runs an electronic file to transfer the securities from the pool accounts of members / custodians with DPs to the DP account of the clearing agency. As per the allocation schedule determined by the clearing agency, the securities are transferred on the pay-out day by the depository from the DP account of the clearing agency to the DP accounts of members / custodians. In case of trades settled under account period settlement, the pay-out of securities are effected on the same day in case of trades settled under rolling settlement. The ownership vests with the buyer as soon as the securities move from DP account of the member / custodian to his DP account.

SEBI has directed that the brokers can issue contract notes authenticated by means of digital signatures, provided the broker has obtained the digital signature certificate from Certifying Authority under the IT Act, 2000.

Select banks have been empanelled by clearing agency for electronic transfer of funds. The members are required to maintain accounts with any of these banks. The members are informed electronically of their pay-in obligations of funds. The members make available required funds in their accounts with clearing banks by prescribed pay-in day.

The securities can move instantaneously from the seller to seller’s broker to clearing agency to buyer’s broker to buyer since all these have accounts with either of the two depositories which are connected to most of the Stock Exchanges. The depositories have been obligated under the Depositories Act, 1996 to transfer securities electronically.
Explanations: While the Exchange provides a platform for trading to its brokers, the Clearing Corporations (CC) determines the funds/securities obligations of the trading members and ensures that clearing members meet their obligations. The Exchange informs the CC on real-time basis relating to the trades of the broker and by end of day final trade file is provided.

1. CC notifies the consummated trade details to Clearing Members / Brokers / custodians who affirm back. Based on the affirmation, CC applies multilateral netting and determines obligations.

2. Download of obligation and pay-in advice of funds/securities.

3. Instructions to clearing banks to make funds available by pay-in time.

4. Instructions to depositories to make securities available by pay-in-time.

5. Pay-in of securities (CC advises depository to debit pool / principal account of custodians / Clearing Member and credit its account and depository executes it).

6. Pay-in of funds (CC advises Clearing Banks to debit account of custodians / Clearing Members and credit its account and clearing bank executes it).

7. Pay-out of securities (CC advises depository to credit pool account of custodians / Brokers and debit its account and depository executes it).
8. Pay-out of funds (CC advises Clearing Banks to credit account of custodians / Brokers and debit its account and clearing bank executes it).

9. Depository informs custodians / Brokers through DPs about delivery of securities.

10. Clearing Banks inform custodians / Brokers about receipt of funds.

11. The Buying Broker / Custodian makes the delivery of shares to the buyer within one working day after the pay out is received from CC.

12. The Selling Broker / Custodian makes the payment of funds to the seller within one working day after the pay out is received from CC.

2.15 Disclosure of Proprietary Trading by Broker to Client: With a view to increase the transparency in the dealings between the broker and the client, SEBI has directed that every broker shall disclose to his client whether he does client based business or proprietary trading as well. Further, the broker shall disclose this information upfront to his new clients at the time of entering into the Know Your Client agreement. In case of a broker who at present does not trade on proprietary account, chooses to do so at a later date, he shall be required to disclose this to his clients before carrying out any proprietary trading.

3. ROLLING SETTLEMENT

A rolling settlement is one in which trades outstanding at the end of the day have to be settled (payments made for purchases or deliveries in the case of sale of securities) within “X” business days from the transaction date. Thus, in a T+2 rolling settlement, a transaction entered into on Monday, for instance, will be settled on Wednesday when the pay-in or pay-out takes place.

In the rolling settlement, trades on each single day are settled separately from the trades done earlier or subsequent trade days. The netting of trades is done only for the day and not for multiple days.

SEBI has gradually mandated most of the scrips to be settled exclusively on Rolling Settlement basis (T+2). The transactions in the Compulsory Rolling Settlement (CRS) are settled on T+2 basis, i.e., both pay- in and pay- out of monies and securities for transactions in scrips on transaction day (T day) would take place on the day after immediately following day.

However, transactions in ‘Z’ group securities are settled only on trade to trade basis on T+2, i.e., the facility of netting up of buy and sell transactions of the same day, as available in other securities, is not available with securities falling under ‘Z’ group. In other words, if an investor buys and sells X no. of shares on the same day then he shall first have to actually deliver and then receive the securities on the settlement day.

In certain segment, Value at Risk (VaR) based marging approach has been adopted. In the VaR system of marging, historical volatilities of scrips and overall market volatility is considered to arrive
at a VaR margin percentage for a scrip. Further, the mark-to-market differences are collected on a daily basis and the broker members are required to maintain a capital level, as prescribed by the Exchange, adequate to support their exposure at all times.

In case, a member fails to deliver the shares sold in rolling settlement, the Exchange conducts an auction session on T+2, to meet the shortfall created by non-delivery of shares. In this auction session, offers are invited from the other members to deliver the shares sold by originally selling member, since delivery has to be made to the buying member. In case no shares are received in auction, the sale transaction is closed-out at a close-out price, determined by higher of the following:

| ♦ | Highest price recorded in the scrip from the settlement in which the transaction took place upto a day prior to the auction. |
| ♦ | 20% above the closing price on a day prior to the auction. |

In this case, the auction price/close-out and difference between sale price, if positive is payable by the seller who failed to deliver the scrips. In case, auction/close out price is less than sale price, the difference is not given to the seller but is credited to Investor Protection Fund.

4. DERIVATIVES

Derivative is a security whose price is dependent upon or derived from one or more underlying assets. The derivative itself is merely a contract between two or more parties. Its value is determined by fluctuations in the underlying asset.

4.1 Derivatives Market at NSE: The derivatives trading on the NSE commenced with S&P CNX Nifty Index futures on 12th June, 2000. The futures contract on NSE is based on S&P CNX Nifty Index. Currently, it has a maximum of 3 month expiration cycle. Three contracts are available for trading, with 1 month, 2 months and 3 months expiry. A new contract is introduced on the next trading day following the expiry of the near month contract.

The Futures and Options trading system of NSE called NEAT-F&O trading system, provides fully automated screen based trading for S&P CNX Nifty futures on a nationwide basis and an online monitoring and surveillance mechanism. The NEAT-F&O trading system is accessed by two types of users. The Trading Members (TM) have access to functions such as, order entry, order matching, order and trading management. The Clearing Members (CM) uses the trader workstation for the purpose of monitoring the trading members for whom they clear the trades. Additionally, they can enter and set limits to positions, which a trading member can take.
There are Two Types of Clearing Members:

(I) Trading Member Clearing Member (TM-CM) is a CM who is also a TM. TM-CM may clear and settle his own proprietary trades and clients’ trades as well as clear and settle for other TMs.

(II) Professional Clearing Members (PCM) is a CM who is not a TM. Typically banks and custodians could become a PCM and clear and settle for TMs.

Nifty index futures contracts are cash settled on a daily basis by marking to market all open positions on the basis of the daily settlement prices. Members are required to pay the mark to market losses by T+1 day and the same is in turn paid to the members who have made a profit. The contracts are finally settled on expiry of Nifty index futures contract, when NSCCL marks the open positions of a CM to the closing price of underlying index and resulting profit / loss is settled in cash.

For settlement purposes, the daily settlement price is the closing price of futures contract. Trading in Index Options and Stock Futures & Options has also been introduced in Derivatives Segment of NSE.

4.2 Derivative Trading at BSE: The derivatives trading on the BSE commenced with BSE Sensitive Index futures on 9th June, 2000. The futures contract on BSE is based on BSE Sensitive Index (Sensex). The trading and settlement mechanism is more or less on the same lines as in NSE. However, for settlement purposes, the daily settlement price is calculated as the weighted average price of trades during the day. Trading in Index Options and Stock Futures & Options has also been introduced in Derivatives Segment of BSE.

5. CIRCUIT FILTERS OR CIRCUIT BREAKERS

Circuit Breakers or circuit filters are the price bonds that set the upper and lower limit within which a stock can fluctuate on any particular day.

A price band for a day is a function of previous trading day’s closing.

SEBI has directed the exchanges to apply circuit filters on scrips traded in Rolling Settlement if their price fluctuates more than prescribed % of the closing price of scrips on the previous day in any direction.

Price bands restrict extreme price movements and thereby resist price manipulation. These protect investors from extreme fluctuations in a panic market created by rumours and short term fears.

Market Wide Circuit Breakers (MWCB) - Market wide circuit breakers do the same job for the entire market what circuit filters do for individual scrips. MWCB has been introduced to control excessive market movements in BSE sensex and Nifty. SEBI has introduced MWCB at 10-15-20% of the movements in these indices. The stock exchange on a daily basis shall translate the 10%, 15% and 20% circuit breaker limits of market-wide index variation based on the previous day's closing level of the index. The breakers provide the time to participants to react to the movement by way of the
trading halt. A 15 minutes pre-opening session post each trading halt has been introduced. However, such limits vary from time to time. Auditor need to ensure that relevant notification/circular is referred to which deals with such matters.

**6. ACCOUNTING FOR STOCK EXCHANGE TRANSACTIONS**

A trading member is required to keep proper records and accounts for securities and monies receivable from and payable/transferable to both his clients as well as the Stock Exchange. The trading member is firstly required to enter the order into an Electronic Order Entry Book which then transfers the order to the Stock Exchange’s trading system. As soon as the same is matched by a corresponding order by another trading member, the trade is said to be confirmed. A trading member is then required to pay margins (Mark-to-Market, Volatility, Gross Exposure) which are required to be collected from respective clients, wherever applicable. Since it is not feasible to collect margins from a client on a frequent basis, the trading member, generally, collects sufficient margin against each transaction at the point of execution of transaction. This margin is finally adjusted against outstanding in case of settlement of buy positions. If the client fails to pay for the securities purchased, the margin is used to take delivery and subsequently adjust the loss incurred in squaring off the transaction. In case of execution of sale order, the entire margin is refunded back along with the sale value of securities (net of brokerage and other costs) after the funds pay-out is received for securities delivered by the client. In case, the client fails to deliver the securities, the securities are required to be bought by the selling trading member to deliver to the buying trading member through auction. The margin is then used to adjust the loss on account of the difference between the buying price in auction and the price at which the security was original sold.

No entry is required to be passed by the trading member at the time of entering the order in Order Entry Book. Again on execution of trade, no entry is required to be passed in the books of accounts. All the transactions of each client are cumulated for an entire settlement before passing the entries in the ledger. However, it may be possible that a client may have made only one transaction in a given settlement.

Presuming that the client Mr. A (Client Code A0001) is the only client of the member for Rolling Settlement No. 200102151 and has done the following transactions in the said settlement -

<table>
<thead>
<tr>
<th>Bought / Sold</th>
<th>Qty</th>
<th>Scrip Name</th>
<th>Transaction Rate (₹)</th>
<th>Brokerage @ 1% (say) (₹)</th>
<th>Effective Rate (₹)</th>
<th>Total Value (₹)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bought</td>
<td>10</td>
<td>Infosys Technologies</td>
<td>3,000</td>
<td>30</td>
<td>3,030</td>
<td>30,300</td>
</tr>
<tr>
<td>Bought</td>
<td>100</td>
<td>TISCO</td>
<td>100</td>
<td>1</td>
<td>101</td>
<td>10,100</td>
</tr>
<tr>
<td>Sold</td>
<td>100</td>
<td>Reliance Industries</td>
<td>300</td>
<td>3</td>
<td>297</td>
<td>-29,700</td>
</tr>
</tbody>
</table>

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In the above case, it may be noted that the client has to pay ₹ 10,700/- to the trading member. The trading member earns a brokerage of ₹ 700/- (i.e. 10 x 30 + 100 x 1 + 100 x 3) and is required to pay ₹ 10,000/- (10 x 3000 + 100 x 100 - 100 x 300) to the Clearing Corporation/Clearing House towards his outstanding position for the settlement. The trading member would also have to add 5 % as service tax on brokerage earned amounting to ₹ 35/- on the net settlement position which is required to be paid to the Service Tax authorities.

It may be noted that the gross value of transactions done in the abovementioned example is ₹ 70,000/- (i.e. 10 x 3000 + 100 x 100 + 100 x 300). Considering the margin requirement @ 10% on gross value of transactions done, the trading member may collect ₹ 7,000/- from the client and for onward remittance to the Clearing Corporation / Clearing House. At times this margin is also required to maintained upfront.

In case, the client is unable to deliver the securities sold on the securities pay-in date, the same are auctioned by the Exchange (Auction Settlement Type A). This means that the Exchange allows any other Trading Member or his Client (through the Trading Member) bid for delivering the same. The client who has not been able to deliver the securities is required to treat the same as a buy order in his behalf and is bound to pay for the same.

Thus, if Mr. A (through his Trading Member) was unable to deliver 100 shares of Reliance Industries Ltd. on or before the pay-in day for securities and the these shares were auctioned at a rate of ₹ 320 each, a fresh purchase entry would be passed in the books while no effect would be given to the original sales.

In case there are no bidders for selling the securities in an auction settlement for a particular auction scrip and quantity, then the original sale is closed out by squaring as per the rules of the Exchange. The entries nevertheless remain the same.

In case any amount is charged by the Exchange or clearing house towards any pay-in or pay-out defaults, the same is debited and collected from the client to the extent attributable to default committed by the client. The Member is also liable to pay transaction charges and various other charges, fines, interest, etc. to the Exchange or Clearing Corporation / Clearing House which along with other expenses are directly debited to the profit & loss account through respective accounts.

7. CONDUCT OF AUDIT

As stated earlier, in exercise of the powers vested in the Central Government under Rule 12 of the Securities Contracts (Regulation) Rules, 1957, the Government issued a notification dated 29th January, 1983 requiring the accounts of active members of stock exchanges to be audited by chartered accountants. The audit comes into effect from the financial year commencing after 31st March, 1984 as per the Notification dated 11th January, 1984. Thus, accounts of members in respect
of the financial years beginning on and after 1st April, 1984 are required to be audited by chartered accountants. Subsequent to the corporatisation of the Members of Stock Exchanges, statutory audit is now required under the Companies Act.

7.1 The Nature and Scope of the Audit: It has been clarified by the Government, vide its letter dated 31st May, 1984, that a member of the stock exchange, irrespective of the size of his business, would be considered ‘active’ for the purpose of audit if he has conducted business in securities even for a single day in the accounting year. The same letter also clarifies that the annual audit of accounts of a member of a stock exchange will be of the nature of the normal audit, as is conducted in the case of companies, co-operative societies and other entities. It will also hold good for the audits governed under the Companies Act.

Rule 12 of the Securities Contracts (Regulation) Rules, 1957 provides that “Every member shall get his accounts audited by a chartered accountant whenever such audit is required by the Securities and Exchange Board of India”.

A sole proprietor, partnership firm, a corporate body and a financial institution also become members of the stock exchanges. Such members may get their financial statements audited under the statute governing them. For example, a company which is a member of a stock exchange would get its accounts audited under the provisions of the Companies Act, 2013. The members of stock exchanges may also get their accounts audited under the Income Tax Act, 1961.

7.2 The Books of Account and Other Documents subject to the Audit: According to the notification, audit is intended to cover the books of account and other documents specified under Securities Contracts (Regulation) Rules, 1957 and SEBI (Stock Brokers and Sub-Brokers) Rules, 1992. The members of the Exchange are required to maintain the following books of accounts and records as per Rule 15 of the Securities Contracts (Regulation) Rules, 1957 and Regulation 17 of the SEBI (Stock Brokers and Sub-Brokers) Rules, 1992:

1. Solicit Input from Senior Management, System-wide management and entry level management
2. Rely on existing Risk Identification processes wherever they exist
3. Gather and assess input from external sources
4. The result of Risk Assessment is an informed perspective on the current environment risk
| ✦ Register of Transactions (Sauda Book) / Daily Transaction List | ✦ Clients Ledger |
| ✦ General Ledger | ✦ Journals |
| ✦ Cash Book | ✦ Bank Pass Book |
| ✦ Documents Register/Inward-Outward Register showing full particulars of shares and securities received and delivered |
| ✦ Members’ contract book showing details of all contracts entered into by him with other members of the same exchange or counterfoils or duplicates of memos of confirmation issued to such other member |
| ✦ Counterfoils or duplicates of contract notes issued to clients | ✦ Written consent of clients in respect of contracts entered into as principals |
| ✦ Margin Deposit Book | ✦ Register of accounts of sub-brokers |
| ✦ An agreement with a sub-broker specifying the scope of authority and responsibilities of the stock-broker and such sub-brokers |
| ✦ An agreement with the sub-broker and with the client of the sub-broker to establish privity of contract between the stock broker and the client of the sub-broker. |

In addition to the above statutory requirements, the Exchange as per its rules, regulations and bye-laws, may also require their Members to maintain the following records / documents-

✦ Copies of all margin statements downloaded from the Exchange.
✦ Copies of Settlement Sheet along with all relevant sheets.
✦ Details of Spot Delivery transactions entered into (including securities delivered and payments made to the members)
✦ Client database & Broker Client Agreement.
✦ Copy of Registration Certificate of each Sub-broker issued by SEBI.
✦ Copy of approval for each Remisier given by the Exchange.
✦ Copy of the Power of Attorney/Board Resolution authorizing Directors/employees to sign the Contract Note.
✦ Copies of Pool Account Statements.

If a member of the Stock Exchange also holds’ membership of any other recognized Stock Exchange or in a different segment of the same Exchange, (e.g., Derivatives Segment) then such member is required to maintain a separate set of books of accounts, records and documents for trades executed on each recognized stock exchange or each segment of the exchange. The auditor should verify whether the member is maintaining all the above books, documents, etc. and they are up to date.
Considering the extent of computerisation at the level of Stock Exchange as well as at member’s end, an auditor may determine the extent and depth of verification of the audit. For this, the auditor needs to study and understand the various manual and computerised accounting processes employed by the Member and various controls and checks embodied therein. On the basis of same and the materiality thereof, the auditor may decide his audit procedures, extent of checking required and exercise his diligence for the purpose of reporting. Some of the important books of accounts, documents and relevant auditing procedures / tests are discussed below.

7.3 Daily Transactions List (Sauda Book) / Register of Transactions: All members are required to maintain a ‘Sauda Book’, which contains details of all deals transacted by them on a day to day basis. This is also known as trade file. This is a basic record, which each member is required to maintain regularly on day-to-day basis. It contains the details regarding the name of the code of...
the client on whose behalf the deals have been done, rate and quantity of bought or sold. These details are maintained date wise.

<table>
<thead>
<tr>
<th>This register contains all the transactions, which may be of any of the kind mentioned below:</th>
</tr>
</thead>
<tbody>
<tr>
<td>◆ member’s own business on the Exchange</td>
</tr>
<tr>
<td>◆ member’s business on the Exchange on behalf of clients</td>
</tr>
<tr>
<td>◆ member’s business with the clients on principal-to-principal basis</td>
</tr>
<tr>
<td>◆ member’s business with the members of other Stock Exchanges</td>
</tr>
<tr>
<td>◆ member’s business on behalf of his clients with the members of other Stock Exchanges</td>
</tr>
<tr>
<td>◆ Spot transactions, etc.</td>
</tr>
</tbody>
</table>

**7.4 Contract Notes:** Contract note is a document through which a contractual obligation is established between a member and a client. Every member of the stock-exchange has to issue contract notes to his clients for the trades executed on their behalf. The contract notes are required to be issued to the Client within 24 hours of execution of the trades. Members are also required to preserve counter-foils or duplicates of the copies of contract notes issued to clients. The member is also required to maintain written consent of clients for the contracts entered into as Principal. Contract notes issued to clients should show the brokerage separately. The total brokerage charged by the member should not exceed the specified value of the trade. It may be noted that the brokerage percentage is prescribed from time to time. The Contract Notes are required to be signed either by the member himself or his constituted attorney. In case of corporate membership, a board resolution is required to authorise a person including Directors to sign the contract notes.

The member then prepares a Contract Note in the prescribed form after adding the brokerage and sends the original Contract Note to the client. Now a days there is a system sending e-contract through email. The auditor should evaluate the internal control procedures instituted by the stock broker for proper maintenance and issuance of contract notes. The auditor should verify that the transactions done by a member are recorded in the sauda book. It should also be examined that contract notes are issued for all the business conducted on behalf of the clients. The auditor should verify the list of trades executed with the bills raised.

The auditor should apply appropriate audit procedures to satisfy himself that -

- Contract notes have been serially numbered.
- No serial number has been left blank.
- Format of the Contract Note is as prescribed by the Regulations of the Exchange.
- Duplicate copies / counterfoils of contract notes are maintained.
Brokerage charged in contract notes is within the permissible limits and is indicated separately including service tax.

Contract notes have been signed by an authorised person.

Contract notes have been issued in respect of all transactions.

Transaction Identification, Trade Identification and Trade Execution time has been printed on the contract note issued.

SEBI Registration number, Settlement number, Settlement dates have been mentioned.

PAN number of the member and client has been mentioned on Contract Note where if required.

All clauses specified by the Exchange have been printed on the reverse of the contract notes.
7.5 Goods & Service Tax (GST): Goods & Service Tax on a member of a stock exchange had been introduced by the Government is levied on the value of taxable services which shall be the gross amount charged by the service provider of such service provided or to be provided by him at the rate prescribed from time to time by the Government as any service provided to any person by a stock broker in connection with the sale or purchase of securities listed on a recognized stock exchange services provided by sub-brokers has also been proposed to be brought into tax net w.e.f. 01.07.2017. Prior to this date Service Tax provisions were applicable.

7.6 Security Transaction Tax (STT): In the Union Budget for 2004-05, Government has introduced Securities Transaction Tax to be levied on all transactions done on stock exchange. As per the provisions of the Finance Bill, the stock exchanges have been entrusted with the responsibility of levy, collection and remittance of the STT on all transactions from the date of notification by the Government of India. SEBI vide its Circular No.MRD/DOP/Cir-28/2004 dated August 23, 2004 directed that no stock exchange shall permit trading activities unless it implements necessary software and procedures for the levy collection and remittance of STT. The auditor should verify the STT charged to client with STT paid to exchange and check the reconciliation for difference if any.

7.7 Client Bills: Client Bills represents the summary of all trades executed on behalf of the client during a particular settlement. It also reflects the net amount receivable or payable to the Member from / to the client. This amount is normally posted to the individual ledger account. The auditor may
call for the bills for verification and check whether the same have been properly posted to client's ledger.

7.8 Clients Ledger: Every broker is required to maintain a clients' ledger. This ledger contains the details of the bills raised and the payment received from or made to the clients. As mentioned earlier, Client Ledger is required to be maintained separately for different Exchange or for different Trading Segment of the same Exchange. It may be noted that SEBI Rules provides that payment is to be made to the client within 24 hours of pay-out by the Exchange. He should further verify that the clients’ receipts / payments are made through designated “Client Bank Account” of the Member. It may be mentioned here that payments not made or received since a considerable period or the amount of payment made or received is consistently different for bills raised over a period of time in respect of some clients. These may represent some financial or accounting irregularity which would require further attention of the Auditor. The auditor may also scrutinise the client ledger to identify accounts whether loans or deposits received from a paid to the clients have been passed through this account. The client may also obtain from member clients the letters confirming their balances at the end of the financial year as appearing in his books of account on a test basis. Preferably, such letters of confirmation should be sent to the clients directly by the auditor. The auditor should carry out scrutiny of the accounts appearing in the Clients’ Ledger with a view to ascertain the age of clients’ accounts and in case of old debit balances for determining provision for bad and doubtful debts. As per the exchange regulations there cannot be running credit account in any client ledger which is more than three months.

7.9 Settlement Control Account: At the end of the settlement, Client Bills are posted to Client Ledger account as mentioned above. At the same time the net amount receivable from or payable to the Exchange, Clearing house is posted to the Settlement Control Account. The payment made to / received from Clearing House for a particular settlement should match with the pay-in / pay-out entries. The auditor should verify that the balance in this account after his settlement should ideally be nil and in case of any balance in this account, the reconciliation statement from the member should be obtained.

7.10 Clearing House Bank Account: At the end of the settlement, the payment related to the pay-in or pay-out is routed through the Clearing House account. This account normally reflects the bank entries which are passed in the Clearing Bank account. The book balance in this account should be reconciled with the balance in Clearing Bank account as per bank statement.

7.11 Brokerage Account: At the end of the each settlement, brokerage income is credited to brokerage account appearing in general ledger. The auditor should verify whether brokerage is credited for each settlement or not, failing which the reasons thereof can be inquired into. The brokerage amount should be periodically reconciled with the amount on which the service tax/GST has been paid as disclosed in service tax/GST return. Since brokerage is the main source of income for members of stock exchanges, the auditor should pay particular attention to revenue recognition aspect. Brokerage income is recognised as income on the basis of principles laid down in Accounting
Standard (AS) 9, Revenue Recognition. In computerized accounting system the brokerage entry is directly credited to brokerage account by system during settlement accounting.

**7.12 Margin Deposit Book:** A member is required to maintain a margin deposit book wherein details of all the margins deposited with the Clearing House are to be recorded. The book should be verified to ascertain whether the member has complied with all the directives regarding margins, etc. issued by SEBI or Stock Exchange from time to time. The margin payments made by the member may be cross-checked with the daily margin statements downloaded from the Stock Exchange.

The auditor should apply appropriate audit procedures to satisfy himself that margins have been properly calculated, collected and paid. The auditor should examine that margin deposit lying with the Clearing House are supported by the confirmation. The auditor should verify whether adjustment entries relating to settlement margin and daily margin which is adjusted at the time of settlement are correctly passed or not. The auditor should also ensure that exemptions from payment of margins of Institutional Trades have been claimed correctly.

**7.13 Members’ Own Trading Account:** Many a times, member of the Exchange executes the trade on his own behalf. In such cases, the entry related to trades is passed in the same way as it is done for a client. Members own trading account normally appears in general ledger. The auditor should verify the entries appearing in this account with respect to the bills raised for own account trading. The balance appearing in this account should be identified into profit or loss or closing stock-in-hand, as the case may be.

**7.14 Bank Book:** A member of a Stock Exchange is required to maintain separate bank account for the client's money and their own money. No payment for a transaction in which the member has traded on his own account shall be made from clients account. No money can be paid into clients account other than -

1. Money held or received on account of clients.
2. Money for replacement for any sum which may by mistake or accident drawn from the account.
3. A cheque or draft received from a client.

No money can be paid from client’s account other than -

1. The money required for payment to the Clearing Corporation / House on behalf of clients.
2. Money for replacement for any sum which may by mistake or accident deposited into client account.

The auditor should verify the bank reconciliation statement for all the bank accounts in the usual manner.

**7.15 Documents Register (Inward / Outward Register):** This register contains the particulars of the securities including their distinctive numbers received from or delivered to clients in a physical
form by a member. This is a primary record, which lists and identifies every security available with the member at any given time. Generally, it is observed that members maintain a ledger, which contains only the number received, delivered and balance. This ledger does not provide for the distinctive numbers of the scripts received from or delivered to the clients. It may be mentioned that if distinctive numbers are not recorded properly then the identification of introducer cannot be established.

While scrutinizing this register, the auditor should analyse the balances of stock appearing in this register and segregate the same into client stock and own stock. The auditor should inquire the reasons for client’s stock remaining with the Member. Further, the auditor may also, on a random basis, physically verify the stock available with a member in certain scrips, if so, desired.

7.16 Maintenance of Books of Accounts and Other Documents: In terms of Rules 14 and 15 of Securities Contracts (Regulation) Rules, 1957, every recognized stock exchange and its members are required to maintain and preserve the specified books of account and documents for a period of five years. Further, as per regulation 18 of SEBI (Stock Brokers & Sub-Brokers) Regulation, 1992, every stock broker shall preserve the specified books of account and other records for a minimum period of five years.

7.17 Dematerialized Securities: On account of compulsory dematerialisation of most of the securities listed on the Exchange, all stock brokers are required to maintain two accounts with their Depository Participants (DP) for handling the receipt and delivery of securities in demat. One account is ‘Beneficiary Account’ wherein the demat securities belonging to the members’ for their own account are held and the other is ‘Pool Account’ wherein the demat securities of the clients are temporarily lodged for transfer to/from the Clients / Clearing House in the Pay-in/Pay-out.

In case of sale of securities by clients, the clients transfer the same in the demat form to the member’s Pool Account to the Clearing House on the Pay-in day. In case of purchase of securities by the Client, the Clearing House transfers the securities to the Pool Accounts of the members and the members then transfer the same to the accounts of individual clients. The members are required to maintain a proper record of all shares received and delivered from their Pool Account as well as preserve acknowledged copy of the delivery instructions given to their DP’s for transferring the securities from the Pool Account to the Clients’ account after the Pay-out.

The auditor should verify whether the securities received by the member in the Pool Account are regularly transferred to the buying clients’ Demat Accounts within 24 hours of declaration of Pay-out of the relevant settlement of the Exchange. It may be noted that Sometimes, the clients instruct the brokers to retain the shares in the Pool Account either because they have not opened a demat account or because they intend to sell the shares they have bought earlier, in the subsequent settlement and thereby avoid transaction charges.

The auditor should check that the shares lying in the Pool Account have not been utilized by the member to meet his own pay-in obligations or used for meeting auction obligations. If the auditor
discovers something like this then, he should further enquire into the matter. Such instances might indicate the breach of fiduciary trust by the member of the stock exchange.

Depending upon the nature of the business carried on by the member, the auditor may apply such procedural tests as he considers necessary on major items of income and expense such as, commission, sub-brokerage, underwriting income, interest and dividends, advisory fees, interest, amounts payable towards transactions charges and other charges to the Exchange or Clearing House and other income and expenses.

The auditor should apply analytical procedures on the financial statements of the member. The auditor should compare current operating results with those of the prior period to ascertain that the variations are logical in the circumstances such as volume of business at the stock-exchanges, the brokerage concern’s share of the market, changed business conditions such as volume of new securities issued, changes in the character of the business of the brokerage concern, and trend prices of securities. A discussion of this comparative data with the officials of the member may highlight areas where added audit emphasis may be directed.

8. AUDITOR’S REPORT

As per the notification issued by the Government, an auditor should submit his report in the following form:

“We have audited the attached balance sheet of M/s. ABC as at _________ and the profit and loss account for the year ended on that date annexed thereto and report that:

We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit.

In our opinion, proper books of account and records as specified in Rule 15 of the Securities Contracts (Regulation) Rules, 1957 have been kept so far as appears from our examination of such books.

The stock broker has complied with the requirements of the stock exchange so far as they relate to maintenance of accounts and was regular in submitting the required accounting information to the stock exchange.

The balance sheet and the profit and loss account referred to in this report are in agreement with the books of account.

In our opinion and to the best of our information and according to the explanations given to us, the said balance sheet and the profit and loss account read together with the notes thereon give a true and fair view insofar as it relates to the balance sheet, of the state of affairs of M/s. ABC, and insofar as it relates to profit and loss account, of the profit of M/s. ABC for the year ended on that date.”
According to clause (c) of the form of audit report prescribed by the Government, the auditor is required to report whether the member of the stock exchange had complied with the requirements of the stock exchange insofar as they relate to maintenance of accounts and that he was regular in submitting the required accounting information to the stock exchange. The auditor is therefore required to acquaint himself with the said requirements of the stock exchange and / or the Ministry of Finance.

The audit reports to be submitted to the aforesaid authorities need not be accompanied by copies of the relevant profit and loss account and balance sheet. However, the said authorities have right to demand profit and loss account and / or balance sheet wherever they consider necessary.

It may be noted that in cases where the member is a company registered under the Companies Act, the reporting consideration that apply to other companies shall also apply to the member company. For example, the audit would have to necessarily make the assertions given in sub-section (2) and (3) of section 143 of the Companies Act, 2013.

**Internal Audit for stock brokers/trading members/clearing members:**

SEBI vide its Circular dated 21.10.2008 has decided that stock brokers/trading members/clearing members shall carry out complete internal audit on a half yearly basis by an independent qualified chartered accountants, company secretaries or cost and management accountants who are in practice and who do not have any conflict of interest.

### 9. CHECKLIST FOR AUDIT OF MEMBERS OF STOCK EXCHANGES

<table>
<thead>
<tr>
<th>Sr No.</th>
<th>Area of Verification</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Client registration documentation / Anti Money Laundering compliance</td>
</tr>
<tr>
<td>2</td>
<td>Order management and risk management systems</td>
</tr>
<tr>
<td>3</td>
<td>Contract notes, Client margin details and Statement of accounts</td>
</tr>
<tr>
<td>4</td>
<td>Dealing with clients’ funds and securities</td>
</tr>
<tr>
<td>5</td>
<td>Banking and Demat account operations</td>
</tr>
<tr>
<td>6</td>
<td>Terminal operations and systems</td>
</tr>
<tr>
<td>7</td>
<td>Management of branches / sub brokers and internal control</td>
</tr>
<tr>
<td>8</td>
<td>Investor grievance handling</td>
</tr>
<tr>
<td>9</td>
<td>Maintenance of Books of Accounts</td>
</tr>
<tr>
<td>10</td>
<td>Systems &amp; Procedures pertaining to Prevention of Money Laundering Act, PMLA, 2002</td>
</tr>
<tr>
<td>11</td>
<td>Transfer of trades</td>
</tr>
<tr>
<td></td>
<td>Special Audit Assignments</td>
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<tr>
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<td>----------------------------</td>
</tr>
<tr>
<td>12</td>
<td>Margin Trading</td>
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<tr>
<td>13</td>
<td>Proprietary Trading</td>
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<tr>
<td>14</td>
<td>Internet Trading</td>
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<tr>
<td>15</td>
<td>Execution of Power of Attorney (POA)</td>
</tr>
<tr>
<td>16</td>
<td>Operations of Professional Clearing member/ Members clearing trades of other trading members</td>
</tr>
<tr>
<td>17</td>
<td>Securities Lending &amp; Borrowing Scheme</td>
</tr>
<tr>
<td>18</td>
<td>Compliance status of last inspection carried out by SEBI/ Exchanges/ Internal Auditor</td>
</tr>
<tr>
<td>19</td>
<td>Comments of the auditor on any other area</td>
</tr>
</tbody>
</table>