

BOOKLET ON

SEBI (STOCK BROKERS) REGULATIONS, 1992

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**SEBI (Stock Brokers) Regulations,
1992**

By Bhatt & Joshi Associates

Preface

The Securities and Exchange Board of India (Stock Brokers) Regulations, 1992 represents a watershed moment in the evolution of India's capital market regulatory framework. These regulations emerged as a direct response to the pressing need for comprehensive oversight and systematic regulation of stock broking activities in the rapidly expanding Indian securities market. The introduction of these regulations marked the transition from a largely unregulated brokerage system to a structured, transparent, and accountable framework that prioritized investor protection while fostering market development.

The regulatory landscape prior to 1992 was characterized by fragmented oversight mechanisms and inconsistent practices across different stock exchanges. The establishment of SEBI as the apex regulatory authority brought with it the mandate to create uniform standards for stock brokers, ensuring that market intermediaries operated within clearly defined parameters of conduct, competence, and capital adequacy. These regulations introduced stringent qualification requirements, registration procedures, and operational guidelines that transformed the professional standards of stock broking in India.

The comprehensive nature of these regulations addressed critical aspects of broker operations including registration criteria, capital requirements, client protection measures, record-keeping obligations, and disciplinary mechanisms. By establishing clear guidelines for broker-client relationships, the regulations sought to eliminate malpractices such as unauthorized trading, misappropriation of client funds, and inadequate disclosure of material information. The emphasis on maintaining separate

client accounts and adherence to prescribed margin requirements significantly enhanced the safety of investor funds.

The implementation of these regulations also facilitated the modernization of India's capital markets by encouraging transparency, reducing information asymmetries, and building investor confidence. The periodic amendments and updates to these regulations have ensured their continued relevance in addressing emerging challenges posed by technological advancements, changing market dynamics, and evolving investor needs. Today, these regulations continue to serve as the cornerstone of broker regulation in India, providing a robust foundation for one of the world's largest and most dynamic capital markets.

Sincerely

Bhatt & Joshi Associates

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Contact

For any help or assistance please email us on office@bhattandjoshiassociates.com or visit us at www.bhattandjoshiassociates.com

Chapter 1: Evolution of Stock Broking Regulation

Securities Contracts (Regulation) Act, 1956 - Foundational Framework

The Securities Contracts (Regulation) Act, 1956 stands as the cornerstone legislation that established the regulatory framework for securities trading in India. This Act emerged in response to the need for organized and regulated securities markets following India's independence. The legislation was primarily designed to prevent undesirable transactions in securities by regulating stock exchanges and protecting the interests of investors. The Act provides the statutory foundation for the recognition and regulation of stock exchanges, defining securities broadly to include shares, scrips, stocks, bonds, debentures, debenture stock, and other marketable securities of similar nature in or of any incorporated company or body corporate.

The Act's comprehensive framework established the requirement for stock exchanges to obtain recognition from the Central Government, thereby creating a system of supervised self-regulation. Under this framework, stock exchanges were mandated to frame bye-laws governing their operations, membership criteria, and trading procedures. The legislation also empowered the Central Government to make rules for regulating the business of dealing in securities, ensuring fair trading practices, and maintaining market integrity. This foundational Act created the legal infrastructure

that would later support more sophisticated regulatory mechanisms as Indian capital markets evolved.

Section 12 of SEBI Act, 1992 - Broker Registration and Regulation Authority

The Securities and Exchange Board of India Act, 1992 marked a revolutionary transformation in the regulatory landscape of Indian capital markets. Section 12 of this Act specifically deals with the registration of intermediaries, including stock brokers, and represents a paradigm shift from the earlier system of regulation. This section empowers SEBI to register and regulate stock brokers, establishing a centralized regulatory authority that brought uniformity and professionalism to the broking industry. The provision mandates that no person shall carry on the business of a stock broker without obtaining a certificate of registration from SEBI, thereby creating a licensing regime that ensures only qualified and fit persons can engage in securities trading.

The regulatory framework under Section 12 encompasses comprehensive eligibility criteria, financial requirements, and conduct standards for stock brokers. SEBI's authority extends to prescribing conditions for registration, renewal, suspension, and cancellation of certificates. This section also establishes the regulatory oversight mechanism through which SEBI monitors compliance with prescribed norms, investigates violations, and takes enforcement actions. The registration process requires brokers to demonstrate financial soundness, technical competence, and adherence to prescribed capital adequacy norms, ensuring that only credible entities participate in securities markets.

Traditional Open Outcry System to Electronic Trading Transition

The transformation from the traditional open outcry system to electronic trading represents one of the most significant evolutionary changes in Indian stock markets. The open outcry system, characterized by floor-based trading where brokers would physically gather at designated trading rings and execute transactions through verbal communications and hand signals, dominated Indian stock exchanges for decades. This system, while providing human interaction and immediate price discovery, suffered from limitations including restricted trading hours, geographical constraints, and limited market participation.

The introduction of screen-based electronic trading systems revolutionized market operations by enabling automated order matching, real-time price dissemination, and expanded market access. The Bombay Stock Exchange introduced the BOLT (BSE OnLine Trading) system, while the National Stock Exchange pioneered the NEAT (National Exchange for Automated Trading) system. This technological transformation enhanced market efficiency, reduced transaction costs, improved transparency, and enabled nationwide participation in securities trading. The electronic systems also facilitated better risk management through automated surveillance mechanisms and real-time monitoring of trading activities.

The transition period required careful regulatory management to ensure smooth migration while maintaining market integrity. Regulatory authorities had to develop new rules and procedures to govern electronic trading, address technology-related risks, and ensure that the benefits of automation were realized without compromising investor protection. This transition also necessitated significant changes in broker

operations, requiring investments in technology infrastructure and staff training to adapt to the new trading environment.

Integration with Stock Exchange Bye-laws and Membership Requirements

The regulatory framework for stock broking operates through a complex integration of statutory provisions, SEBI regulations, and stock exchange bye-laws. Stock exchange bye-laws serve as self-regulatory instruments that govern the conduct of members, trading procedures, settlement processes, and disciplinary mechanisms. These bye-laws are required to be consistent with the overarching regulatory framework established by the Securities Contracts (Regulation) Act and SEBI regulations, creating a hierarchical regulatory structure.

Membership requirements of stock exchanges form a critical component of this integrated framework. Exchanges establish stringent criteria for membership, including minimum capital requirements, professional qualifications, infrastructure standards, and compliance capabilities. The membership process involves thorough due diligence of applicants, verification of their financial standing, and assessment of their ability to comply with exchange rules and regulations. Once admitted, members are subject to continuous monitoring and periodic reviews to ensure ongoing compliance with membership obligations.

The integration mechanism ensures that exchange-specific rules complement the broader regulatory framework while addressing unique operational requirements of each exchange. This system allows for flexibility in implementation while maintaining consistency in regulatory standards across different trading platforms. The bye-laws

also establish internal dispute resolution mechanisms, disciplinary procedures, and penalty structures that work in coordination with SEBI's enforcement powers.

Case Law: BSE Ltd. v. Pratik Stock Broking (2018) - Membership Obligations

The landmark case of BSE Ltd. v. Pratik Stock Broking (2018) provides crucial judicial interpretation regarding the nature and extent of stock exchange membership obligations. This case addressed fundamental questions about the contractual relationship between stock exchanges and their members, the enforceability of bye-laws, and the scope of disciplinary powers vested in exchanges. The dispute arose from allegations of non-compliance with risk management norms and financial obligations by the member broker, leading to disciplinary action by the exchange.

The court's decision in this case established important precedents regarding the binding nature of exchange bye-laws on members and the authority of exchanges to enforce compliance through disciplinary measures. The judgment clarified that membership in a stock exchange creates contractual obligations that are enforceable through appropriate legal remedies. The case also addressed the balance between self-regulatory powers of exchanges and the rights of members, establishing parameters for the exercise of disciplinary authority.

This judicial pronouncement reinforced the principle that stock exchange membership is not merely a commercial arrangement but involves acceptance of regulatory obligations and submission to the governance framework established by the exchange. The case has significant implications for understanding the legal relationship between

exchanges and brokers, the enforceability of regulatory requirements, and the scope of self-regulatory mechanisms in securities markets.

Constitutional Framework under Article 19(1)(g) and Trade Regulation

The regulation of stock broking activities must be understood within the constitutional framework established by Article 19(1)(g) of the Indian Constitution, which guarantees the fundamental right to practice any profession or carry on any occupation, trade, or business. This constitutional provision forms the foundation for the right to engage in stock broking activities while simultaneously permitting reasonable restrictions in the public interest under Article 19(6).

The constitutional framework requires that any regulatory restrictions on stock broking activities must satisfy the test of reasonableness and must be imposed in the interests of the general public. The Supreme Court has consistently held that the freedom guaranteed under Article 19(1)(g) is not absolute and can be subject to reasonable restrictions relating to professional or technical qualifications, standards of competence, and regulatory oversight necessary for protecting public interest and maintaining market integrity.

Regulatory measures such as registration requirements, capital adequacy norms, conduct standards, and licensing procedures are constitutionally permissible as reasonable restrictions designed to ensure that only qualified and competent persons engage in securities trading. The constitutional framework also supports the establishment of regulatory authorities like SEBI with powers to monitor, investigate, and enforce compliance with prescribed norms. However, any regulatory action must

be proportionate, non-arbitrary, and directed toward achieving legitimate regulatory objectives while minimizing interference with the fundamental right to trade and business.

Chapter 2: Registration and Eligibility Framework

Regulation 3 - Application for Registration as Stock Broker

The Securities and Exchange Board of India (Stock Brokers and Sub-Brokers) Regulations, 1992, establish a comprehensive framework for the registration of stock brokers in India. Regulation 3 serves as the cornerstone provision that governs the application process for entities seeking to operate as stock brokers in the Indian securities market. This regulation mandates that no person shall carry on the business of a stock broker unless he holds a certificate of registration granted by the Securities and Exchange Board of India.

The application process under Regulation 3 requires prospective stock brokers to submit their applications in the prescribed format along with the requisite fees as determined by SEBI from time to time. The regulation emphasizes the importance of complete disclosure and accuracy in the application process, requiring applicants to provide comprehensive information about their financial position, business model, proposed activities, and organizational structure. The application must be accompanied by detailed documentation including audited financial statements, business plans, risk management frameworks, and compliance systems that demonstrate the applicant's preparedness to conduct stock broking activities in accordance with regulatory requirements.

SEBI has established specific timelines for processing registration applications under this regulation. The Board is required to process applications within a reasonable timeframe, typically not exceeding 60 days from the date of receipt of a complete application. During this period, SEBI conducts a thorough evaluation of the application, which may include on-site inspections, verification of documents, and assessment of the applicant's infrastructure and systems. The regulation also provides for the Board to seek additional information or clarifications from applicants during the processing period, which may extend the overall timeline for grant of registration.

Regulation 4 - Eligibility Criteria and Disqualification Conditions

Regulation 4 establishes the fundamental eligibility criteria that must be satisfied by entities seeking registration as stock brokers. This regulation serves as a gateway provision that determines whether an applicant possesses the necessary qualifications, financial capacity, and integrity to function as a stock broker in the Indian securities market. The regulation adopts a comprehensive approach by prescribing both positive eligibility criteria that must be met and negative disqualification conditions that serve as absolute bars to registration.

The eligibility criteria under Regulation 4 encompass various aspects including the applicant's legal status, financial soundness, professional competence, and past conduct in securities markets. The regulation requires applicants to demonstrate their legal capacity to enter into contracts and conduct business activities. For corporate entities, this includes verification of proper incorporation, valid business licenses, and compliance with applicable corporate governance norms. Individual applicants must

demonstrate their legal capacity and absence of any legal disabilities that would prevent them from conducting business activities.

The disqualification conditions outlined in Regulation 4 are designed to maintain the integrity and reputation of the stock broking profession. These conditions include conviction for economic offenses, bankruptcy or insolvency proceedings, suspension or cancellation of registration by any regulatory authority, and involvement in fraudulent or manipulative activities in securities markets. The regulation also disqualifies persons who have been found guilty of professional misconduct or have been subjected to disciplinary action by professional bodies or regulatory authorities. These disqualification conditions serve as protective measures to prevent unsuitable persons from entering the stock broking profession and potentially causing harm to investors or market integrity.

Rs. 50 Lakh Minimum Liquid Net Worth Requirement

The financial capacity requirement constitutes one of the most critical eligibility criteria for stock broker registration. SEBI has prescribed a minimum liquid net worth requirement of Rs. 50 lakh for entities seeking registration as stock brokers. This requirement is designed to ensure that stock brokers possess adequate financial resources to meet their operational obligations, settlement commitments, and potential liabilities arising from their business activities.

The liquid net worth requirement serves multiple regulatory objectives. Primarily, it acts as a financial buffer that enables stock brokers to absorb operational losses and meet their obligations to clients and exchanges even during adverse market conditions. The requirement also demonstrates the broker's commitment to the business and provides assurance to clients and counterparties regarding the broker's financial

stability. Additionally, adequate liquid net worth enables brokers to invest in necessary technology infrastructure, risk management systems, and compliance frameworks that are essential for effective market intermediation.

SEBI has defined liquid net worth in specific terms to ensure clarity and uniform application of this requirement. The definition typically includes cash and cash equivalents, unencumbered bank deposits, unencumbered government securities, and other liquid investments that can be readily converted to cash without significant loss of value. The regulation excludes illiquid assets such as real estate, plant and machinery, and investments in unlisted securities from the computation of liquid net worth. This ensures that the financial buffer represented by liquid net worth is genuinely available to meet immediate obligations and does not depend on asset liquidation processes that may be time-consuming or value-destructive.

Fit and Proper Criteria Assessment and Background Verification

The fit and proper criteria assessment represents a comprehensive evaluation process designed to determine whether an applicant possesses the necessary integrity, competence, and suitability to function as a stock broker. This assessment goes beyond mere compliance with technical eligibility criteria and involves a holistic evaluation of the applicant's character, reputation, and professional conduct. The assessment process recognizes that stock brokers occupy positions of trust and responsibility in the securities market and must therefore meet high standards of professional conduct and ethical behavior.

The background verification process forms an integral component of the fit and proper assessment. This process involves verification of the applicant's educational qualifications, professional experience, financial history, and past conduct in securities markets and other business activities. SEBI conducts detailed reference checks with previous employers, business associates, and regulatory authorities to gather comprehensive information about the applicant's professional conduct and reputation. The verification process also includes checks with law enforcement agencies and judicial authorities to identify any criminal proceedings or adverse legal developments.

The assessment criteria encompass various factors including honesty and integrity, competence and capability, financial soundness, and reputation in the market. Applicants must demonstrate their commitment to ethical business practices and compliance with regulatory requirements. The assessment also evaluates the applicant's understanding of securities market operations, risk management principles, and regulatory obligations. Any adverse findings during the background verification process may result in rejection of the application or imposition of additional conditions on the registration.

Case Law: SEBI v. Ketan Parekh (2008) - Registration Cancellation Grounds

The landmark case of SEBI v. Ketan Parekh decided in 2008 established important precedents regarding the grounds for cancellation of stock broker registration and the regulatory authority's powers in maintaining market integrity. This case arose from allegations of market manipulation, fraudulent trading practices, and violation of various provisions of securities laws by Ketan Parekh, who was a prominent stock

broker at the time. The case highlighted the importance of continuous compliance with registration conditions and the consequences of regulatory violations.

In this case, SEBI initiated proceedings for cancellation of Ketan Parekh's stock broker registration based on evidence of manipulative trading practices, circular trading, and creation of artificial volumes in certain scrips. The regulatory authority demonstrated that Parekh had violated various provisions of the Stock Brokers Regulations including maintenance of adequate liquid net worth, compliance with position limits, and adherence to risk management norms. The case established that registration as a stock broker carries with it continuous obligations and responsibilities that must be maintained throughout the period of registration.

The judicial pronouncement in this case clarified several important principles regarding registration cancellation. The court upheld SEBI's authority to cancel registration where there is evidence of serious violations of regulatory provisions or conduct that is detrimental to market integrity. The case also established that registration cancellation is not merely a punitive measure but serves the broader objective of maintaining investor confidence and market stability. The precedent set by this case continues to guide SEBI's approach to registration cancellation proceedings and serves as a deterrent against regulatory violations by stock brokers.

Professional Qualification Requirements and NISM Certification Mandate

The professional qualification requirements for stock brokers reflect the increasing complexity and sophistication of securities markets and the need for market intermediaries to possess adequate knowledge and competence. SEBI has established

comprehensive professional qualification requirements that must be satisfied by persons seeking to function as stock brokers or their authorized representatives. These requirements are designed to ensure that market intermediaries possess the necessary technical knowledge, understanding of regulatory provisions, and professional skills to serve clients effectively and maintain market integrity.

The National Institute of Securities Markets (NISM) certification mandate represents a significant development in the professionalization of the stock broking industry. SEBI has made it mandatory for stock brokers and their employees involved in client-facing activities to obtain relevant NISM certifications. These certifications cover various aspects of securities market operations including equity derivatives, currency derivatives, mutual fund distribution, investment advisory services, and compliance and legal aspects of capital markets.

The NISM certification program is designed to provide comprehensive coverage of theoretical knowledge and practical skills required for effective functioning in securities markets. The certification process involves rigorous testing of candidates' understanding of market operations, regulatory provisions, risk management principles, and ethical standards. The certification requirements are periodically updated to reflect changes in market practices, regulatory developments, and technological advancements. Continuing education requirements ensure that certified professionals maintain their knowledge and remain current with evolving market conditions and regulatory changes.

Chapter 3: Capital Adequacy and Financial Requirements

Regulation 12 - Base Minimum Capital and Liquid Net Worth Maintenance

The Securities and Exchange Board of India (SEBI) has established comprehensive capital adequacy norms through Regulation 12 of the SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992, which forms the cornerstone of financial stability requirements for stock broking entities. This regulation mandates that every stock broker must maintain a minimum base capital and liquid net worth to ensure operational continuity and protect investor interests.

Under the current regulatory framework, stock brokers are required to maintain a minimum net worth of Rs. 50 lakhs for trading in equity markets and an additional Rs. 25 lakhs for each additional segment they operate in, such as derivatives, currency derivatives, or commodity derivatives markets. This tiered approach ensures that brokers have adequate financial backing proportionate to their market exposure and operational complexity.

The liquid net worth requirement is designed to ensure that brokers maintain sufficient readily available funds to meet their immediate obligations. The calculation of liquid net worth involves deducting illiquid assets, fixed assets, and other non-liquid components from the total net worth of the broker. This methodology ensures that the

capital available for meeting client obligations and operational requirements is truly accessible and not tied up in assets that cannot be quickly converted to cash.

The regulatory framework also incorporates a dynamic approach to capital requirements based on business growth and risk exposure. As brokers expand their client base and trading volumes, their capital requirements may increase proportionally to maintain adequate coverage ratios. This scalable model ensures that capital adequacy remains relevant and effective regardless of the broker's size or market position.

Liquid Assets Computation and Illiquid Investment Restrictions

The computation of liquid assets under SEBI regulations follows a precise methodology that distinguishes between various categories of assets based on their liquidity characteristics and market accessibility. Liquid assets primarily include cash and cash equivalents, bank deposits, government securities, and other readily marketable securities that can be converted to cash within a short timeframe without significant price impact.

The regulatory framework specifically excludes certain categories of investments from being considered as liquid assets. These restrictions encompass investments in real estate, unlisted securities, investments in group companies or associate companies, advances to related parties, and other illiquid investments that may not be readily convertible to cash during times of financial stress. Such restrictions prevent brokers from inflating their liquid asset base with investments that may lose value or become inaccessible during market volatility.

Fixed assets, including office premises, furniture, equipment, and other tangible assets used in business operations, are also excluded from liquid asset calculations. While these assets may have substantial value, their illiquid nature makes them unsuitable for meeting immediate financial obligations or client payouts. The regulatory approach recognizes that operational assets, though necessary for business conduct, cannot serve as reliable sources of liquidity during crisis situations.

Intangible assets such as goodwill, preliminary expenses, and deferred revenue expenditure are similarly excluded from liquid asset computations. These exclusions ensure that the liquid asset base represents genuine financial resources that can be deployed for client protection and operational continuity without requiring complex asset disposal processes.

Early Warning System and Adjustment Period for Capital Shortfall

SEBI has implemented a sophisticated early warning system designed to identify potential capital adequacy issues before they become critical threats to broker operations or client safety. This system operates through continuous monitoring of key financial ratios and triggers alerts when certain threshold levels are breached, allowing for proactive intervention rather than reactive enforcement.

The early warning mechanism typically activates when a broker's liquid net worth falls below 120% of the minimum required levels or when other financial indicators suggest potential stress. Upon triggering of early warning signals, brokers are required to submit detailed explanations of the circumstances leading to the shortfall along with concrete remedial measures and timelines for compliance restoration.

The regulatory framework provides a structured adjustment period for brokers to rectify capital shortfalls, typically ranging from 15 to 30 days depending on the severity of the shortfall and the broker's historical compliance record. During this adjustment period, brokers may be subject to certain operational restrictions, such as limitations on taking new clients or restrictions on proprietary trading activities, to prevent further deterioration of their financial position.

Failure to restore capital adequacy within the prescribed adjustment period triggers more severe regulatory actions, including suspension of trading activities, imposition of penalties, and potentially the initiation of liquidation proceedings. This graduated response system ensures that brokers have reasonable opportunities to address temporary financial difficulties while maintaining strict standards for client protection.

Bank Guarantee and Deposit Requirements with Exchanges

Stock exchanges impose additional security requirements on their members through mandatory bank guarantees and deposit mechanisms that serve as supplementary protection layers beyond regulatory capital requirements. These requirements are designed to create multiple safeguards for investor funds and ensure that exchanges have immediate recourse to funds in case of member defaults.

The bank guarantee requirements typically mandate that brokers provide unconditional bank guarantees from scheduled commercial banks, with the guarantee amounts being determined based on the broker's trading limits, client base size, and risk profile. These guarantees serve as first-loss protection for exchanges and can be invoked immediately upon member default without lengthy legal proceedings.

In addition to bank guarantees, exchanges require brokers to maintain various forms of deposits, including base minimum deposits, additional deposits based on trading turnover, and special deposits for specific market segments. These deposits are typically held in the form of cash, bank guarantees, or approved securities, creating a comprehensive security framework that protects both the exchange and market participants.

The deposit requirements are subject to periodic review and adjustment based on market conditions, volatility levels, and individual broker risk assessments. Exchanges maintain the discretion to increase deposit requirements for brokers who demonstrate higher risk profiles or who have experienced compliance issues, ensuring that security levels remain commensurate with actual risk exposure.

Case Law: Karvy Stock Broking Ltd. Capital Adequacy Violation

The case of Karvy Stock Broking Ltd. in 2019 represents a landmark enforcement action that highlighted the critical importance of capital adequacy compliance and the severe consequences of regulatory violations. This case involved significant misuse of client securities and funds, leading to substantial capital adequacy shortfalls and ultimately resulting in the revocation of the broker's registration.

The regulatory investigation revealed that Karvy had pledged client securities worth approximately Rs. 2,300 crores without proper authorization, creating unauthorized exposures that severely compromised the company's financial position. This misuse of client assets not only violated specific provisions regarding client asset protection but

also created artificial inflation of the company's apparent financial strength while simultaneously exposing clients to unacceptable risks.

SEBI's enforcement action in this case included immediate suspension of trading activities, appointment of an administrator to oversee client asset recovery, and initiation of proceedings for permanent cancellation of registration. The case demonstrated that capital adequacy violations, particularly those involving misuse of client assets, attract the most severe regulatory penalties and can result in complete business termination.

The Karvy case also established important precedents regarding regulatory responsibility for ongoing monitoring and the limitations of periodic compliance reporting in detecting sophisticated violations. The case highlighted the need for enhanced surveillance mechanisms and more frequent verification of broker compliance with capital adequacy norms.

Adjusted Net Worth Calculation Methodology and Compliance Monitoring

The calculation of adjusted net worth for stock brokers follows a comprehensive methodology that ensures accurate assessment of available capital for meeting regulatory requirements and client obligations. This calculation begins with the broker's total net worth as per audited financial statements and then applies various adjustments to arrive at the liquid net worth figure used for compliance purposes.

The primary adjustments involve deducting illiquid assets, including fixed assets, investments in group companies, advances to related parties, preliminary expenses, and other non-liquid items that cannot be readily converted to cash. Additional

adjustments may include provisions for doubtful debts, contingent liabilities, and other potential obligations that could impact the broker's financial position.

SEBI has established detailed guidelines for the treatment of various asset categories in net worth calculations, ensuring consistency across the industry and preventing manipulation of capital adequacy ratios through creative accounting practices. These guidelines are regularly updated to address emerging issues and maintain relevance with evolving market practices and accounting standards.

The compliance monitoring framework operates through multiple layers, including self-certification by brokers, periodic audits by chartered accountants, exchange-level monitoring, and direct SEBI supervision. This multi-tiered approach ensures comprehensive oversight while distributing monitoring responsibilities across various stakeholders in the regulatory ecosystem. Regular compliance reporting requirements mandate that brokers submit detailed financial information on monthly and quarterly basis, enabling continuous assessment of capital adequacy status and early identification of potential issues.

Chapter 4: Client Registration and Documentation

Regulation 18 - Client Registration and Account Opening Procedures

The Securities and Exchange Board of India (Stock Brokers and Sub-Brokers) Regulations, 1992, under Regulation 18, establishes comprehensive guidelines for client registration and account opening procedures that form the cornerstone of broker-client relationships in the Indian securities market. This regulation mandates that every stock broker must maintain detailed records of all clients and ensure proper documentation before commencing any trading activities on behalf of the client.

Under Regulation 18, stock brokers are required to obtain complete information about their clients including personal details, financial status, investment objectives, and risk tolerance levels. The regulation stipulates that brokers must verify the identity and address of clients through reliable documents and maintain proper records of all client interactions. The account opening process must be completed in accordance with prescribed formats and timelines, ensuring that no trading activities commence until all mandatory documentation is properly executed and verified.

The regulation further emphasizes the importance of maintaining accurate and up-to-date client records, requiring brokers to implement robust systems for data management and periodic updates. Brokers must ensure that client information is securely stored and easily accessible for regulatory inspections and audits. The

prescribed account opening forms must capture essential details including the client's investment experience, financial capacity, and specific instructions regarding trading preferences and risk parameters.

Know Your Customer (KYC) Compliance and Risk Profiling

Know Your Customer compliance represents a fundamental obligation for all stock brokers and forms an integral part of the client onboarding process. KYC procedures are designed to verify client identity, assess their financial standing, and understand their investment objectives while ensuring compliance with regulatory requirements and preventing fraudulent activities in the securities market.

The KYC process begins with the collection and verification of client identification documents, including Permanent Account Number (PAN), Aadhaar card, passport, or other government-issued identity proofs. Brokers must verify the authenticity of these documents through appropriate channels and maintain copies in their records. Address verification is equally critical and must be established through utility bills, bank statements, or other acceptable address proofs that are not older than prescribed time limits.

Risk profiling constitutes a crucial component of KYC compliance, requiring brokers to assess each client's risk tolerance, investment experience, and financial capacity. This assessment involves detailed questionnaires that evaluate the client's understanding of various financial instruments, their investment horizon, income levels, and existing financial commitments. Based on this evaluation, clients are categorized into different risk profiles that determine the types of products and services they can access.

The risk profiling process must be conducted with utmost care and accuracy, as it directly impacts the suitability of investment recommendations and trading strategies. Brokers are required to periodically review and update client risk profiles to ensure they remain current and reflective of any changes in the client's financial circumstances or investment objectives. This ongoing assessment helps maintain the integrity of the advisory process and ensures appropriate investment guidance.

Client Agreement Execution and Rights-Obligations Disclosure

The execution of client agreements represents a critical milestone in the broker-client relationship, establishing the legal framework that governs all future interactions and transactions. These agreements must comprehensively outline the rights and obligations of both parties, ensuring transparency and clarity in the relationship while providing adequate protection to clients' interests.

Client agreements must be executed in the prescribed format as specified by SEBI regulations, covering essential aspects such as brokerage charges, service charges, margin requirements, and settlement procedures. The agreements should clearly specify the scope of services to be provided by the broker, including trading facilities, research support, and advisory services where applicable. All terms and conditions must be presented in clear, understandable language, avoiding complex legal jargon that might confuse clients.

The rights and obligations disclosure forms an integral part of the client agreement, ensuring that clients are fully aware of their entitlements and responsibilities. Clients must be informed about their right to receive contract notes, periodic statements, and

other relevant documents within prescribed timelines. They should also understand their obligations regarding margin payments, settlement of trades, and compliance with exchange regulations.

Brokers are obligated to provide comprehensive disclosures about potential risks associated with securities trading, including market risks, liquidity risks, and operational risks. These disclosures must be presented in a format that enables clients to make informed decisions about their investment activities. The agreement should also specify the dispute resolution mechanisms available to clients and the procedures for grievance redressal.

In-Person Verification (IPV) Requirements and Exceptions

In-Person Verification requirements form a critical component of the client onboarding process, designed to ensure the physical verification of client identity and prevent fraudulent account openings. IPV procedures require designated personnel of the stock broker to physically meet the client and verify their identity through original documents before account activation.

The IPV process involves a face-to-face meeting between the client and an authorized representative of the stock broker, during which the client's identity is verified against original documents such as PAN card, Aadhaar card, or passport. The verification process includes taking a photograph of the client and obtaining their signature on the IPV form, which serves as documentary evidence of the verification process. This physical verification helps establish the authenticity of the client and reduces the risk of identity fraud.

However, regulations provide for certain exceptions to the mandatory IPV requirement under specific circumstances. Clients who have completed their KYC through intermediaries registered with SEBI or other financial sector regulators may be exempted from fresh IPV requirements, provided their existing KYC documentation meets prescribed standards. Additionally, clients residing in remote areas or facing genuine hardships may be allowed alternative verification methods subject to additional safeguards and approvals.

The exceptions to IPV requirements are carefully regulated and require proper documentation and justification. Brokers must maintain detailed records of all cases where IPV exceptions have been granted, including the specific reasons for the exception and the alternative verification methods employed. Regular audits and reviews ensure that these exceptions are not misused and that the integrity of the client verification process is maintained.

Case Law: SEBI v. Sharekhan Ltd. (2017) - Client Documentation Irregularities

The landmark case of SEBI v. Sharekhan Ltd. (2017) provides significant insights into the regulatory expectations regarding client documentation and the consequences of non-compliance with prescribed procedures. This case highlighted critical deficiencies in client onboarding processes and established important precedents for the securities industry regarding documentation standards and regulatory compliance.

In this case, SEBI investigation revealed multiple irregularities in Sharekhan's client documentation procedures, including inadequate KYC verification, improper execution of client agreements, and failure to maintain prescribed records. The

investigation found instances where clients were allowed to trade without completing mandatory documentation requirements, and several cases of insufficient address verification and identity confirmation. These irregularities posed significant risks to market integrity and client protection.

The regulatory action taken by SEBI in this case resulted in substantial penalties and corrective measures imposed on Sharekhan Ltd. The company was required to strengthen its client onboarding processes, implement enhanced verification procedures, and establish robust internal controls to prevent similar violations in the future. The case emphasized the importance of strict adherence to regulatory requirements and the serious consequences of non-compliance.

This case serves as a crucial reference point for the securities industry, highlighting the regulatory emphasis on proper client documentation and the need for brokers to maintain high standards of compliance. It underscores the importance of implementing comprehensive systems and procedures for client onboarding and the need for regular monitoring and review of these processes to ensure continued compliance with regulatory expectations.

Prevention of Money Laundering Act Compliance and Suspicious Transaction Reporting

Compliance with the Prevention of Money Laundering Act (PMLA) represents a critical obligation for stock brokers, requiring them to implement comprehensive systems and procedures to detect, prevent, and report suspicious transactions. These requirements are designed to prevent the securities market from being used for money laundering activities and to ensure the integrity of financial transactions.

Under PMLA requirements, stock brokers must establish robust systems for monitoring client transactions and identifying patterns that may indicate money laundering activities. This includes implementing transaction monitoring systems that can flag unusual trading patterns, large cash transactions, and other suspicious activities. Brokers must maintain detailed records of all transactions and be prepared to provide this information to regulatory authorities when required.

The suspicious transaction reporting mechanism requires brokers to report any transactions or patterns of transactions that appear unusual or inconsistent with the client's known financial capacity or business activities. These reports must be filed with the Financial Intelligence Unit-India (FIU-IND) within prescribed timelines and must contain comprehensive details about the suspicious activities. Brokers must also ensure that their staff is adequately trained to identify and report suspicious transactions.

Compliance with PMLA requirements extends beyond transaction monitoring to include customer due diligence measures, record keeping requirements, and ongoing monitoring of client relationships. Brokers must implement risk-based approaches to client monitoring, with enhanced due diligence measures for high-risk clients and transactions. Regular training programs and awareness sessions must be conducted to ensure that all staff members understand their obligations under the PMLA and are equipped to identify and respond to potential money laundering activities effectively.

Chapter 5: Trading Operations and Risk Management

Regulation 19 - Authorized Representative Appointment and Supervision

The Securities Contracts (Regulation) Rules, 1957, under Regulation 19, establishes a comprehensive framework for the appointment and supervision of authorized representatives by stock brokers. This regulation serves as a cornerstone for ensuring that trading operations are conducted through qualified and supervised personnel who maintain the highest standards of market integrity.

Under Regulation 19, every stock broker must appoint authorized representatives who act as intermediaries between the broker and clients. These authorized representatives must possess the necessary qualifications, including passing the requisite examinations conducted by recognized stock exchanges or SEBI-approved training institutes. The regulation mandates that brokers maintain complete records of their authorized representatives, including their educational qualifications, training certificates, and ongoing performance evaluations.

The supervision aspect of Regulation 19 requires brokers to implement robust monitoring systems to oversee the activities of their authorized representatives. This includes regular training programs, compliance audits, and performance reviews to ensure that representatives adhere to regulatory guidelines and ethical standards.

Brokers are held liable for the actions of their authorized representatives, creating a strong incentive for effective supervision and control mechanisms.

The regulation also establishes clear guidelines for the termination of authorized representatives, including mandatory reporting to exchanges and regulatory authorities. This ensures that any instances of misconduct or regulatory violations are properly documented and communicated across the financial ecosystem, preventing problematic individuals from simply moving between different brokerage firms without disclosure of their past issues.

Position Limits and Exposure Management Systems

Position limits represent a critical risk management tool designed to prevent excessive concentration of positions that could potentially destabilize markets or create systemic risks. These limits are established at multiple levels, including individual client limits, broker-level limits, and market-wide limits across different segments of the securities market.

Individual position limits are calculated based on various factors including the client's financial capacity, trading history, and the nature of securities being traded. These limits serve as the first line of defense against excessive risk-taking and help protect both individual investors and the broader market from potential defaults. Brokers are required to implement real-time monitoring systems that track client positions against these predetermined limits and prevent trades that would result in limit breaches.

Broker-level exposure management systems encompass comprehensive risk assessment frameworks that monitor aggregate exposures across all clients and trading strategies. These systems must be capable of calculating real-time exposures, stress

testing portfolios under various market scenarios, and implementing automatic risk mitigation measures when predetermined thresholds are breached. The systems must also maintain detailed audit trails of all risk management decisions and actions taken.

Market-wide position limits are established by exchanges and regulatory authorities to prevent any single entity or group of entities from accumulating positions large enough to manipulate prices or create undue influence over market movements. These limits are particularly important in derivative markets where leverage can amplify both gains and losses significantly. Regular monitoring and reporting of large positions ensure that regulatory authorities maintain oversight of potential systemic risks.

Margin Collection and Settlement Guarantee Fund Contribution

The margin collection mechanism forms the backbone of risk management in securities trading, ensuring that participants maintain adequate collateral to meet their potential obligations. This system operates on the principle of collecting margins before allowing trades to be executed, thereby reducing counterparty risk and protecting the integrity of the settlement system.

Initial margins are collected at the time of trade execution and are calculated based on the volatility and risk characteristics of the underlying securities. These margins are designed to cover potential losses that might occur between the trade date and the next margin collection cycle. The calculation methodologies employ sophisticated statistical models that analyze historical price movements and volatility patterns to determine appropriate margin requirements.

Variation margins are collected daily to account for mark-to-market losses on outstanding positions. This daily settlement process ensures that losses are recognized and collateralized promptly, preventing the accumulation of large unrealized losses that could threaten the financial stability of market participants. The variation margin system requires participants to make additional payments when their positions move against them, maintaining the adequacy of collateral throughout the life of the position.

Settlement guarantee fund contributions represent an additional layer of protection whereby all clearing members contribute to a common pool of resources that can be utilized to complete settlements in case of member defaults. These contributions are calculated based on the trading volumes and risk profiles of individual members, ensuring that those who contribute more to systemic risk also contribute proportionally more to the protection fund. The guarantee fund serves as a crucial backstop that enables the continuation of market operations even when individual participants face financial difficulties.

Real-time Risk Management and Circuit Breaker Mechanisms

Real-time risk management systems represent the technological backbone of modern securities markets, providing continuous monitoring and automatic intervention capabilities to prevent excessive volatility and maintain orderly trading conditions. These systems operate on microsecond timeframes, analyzing market data and participant positions to identify potential risks before they can materialize into market disruptions.

Circuit breaker mechanisms are automatic trading halts triggered when predetermined price movement thresholds are breached. These mechanisms operate at multiple levels, including individual security level circuit breakers that halt trading in specific stocks experiencing unusual price movements, and market-wide circuit breakers that suspend trading across entire exchanges when broad market indices experience significant declines. The design of these mechanisms balances the need to prevent panic selling with the importance of maintaining market liquidity and price discovery functions.

The implementation of real-time risk management requires sophisticated technology infrastructure capable of processing vast amounts of market data simultaneously. These systems must integrate position data, market prices, volatility measures, and correlation patterns to provide comprehensive risk assessments. Advanced algorithms continuously calculate portfolio risks and trigger alerts or automatic actions when risk parameters exceed predetermined thresholds.

Risk management systems also incorporate pre-trade risk checks that evaluate proposed trades against various risk parameters before allowing execution. These checks include position limit verification, margin adequacy assessments, and concentration risk analysis. Post-trade monitoring continues throughout the trading session, with systems capable of automatically liquidating positions or restricting further trading when risk limits are breached.

Case Law: NSE Co-location Scam (2017) - Fair Access and Risk Management

The NSE co-location scam of 2017 represents a landmark case in Indian securities market regulation, highlighting critical issues related to fair market access and the importance of robust risk management systems. This case emerged when it was discovered that certain high-frequency trading firms had gained preferential access to market data through co-location facilities at the National Stock Exchange, creating an unfair advantage over other market participants.

The investigation revealed that some brokers and trading firms had been provided with faster access to market data feeds, enabling them to place and modify orders with timing advantages measured in milliseconds. This preferential treatment violated the fundamental principle of fair access that underpins market integrity, as it allowed certain participants to consistently profit at the expense of others who did not have access to the same speed advantages.

The regulatory response to this scandal included comprehensive reforms to exchange governance structures, implementation of stricter oversight mechanisms for technology systems, and enhanced surveillance capabilities to detect similar irregularities. SEBI imposed significant penalties on the exchange and individual officials, while also mandating structural changes to prevent recurrence of such violations.

The case established important precedents regarding the responsibility of exchanges to ensure fair access to market infrastructure and the need for continuous monitoring of technological systems that could impact market fairness. It also highlighted the importance of having independent risk management functions that can identify and address potential conflicts of interest between exchange commercial interests and regulatory responsibilities.

Algorithmic Trading Approval and Surveillance Requirements

Algorithmic trading has transformed modern securities markets, requiring comprehensive regulatory frameworks to ensure that automated trading systems operate within acceptable risk parameters and do not compromise market stability. The approval process for algorithmic trading involves detailed scrutiny of trading algorithms, risk management systems, and operational procedures.

The approval requirements mandate that algorithmic trading systems include robust risk management features such as position limits, loss limits, and automatic shutdown mechanisms. These systems must be capable of monitoring their own performance and automatically ceasing operations when predetermined risk thresholds are breached. The algorithms must also include features to prevent erroneous orders and market manipulation, with built-in checks for order size, price, and frequency parameters.

Surveillance requirements for algorithmic trading encompass continuous monitoring of algorithm performance, trade pattern analysis, and detection of potentially manipulative behaviors. Exchanges and regulatory authorities employ sophisticated surveillance systems that can identify unusual trading patterns, detect potential market abuse, and ensure compliance with regulatory requirements. These systems analyze vast amounts of trading data to identify patterns that might indicate algorithm malfunction or manipulative intent.

The regulatory framework also requires detailed documentation of algorithmic trading strategies, including backtesting results, risk assessments, and operational procedures.

Regular audits and compliance reviews ensure that algorithmic trading systems continue to operate within approved parameters and that any modifications or updates are properly authorized and documented. This comprehensive approach helps maintain market integrity while allowing for the benefits of technological innovation in trading operations.

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OUR TEAM



Adv. Aaditya D. Bhatt
Co-Founder



Adv. Chandni Joshi
Co-Founder



Adv. Sneh R. Purohit
Senior Associate



Adv. Arjun S. Rathod
Senior Associate



Adv. Dhruvil V. Kanabar
Associate



Adv. Vishal D. Davda
Associate



Adv. Harshika Mehta
Associate



Adv. Prapti B. Bhatt
Associate

Adv. Aaditya Bhatt

Co-Founder, Bhatt & Joshi Associates

Advocate Aaditya Bhatt, co-founder of Bhatt & Joshi Associates, is a distinguished legal professional with a remarkable career. Renowned for his unwavering ethics and innovative problem-solving, he excels in various legal disciplines. Bhatt's leadership and analytical prowess make him an invaluable asset to the firm and legal community.



Adv. Chandni Joshi

Co-Founder, Bhatt & Joshi Associates

Advocate Chandni Joshi, co-founder of Bhatt & Joshi Associates, is a prominent legal expert with extensive knowledge across multiple disciplines. Her commitment to professional ethics and innovative solutions sets her apart. Joshi's exceptional interpersonal skills and sharp analytical mind make her an indispensable leader in both the firm and the wider legal sphere.



Office No. 311, Grace Business Park B/h. Kargil
Petrol Pump, Epic Hospital Road, Sangeet
Cross Road, behind Kargil Petrol Pump, Sola,
Sagar, Ahmedabad, Gujarat 380060

www.bhattandjoshiassociates.com