

## **Improving the legal process in enforcement at SEBI**

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**Indira Gandhi Institute of Development Research, Mumbai  
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## **Abstract**

*The first statutory regulatory body that the government of India set up post the reforms of 1991 was the Securities and Exchanges Board of India (SEBI). As a regulator for the securities markets, SEBI was given the powers to create subordinate legislation and to investigate wrong-doing and impose relevant penalties. In this paper, we examine and describe the legal processes at SEBI with a focus on the enforcement process, particularly on the quasi-judicial functions. We make an attempt to lay out the principles that ought to drive such functions in a regulatory body, against which we compare the current workings at SEBI. We propose a series of improvements through which the rule of law could be further strengthened.*

## **Keywords:**

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# 1 Introduction

In the post-reform period of the last two decades, one of the more important innovations facilitating a more rapid pace of economic development has been the creation of *regulators*. These are statutory entities that were placed outside of the machinery of the government, but given powers to regulate and supervise a sector. One reason for the government to create such entities was to have expert bodies to regulate sectors where they faced an increasing complexity of economic activities. Here, the regulator would have domain knowledge to deal with such complex issues. A more powerful reason was the arms-length relationship that freed the regulatory entities from the political compulsions of the government. This was especially important in the development of those sectors where there was a dominance of public ownership among the firms in the sector.

In India, there have been several regulators that have been set up, the more prominent of which have been SEBI (securities markets), TRAI (telecom) and CERC (energy). Of these, SEBI was among the first, and has been seen to be one of the more effective in terms of delivering on a mandate that includes (a) protection of the investor, (b) prudential regulation of securities markets intermediaries and (c) development of the markets.

In order to implement the mandate, the legal foundations to create regulators must have broad enabling legislation. The legislation gives the regulator powers to issue regulations for the sector, and to supervise based on the regulation. But most importantly, the regulator must be empowered to conduct investigation of misdemeanours, adjudicate and have the authority to impose fines and other penalties if wrong-doing is established. Lastly, the credibility of the regulatory process of the regulator is enforced when there are in place appeals processes by courts that have specialised domain knowledge to review regulatory action (which, in the case of the SEBI and securities markets, is the Securities Appellate Tribunals or SAT).

This paper examines various aspects of the legal process at SEBI, starting with the separation of powers between Government and SEBI. To date, there has been little intervention by Parliament in the regulations implemented by SEBI. While legislation places much of the details of how regulation is operationalised within SEBI's powers, the government retains the powers to decide the organisational structure, with the powers to appoint the top management at SEBI. Aside of this, SEBI has the freedom to decide how regulation is to be operationalised, which uses the three mechanisms of regulations, circulars and guidelines.

What is pointed out in this paper about the regulatory process at SEBI in comparison to processes of some of the other regulators is the extent to which the process is transparent. This is a key feature that is critical to improve the effectiveness of SEBI both in its mandate to protect the rights of the investor as well as to allow for an enabling framework for markets to develop.

The need for transparency is particularly emphasised in the process of enforcement which has proved to be critical in the effectiveness of a regulator. The enforcement process at SEBI includes inspections of intermediaries on a regular basis, investigations on receipt of some information of violation or possible violation, and disciplinary action, which can include a variety of penalties including monetary fines. Here, it is observed that while the processes at SEBI are some of the most transparent and clear in the market, there are still areas where it can be improved. These include eliminating instances of simultaneous orders, improving consistency of regulatory amendments through circulars, systems for review of the investigative processes, ensuring uniformity of processes followed by adjudicating officers, among others.

This paper is organised as follows. Section 3 outlines the process through which SEBI issues regulations, circulars and guidances. We also focus on the enforcement aspect of the regulatory mandate in detail (Section 3.4) with a view to understand how efficient and fair the enforcement process is. We examine the principles that the process of regulation stands upon in Section 4, comparing the processes at SEBI both with those at other regulatory agencies in India as well international regulatory bodies. Lastly, we combine our understanding of current SEBI systems and those that are desirable according to the principles of regulation to offer some proposals for improving the enforcement process in Section 5. We conclude in Section 6.

## **2 The regulator in the new India**

The economic reforms of the early nineties shifted emphasis away from central planning to a more market-oriented economic process. The role of the government shifted away from running businesses towards regulation and supervision. In the process, new regulatory entities were created. These are entities that are outside of the government, though under the supervision of the government. Thus, they are intended to be more independent of the political compulsions of the political party in power, that typically shape the behaviour of the Government of India (GOI) itself.

Regulators are intended to be free of the conflicts of interest that come from state-ownership the public sector companies (called *public sector units* or PSUs). This is particularly important in making private investors feel comfortable about having a level playing field when competing against PSUs. Regulators are intended to develop specialised skills in the field, by breaking away from human resource policies of the government which emphasise generalists.

The legal foundations for regulators involves broad enabling legislation. The legislation also gives powers to the regulator to issue *subordinate legislation* which are required to be tabled in Parliament after they have been issued. This makes it possible for detailed domain knowledge to be embedded in subordinate legislation, which could evolve rapidly. The regulator would then operationalise these regulations in its supervisory function.

Regulators feature a unique combination of functions of writing law and administering it. Besides conducting investigations, regulators are also responsible for adjudicating and imposing fines and other penalties for misdemeanours.

The establishment of a regulator with such capabilities involves three steps:

- 1. Definition of mandate of the regulator:** Parliament legislates the establishment of a regulator and definition of its mandate.
- 2. Creation of subordinate legislation:** *Rules* are issued/notified by Parliament, which in the case of SEBI, define the organisational structure for the regulator, the powers of the regulator, how the regulator will be financed, etc. This is done by enacting various rules under the Securities and Exchanges Board of India Act (referred to as the SEBI Act) of 1992.

*Regulations* are issued by the regulator on an array of issues defined in the primary legislation. The regulator also issues *guidelines* and *circulars*. These come into play where there is a need for interpretation of regulation and removing difficulties by implementing them. Such requirements arise with *new* regulations or where there is uncertainty about what existing regulations mean for innovation in products and services.

The regulator may also issue an advance ruling which is called an *Informal Guidance*. In the case of SEBI, the regulator only issues *advance rulings* when asked to do so, or is required to.<sup>1</sup>

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<sup>1</sup>SEBI issues Informal Guidance, as legally, the Parliament has not empowered SEBI

**3. Enforcement of the regulatory mandate:** Investigations are carried out by the regulator who is given the authority to enforce the legal framework, by the SEBI Act. The regulator also adjudicates on the violations and is empowered to levy fines and other penalties. This is called the *quasi-judicial* role of the independent regulator.

In order to ensure that penalties are in line with the magnitude of the misdemeanour, the SEBI Act defines limits upon these penalties. Specialised appeals procedures have also been created in order to facilitate rapid review of regulatory actions by courts that have specialised domain knowledge. These are the *Securities Appellate Tribunals* (referred to as SAT).

The relationship between the Parliament and an independent regulatory agency is one of oversight, and of regular reviews of the legal framework. In this supervisory role, the government has to ensure that the independent regulatory agency performs the functions envisaged under the Act.

Over the years, the scale and scope of the activities that SEBI regulates has grown enormously. It is hence useful to review the existing legal process at SEBI to understand:

1. What are the processes in place today, and how have these evolved?
2. Are there changes that needs to be brought into these processes today to obtain greater fairness, and track the best practices worldwide? What are these changes?

### 3 Legal process at SEBI

In this section, we describe the different processes defining the regulatory powers at SEBI, which starts with the legislation called the *SEBI Act, 1992* that creates the regulator.

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with statutory powers to issue advance ruling. However, the principle behind the advance ruling and informal guidance is the same.



### 3.1 SEBI's mandate

The preamble to the SEBI Act, 1992<sup>2</sup> establishes SEBI's mandate. These broadly include:

1. Investor protection,
2. Regulation of the securities market, and
3. Promotion and development of the securities market

SEBI therefore works under a statutory mandate where there is an added mandate of market development and promotion, along with investor protection and market regulation, as the statutory duty of the regulator. In contrast, Box 3.1 indicates that market development is not an explicit goal in the mandate of either the U.S. or the U.K. securities market regulator.

### 3.2 Legislation delegated by the SEBI Act, 1992

GOI and SEBI together provide a regulatory framework for regulating the securities market. Their roles are segregated as:

**Role of the central government:** Organisation of the Board structure as well as the appointment of the SEBI Board members. In particular, GOI is empowered to enact rules<sup>3</sup> relating to:

- Appointment of the Chairman and the Board members of SEBI, along with the terms and conditions of these appointments.
- Accounts, returns and the reports which SEBI is to maintain and/or file with the GOI.
- Imposition by SEBI of monetary penalty for misdemeanour in the securities markets.<sup>4</sup>
- Functioning of the Securities Appellate Tribunal, or SAT, which is a statutory judicial body that can hear appeals inter-alia against SEBI orders.

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<sup>2</sup>The preamble states: "*An Act to provide for the establishment of a Board to protect the interests of investors in securities and to promote the development of, and to regulate, the securities market and for matters connected therewith or incidental thereto.*"

<sup>3</sup>Section 29 of the SEBI Act, 1992.

<sup>4</sup>Section 15-I read with Section 2(g) of the SEBI Act, 1992.

### **Box 1: Comparisons with international financial sector regulators**

Financial sector *regulation in the U.S.* is fragmented between two regulators, the Securities and Exchanges Commission (SEC) which is the securities markets regulator, and the Commodities and Futures Trading Commission (CFTC) which is primarily about the derivatives market for all underlyings. The stated mission of the SEC appears to be to:

- Protect investors,
- Maintain fair, orderly, and efficient markets, and
- Facilitate capital formation with emphasis on investor protection and protecting the savings of the investor with sound market regulation.

The *regulatory framework in the U.K.*, on the other hand, has gone through significant changes over the last decade. Regulation of all financial services was brought under one regulatory entity, the Financial Services Authority (FSA). The enabling act, the Financial Services and Markets Act, 2000 (FSMA) provides for five statutory objectives:

1. Market confidence - maintaining confidence in the financial system;
2. Public awareness - promoting public understanding of the financial system
3. Financial stability - contributing to the protection and enhancement of the UK financial system
4. Consumer protection - securing the appropriate degree of protection for consumers and
5. Reduction of financial crime - reducing the extent to which it is possible for a business to be used for a purpose connected with financial crime.

On a comparison of the objectives of the securities market regulators, investor protection and regulation of the market appear to be common objectives to be achieved by any securities regulator in the world.

The organisation structure set in place for SEBI<sup>5</sup> includes eight members other than the Chairperson:

- Three Board members, who are Whole Time Board Members (referred to as *WTM*).

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<sup>5</sup>Section 4 of the SEBI Act, 1992

- One representative from the Ministry of Finance (*MoF*),
- One representative from the Reserve Bank of India (*RBI*),
- One representative from the Ministry of Corporate Affairs (*MCA*),  
and
- Two other persons, who are experts in their field.

The GOI has the ability to influence SEBI policy decision making process through its nominees on the SEBI Board. So while SEBI has the freedom, independence and autonomy to decide the regulatory framework, GOI through its board members expresses its views that lead up to Board decisions.

**Role of the regulator:** The SEBI Act, 1992 provides the duties<sup>6</sup> of the regulator which includes:

- Regulating intermediaries through regulations, rather than through government notified rules.
- Prohibition and prevention of *Insider Trading*.
- Framing Regulations for *Take-Overs*.
- Preventing unfair trade practice and market manipulation.
- Regulating issue of capital.
- Regulating stock-exchanges and transactions on the stock-exchanges.

The SEBI Act, 1992 gives SEBI power to draft regulations in order to regulate the market and discharge its functions and duties. While the objectives are provided in the SEBI Act, 1992, the implementation details are left to the regulator. The securities market is regulated more through regulations than through the SEBI Act, 1992.

This is in marked contrast to other statutes in India, which provides for the regulatory framework in the parent Act. For example, the Income-Tax Act is a complete self sufficient code, and the income tax authorities are required to implement the Act as against *notifying*<sup>7</sup> the regulatory framework. They are not expected to notify the regulatory framework and be policy decision-makers. The government notifies not

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<sup>6</sup>Section 11(1) and 11(2) of the SEBI Act, 1992

<sup>7</sup>The term “notify” in the context of regulations means the publication of the regulations in the Official Gazette of the GOI.

only the Act but also the rules. Similarly, the Parliament notifies the Indian Companies Act, 1956, and the government notifies the rules thereunder. In the case of SEBI, Parliament has delegated its powers of drafting the regulatory framework to SEBI.

Besides the parent Act, SEBI also has powers under the provisions of the Securities Contract (Regulation) Act, 1956, (referred as the SCR Act) to notify the framework to regulate stock exchanges, and transactions on the stock exchanges, as well as the depositories under the provisions of the Depositories Act, 1996.

While there is one layer of a relationship between GOI and SEBI, there is another layer of a relationship between SEBI and stock exchanges. Stock exchanges themselves perform regulatory and supervisory functions in terms of defining rules and enforcing them.<sup>8</sup> SEBI is required to approve the rules<sup>9</sup> defined by stock exchanges, and also take up enforcement cases which are identified by stock exchanges.

### **3.2.1 Delegated legislation by GOI**

A feature of the SEBI rules framed by GOI is that they are, by and large, not known to the public until *after* they are enacted. Presently, there is no requirement under law for the GOI to have a public consultancy process before notifying the rules under the SEBI Act. Neither has the GOI, barring a few exceptions, called for public comments or consultation before notifying the rules under the SEBI Act, in practice.

In practice, however, since a majority of the rules notified by the GOI have to do with the management of SEBI and the SAT, there has been no occasion when the public have raised their voice, or demanded public consultation, before an enactment of the rule.

### **3.2.2 Delegated legislation by SEBI**

While enacting the SEBI Act, 1992, Parliament laid down only three requirements: (a) that the regulations are to be made by the SEBI Board, (b) these will be in the interest of the investors and the markets, and (c) that

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<sup>8</sup>Section 4 and 9 of the SCR Act, 1956.

<sup>9</sup>Section 8 of the SCR Act, 1956.

after notification in the Official Gazette, they will be placed in the House of the Parliament.

Other than these, the SEBI Act, 1992, has *not* provided for the manner and mechanism by which the regulations will be framed and notified by SEBI. SEBI regulates the markets through three mechanisms: *regulations*, *circulars*, and *guidelines*.

**Regulations:** Unlike the procedure followed by the GOI, SEBI has evolved a more transparent procedure of its own for drafting, formulating and notifying regulations. Right from the start, in 1992, before notifying any regulation, SEBI has issued a public *concept note* or *policy paper* on the proposed regulations.

For example, the SEBI (Insider Trading) Regulations of 1992, which were aimed at prohibiting insider trading, were preceded by a concept paper containing the objectives, rationale and provisions of the proposed regulation. This concept paper was posted on the SEBI website seeking comments and suggestions from the public. On receipt of the comments from the public, these were internally debated within SEBI. The revised draft regulations, along with comments received from the public, were then circulated for the consideration and approval of the SEBI Board.

SEBI also appoints committees to recommend the contents of regulations.<sup>10</sup> The committees, which consist of experts as well as policy-makers, study the matter and present recommendations in a

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<sup>10</sup>An example of this was the notification of the committees for suggesting amendments to the SEBI (Substantial Acquisition of Shares and Take Over) Regulations, 1997. These regulations were initially notified in 1994. Thereafter, when there was a need to review the regulations, SEBI appointed a committee chaired by the former Chief Justice of India, Mr. P.N. Bhagwati in November 1995. The committee, which consisted of lawyers, investors, corporates and representatives of the stock exchange, gave its report along with the draft regulations. The report of the committee along with the proposed regulations were placed on the SEBI website inviting criticisms, comments and suggestions on the same in January 1997. The suggestions were all collated, considered, after which SEBI repealed the regulations of 1994 and notified the Substantial Acquisition of Shares and Take Over Regulations, 1997.

After more than a decade of implementing regulations, the changing economic environment and other growing market needs indicated the need to re-examine even the regulations of 1997. Once again, the same process was followed from the start, with SEBI appointing a committee with lawyers, investors, market participators as well as senior officers of SEBI under the Chairmanship of Mr. Achutan (formerly of SAT) in September 2009. The committee report and draft regulations were posted on the SEBI website for public comments in July 2010.

report. The report first gets placed before the public for a period of time for comments. At the end of this period, SEBI takes a decision, and the regulations are amended. On the day SEBI Board approves the regulations, the decision of the SEBI Board is communicated to the public by means of a press release.

**Circulars and Guidelines:** SEBI also regulates the securities market through guidelines and circulars. Normally, circulars are meant for clarifying the existing regulatory framework, and not for notifying a new framework. Circulars are to be issued within the legal parameters specified in the Act and the regulations. Circulars have been issued by almost all the departments of SEBI.

SEBI does not always follow a public consultation route before the circular is notified. But in many cases, SEBI does discuss the circular with many market participants.

There is significant transparency in the formulation of the regulations of SEBI from the time the regulations are being conceptualised, up to the stage when the regulation is notified. SEBI was the first regulator in the country to bring about this level of transparency in the formulation of its regulatory framework, to the extent that, today, the agenda papers for meetings of the SEBI Board are placed on the SEBI website prior to the meeting itself.

### **3.2.3 Parliamentary control over SEBI regulations**

Regulations drafted by SEBI are required to be presented before each House of Parliament.<sup>11</sup> Only if both Houses of the Parliament decide that the regulations should be rescinded or be modified that the regulations become effective in the modified form. Thus far, such an event has not arisen in the history of SEBI.

## **3.3 Process for Informal Guidance**

While the text of a regulation is visible, there may be a lack of legal certainty owing to poor drafting, lack of precedents, or innovations in products or processes. Under such situations, there is a role for *advanced rulings*, where a participant can approach the regulator for a clarification without prejudice to his contentions and rights. Most regulators typically have a provision of

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<sup>11</sup>Section 31 of the SEBI Act, 1992.

*advance ruling* in the parent Act, where the statutory binding provisions are found in the statutes.<sup>12</sup>

The advantage of statutory provisions is that these become binding on all the parties concerned. Thus, even though the use of advance ruling arises because of ambiguity about the regulation, once the advance ruling is resolved as a decision, no one can resile from the same or challenge the same as being non-binding.

In contrast, SEBI introduced the SEBI (Informal Guidance) Scheme, 2003, which enables any intermediary registered with SEBI to make a request for informal guidance.<sup>13</sup> The intermediary can be a listed company, a company seeking listing, a mutual fund, a trustee company, an asset management company or an acquirer/prospective acquirer.

The scheme enables an applicant to seek guidance from a department of SEBI. They can request the department of SEBI to issue either an *interpretive letter* and/or a *no action letter*.<sup>14</sup>

- The *interpretive letter* enables the applicant to seek interpretation from a department of SEBI on the specific provision of the Act, rules, regulation, circulars, guidances, within the context of either a proposed transaction, or a specific factual situation.

The applicant is required to disclose all material facts, circumstances, the legal provisions, as well as whether the request is confidential. These facts have to be kept confidential by SEBI. The request for confidentiality holds for 90 days from the date of response from the

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<sup>12</sup>For example, the Income-Tax Act, 1961 (referred to as the IT Act) provides for advance ruling. The statutory provisions of the IT Act, 1961, enables a person affected and liable to pay income tax under the transaction to approach the IT Department by asking for advance ruling from the *Advance Tax Authority* (ATA). The ATA is defined, under the IT Act, as a statutory authority consisting of senior personal e.g. a Retired Supreme Court Judge, an IRS officer qualified to be a member of the Central Board of Direct Taxes (CBDT), a board constituted under the Income Tax Act to which all the income tax employees report to, and a legal service officer qualified to be an additional secretary to the GOI.

The ATA, as per the provisions of the IT Act, 1961, is considered a judicial authority with powers of the Civil Court. Before accepting or rejecting an application of *advance ruling*, the ITA grants an opportunity of personal hearing to the applicant. The decision of the authority then becomes final and binding on the IT department as well as the applicant.

<sup>13</sup>Clause/Item 4, SEBI (Informal Guidance) Scheme, 2003.

<sup>14</sup>Clause/Item 5, SEBI (Informal Guidance) Scheme, 2003.

department, if the department is agreeable to the request.<sup>15</sup>

If the confidentiality request is denied, the applicant is so advised, and they may withdraw the informal guidance letter within 30 days of receiving the advice from the SEBI department. The concerned department is required to dispose of the request within 60 days of the receipt of the request.

If the letter issued by the department has been obtained either by fraud, misrepresentation, the department has the choice of declaring such a letter to be *non-sent*. The case will then be dealt with as if such a letter had never been issued by SEBI.

- The *no action letter* enables the applicant to apply to SEBI to find out whether the concerned department of SEBI will or will not recommend any action under the regulatory framework of SEBI in case a proposed transaction is consummated.

As per the provisions of the scheme, the no action or interpretive letter constitutes the views of the department, and is not binding on SEBI. This is strikingly different from the case of the IT Department example above. In general, SEBI has been known to act in accordance with the no action letter or the interpretive letter issued by the department. Neither is to be construed as conclusive decision or determination of any question of law or violation by SEBI. However, when a no action letter is issued by a department, it means that the department is unlikely to recommend enforcement action to the Board.

## 3.4 Enforcement

The first step in the enforcement process is conducting inspections and investigations. The second step are actions taken based on the findings of the inspection and investigations.

### 3.4.1 Inspections and Investigations

Typically, investigations are conducted when SEBI gets knowledge of misdemeanour. Some of the major sources of information that SEBI relies on are investors, intermediaries, adversaries, insiders and media. Another

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<sup>15</sup>Clause 11 (a) of SEBI (Informal Guidance) Scheme, 2003.



source of information are the periodic inspections of intermediaries which SEBI undertakes.

**Inspections** SEBI is empowered to conduct inspections of registered intermediaries.<sup>16</sup> These can be initiated either as a matter of routine, or to ensure compliances with the provisions of law, or on investor complaints. The procedure followed by SEBI in all cases is normally the same. Hence though different regulations may be applicable to different intermediaries, the procedure in case of inspection and investigation is almost the same.

Inspections are authorised by the Whole Time Member (WTM) on the board of SEBI who is in charge of intermediaries. For example, SEBI (stock-broker and sub-broker) regulations empowers SEBI to conduct inspection of stock brokers and sub-brokers. The WTM also appoints the inspection officer. In case of routine inspections, prior notice is always given by SEBI. However, regulations entitle the inspecting officer to waive the requirement of prior notice.<sup>17</sup>

Regulations empower SEBI to take help of outside professional independent auditors during inspection.<sup>18</sup> Intermediaries and their employees are under a statutory obligation to co-operate in the inspection process.

Upon completion of the inspection, SEBI forwards the inspection report to the intermediary for its comments on the alleged violations, or irregularities, thus giving the intermediary an opportunity for written (not only oral) representation before initiating disciplinary proceedings. After considering oral and written submissions, the WTM decides whether action should be initiated against the intermediary.

**Investigation** Besides inspection, SEBI is empowered to conduct investigations in case of breach of any regulation, or in case of action detrimental to interest of investors.<sup>19</sup>

On receipt of information of a violation, or a possible violation, the WTM may pass a formal order appointing one of its officers to investigate the alleged violation. The investigating officer can summon

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<sup>16</sup>Section 11(2)(i) of the SEBI Act, 1992

<sup>17</sup>For example, Regulation 20(2) of the SEBI (Stock Broker and Sub Broker) Regulations, 1992.

<sup>18</sup>Regulation 24 of the SEBI (Stock Broker and Sub Broker) Regulations, 1992.

<sup>19</sup>Section 11(c)(1) of SEBI Act, 1992.

the intermediary to appear before them to produce documents and to give evidence.

The investigating officer can conduct a search of premises and seize books and registers. But they are required to approach a Judicial Magistrate for appropriate orders, before exercising the search and seizure powers, even for attaching the bank account of any person.<sup>20</sup>

The investigating authority thereafter submits either an interim report or a final report which is circulated to a internal committee of senior officers of SEBI. The internal committee will decide whether any enforcement action needs to be initiated. The report of the internal committee the report is then forwarded to the WTM to decide on the further course of action.<sup>21</sup>

SEBI's powers of enforcement have become substantially enhanced with various amendments<sup>22</sup> to the parent Act, compared to the powers of enforcement when the SEBI Act was first enacted in 1992. For example, this includes the power of search-and-seizure, the power to impose monetary penalty, and enhanced criminal penalty.

### 3.4.2 Orders and Directions

If evidence of misdemeanour is found, SEBI initiates disciplinary action (given its quasi-judicial authority). These can be one of two types: *orders* and *directions*, and varies depending upon the offence for which the action is being issued, which are the following:

- Suspending or canceling certificate of registration of the certificate,<sup>23</sup>
- Imposition of monetary penalty,<sup>24</sup>
- Restraining a person from accessing the securities market.<sup>25</sup> These can even be issued without giving an opportunity of hearing, provided that a post decisional opportunity of hearing is given.<sup>26</sup>

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<sup>20</sup>Section 11(4)(e) and 11(c)(8) of SEBI Act, 1992.

<sup>21</sup>The internal committee discussion is not a statutory requirement, but it is a procedure that SEBI has adopted.

<sup>22</sup>SEBI (Amendment) Act, 2002, w.e.f. 29 – 10 – 2002.

<sup>23</sup>Section 12(3) of SEBI Act, 1992.

<sup>24</sup>Section 15(A) to Section 15(J) of SEBI Act, 1992.

<sup>25</sup>Section 11(4)(b) of SEBI Act, 1992.

<sup>26</sup>2<sup>nd</sup> proviso of Section 11(4) of SEBI Act, 1992.

- Initiate criminal proceedings by filing a criminal complaint before the Sessions Court.<sup>27</sup>

The precise mechanism employed at SEBI consists of the following categories:

- *Orders in case of cancellation or suspension of the registration granted to an intermediary*

The SEBI (Intermediaries) Regulations 2008 provides the procedure to be followed for initiating action against the intermediary whose registration is to be cancelled or suspended.<sup>28</sup>

The first step involves appointing an enquiry officer<sup>29</sup> (EO) as the designated authority. The EO can issue show cause notices specifying the alleged contraventions and annexing the copies of the relevant documents. The noticee is given a specified time period within which written and oral representations can be made.<sup>30</sup> At the end of the process, EO submits a report which contains the findings as well as the recommended penalty.<sup>31</sup>

It is the WTM who then issues a show cause notice to the intermediary. The intermediary has another chance to make both oral and written representations on the conclusions as well as the penalty imposed, after which, the WTM passes an order.<sup>32</sup>

- *Orders imposing monetary penalty*

While the SEBI Act initially did not have any provisions for imposing monetary penalty, the amendment of 25 January, 1995 incorporated a new chapter in the SEBI Act introducing *monetary penalty*.<sup>33</sup>

This penalty can be imposed, for example, when there is, inter-alia, (a) failure to furnish information to SEBI, (b) in case of insider trading violations, and (c) takeover violations, etc. Originally the maximum amount of possible penalty was restricted to INR.500,000. These have

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<sup>27</sup>Section 26(2) of SEBI Act, 1992.

<sup>28</sup>Hence the provisions of these regulations cannot be invoked against any person who is not a intermediary under the SEBI Act.

<sup>29</sup>Regulation 24 of SEBI (Intermediary) Regulations, 2008.

<sup>30</sup>Regulation 25 of SEBI (Intermediary) Regulations, 2008.

<sup>31</sup>Regulation 27 of SEBI (Intermediary) Regulation, 2008.

<sup>32</sup> The WTM can pass an order of censure, debarring a officer of the intermediary from carrying out activities for a specified period, debarring a branch of an intermediary from carrying out activities for a specified period, prohibiting the noticee from carrying out activities for a specified period, suspension of certificate, or cancellation of certificate.

<sup>33</sup>Securities Laws (Amendment) Act, 1995.

now been enhanced to INR.250 million or three times the amount of the profit, whichever is higher.<sup>34</sup>

However, unlike with the cancellation of the registration, the procedure to hold enquiry is notified by the GOI, rather than SEBI. SEBI appoints an *Adjudicating Officer* (AO) who is required to hold an inquiry, during which the intermediary can submit oral and/or written submissions. After this, the AO himself can pass an order imposing the monetary penalty.<sup>35</sup>

- *Directions in the interest of investors, intermediaries and securities market*

In 1992, while the SEBI Act contained specific provisions enabling SEBI to take action against the intermediaries, there were no specific provisions enabling SEBI to take action against companies issuing capital or the investors manipulating the market since the regulatory and supervisory powers over companies were with the Ministry of Corporate Affairs.

Instead, SEBI took recourse to Section 11B, which empowered it to issue directions. These are used to:

1. Prohibit companies from making an attempt to issue capital with false or misleading information.
2. Prohibit investors who manipulated the market from buying, selling or dealing in securities market.
3. Prohibit intermediaries in case urgent remedial orders were required to be passed and the enquiry procedure against the intermediaries being time consuming did not permit ex-parte orders against the intermediary.

Subsequently, the SEBI Act, 1992, was amended to provide for a provision specifically empowering SEBI to issue directions.<sup>36</sup> There are no prescribed rules specifying the manner in which the directions will be issued by SEBI. However, SEBI practice involves the following procedure taken before issuing directions:

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<sup>34</sup>SEBI (Amendment) Act, 2002.

<sup>35</sup>As per the provisions of SEBI Act all sums realized by SEBI by way of monetary penalty are required to be deposited in the consolidated funds of India and cannot be retained by SEBI.

<sup>36</sup>Securities Laws (Amendment) Act, 1995.

- A member of the SEBI Board will issue a show cause notice to the person against whom directions are proposed to be issued.
- Initiation of an investigation or an inquiry is a must to use the powers to use directions.
- An opportunity of making written and oral submissions is given to the noticee. However, in case SEBI has to take action urgently in the interest of the investor or the intermediaries or the security market, then SEBI has on many occasions passed directions by giving a post decisional hearing.<sup>37</sup> In other words, SEBI would take action and thereafter will give hearing.<sup>38</sup>

However, the recent trend in SEBI is not to resort to post decisional hearing but to pass orders after a hearing is given. This can be substantiated by the observation that the majority of the orders passed after 2008 are orders passed after giving a hearing.

- In the hearing, the noticees are permitted to be represented through a lawyer and thereafter an order is passed.

After the hearing, a formal order is passed. The help of the legal department may or may not be taken. The quasi judicial orders of SEBI are passed by the following officers:

1. Monetary penalty is imposed by a Division Chief.<sup>39</sup>
2. Orders to intermediaries under their respective regulations as a consequence of a report by the EO is passed by the WTM.
3. Directions or orders under the SEBI Act are passed by WTMs.<sup>40</sup>

All orders passed by SEBI are reasoned orders. Each order is self sufficient containing facts and rationale before it is disseminated to the public. During the enforcement, or once the enforcement functions of SEBI are complete, the aggrieved person can appeal to the Securities Appellate Tribunal (SAT) against any order passed by SEBI.<sup>41</sup>

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<sup>37</sup>2<sup>nd</sup> proviso of Section 11(4) of the SEBI Act, 1992.

<sup>38</sup>There are numerous case laws on this. One example is the Order in the matter of IPO irregularities. [http://www.sebi.gov.in/cms/sebi\\_data/attachdocs/1287741363827.pdf](http://www.sebi.gov.in/cms/sebi_data/attachdocs/1287741363827.pdf)

<sup>39</sup>Section 15(I) of the SEBI Act, 1992.

<sup>40</sup>Section 11, 11(B), 11(D) and 11(4) of SEBI Act, 1992

<sup>41</sup>Section 15T of the SEBI Act, 1992.

**Table 1** Annual outcomes on SAT hearings on appeals against SEBI orders, 1998–2009

This is an analysis series of case outcomes heard by the SAT between 1998 and 2009, where the case is an appeal against a SEBI order. The outcomes are organised as

- *For* where SAT upholds the SEBI order fully,
- *Against* where SAT does not,
- *Others* means those cases that include *infructuous petitions, withdrawn appeals, time barred appeals* and so on. These are cases that effectively uphold the SEBI order, but have not been decided based by examining the merits of the case.
- *Modified* stands for cases when the original SEBI order was upheld, but the SAT changes it in order for it to be made more just or equitable. When the penalties are reduced, the order of imposing the penalty is upheld, but the amount of the penalty is reduced, thus this is a decision which *modifies* the earlier order.

In the last two columns in the table, we club the cases into a binary classification of *For\** and *Against*. Here, the cases marked as *Others* and *Modified* have been included in the set of outcomes marked *For\** SEBI.

Year	Number of hearing outcomes					Fraction of total (%)	
	Against	For	Others	Modified	Total	Against	For*
1998	1	1			2	50	50
1999	3	2		1	6	50	50
2000	8	6			14	57	43
2001	14	17	5	5	41	34	66
2002	13	13	7	1	34	38	62
2003	17	18	2	7	44	39	61
2004	30	63	18	40	151	20	80
2005	27	76	21	55	179	15	85
2006	145	85	46	16	292	50	50
2007	44	56	24	13	137	32	68
2008	69	57	66	9	201	34	66
2009	56	88	48	16	208	27	73
Total	427	482	237	163	1309	32	67

Source: Compiled from Orders of SAT under Orders/Rulings at <http://www.sebi.gov.in>

Table 1 shows how the SAT has ruled on appeals against SEBI orders between 1998 and 2009 (inclusive). On average, SAT has upheld the SEBI order (*For*) in typically 70 percent of the cases. However, a significant fraction of these are cases that are those where the complainant has not followed up on the appeal (counted as *Other*) and therefore gets counted in the *For* category. These were around 14 percent in 2005 and 32 percent in 2009. More interesting are those cases when SAT upholds the SEBI order, but chooses to modify

the order. These are also a sizeable fraction of the *For* SAT outcomes, as much as 36 percent in 2005 and then reducing significantly after to around 11 percent in 2009.

This is a useful snapshot of the quality of outcomes of the legal process at SEBI. If the cases had fallen unilaterally either in the category of *For* or *Against*, it ought to be treated as a cause for concern: an appeals process against the regulator ought to be capable of taking an independent view of the order.

## 4 Principles

The previous section has summarised the mechanisms used by SEBI in the enforcement process. We now turn to the foundations, to the principles which must guide the regulatory process, which are:

1. Transparency and fairness in regulatory functioning.
2. The enforcement mechanism adopted by SEBI gives due recognition to the principles of natural justice and the fundamental rights guaranteed under the Constitution of India.
3. Judicial control of administrative action.

### 4.1 Transparency and fairness in regulatory functioning

Transparency in the proposed regulatory frame work provides for a salient and democratic safeguard against uncertainty, suspicion, mistrust and apprehension in the minds of the market participants about the regulatory framework. It is a mechanism to ensure that the regulatory framework is not de-hors or beyond the provisions of the parent Act or will not be in violation of the fundamental rights guaranteed to every citizen of this country under the Constitution of India.

The consultation process enables market participants to be involved in the decision making process. The consultation process enables the regulator to get information regarding the ground reality so that regulatory decisions are sound. It also enables the regulator to make adjustments in regulations

before they are promulgated. This ensures the existence of more balanced *sub-ordinate regulations*.<sup>42</sup>

It is also a mechanism to ensure that powers are not misused or abused. Since the process interfaces with the public domain, the misuse of powers can be reduced by the parties interested in sound regulation – the government, market participants, as well as investors. Further, the ability of the regulator to notify the regulatory framework gives autonomy and independence to the regulator. With such a process in place, to a large extent, the securities market gets regulated by desirable best practice regulations as the process drives the regulator to introduce a framework that is conducive to the market and the investors.

## 4.2 Enforcement mechanism

For a regulator to effectively discharge the various activities entrusted to it, it needs powers to enforce regulations. This means that when there are alleged violations of regulations the regulator has to be able to conduct effective investigations and enquiry. The regulator has to be equipped to garner information, gather evidence and facts *in a timely manner* from the concerned entities.

However, it must be ensured that the investigations and enquiry are conducted within the four cornerstones of law while respecting the fundamental rights guaranteed to a person under the Constitution of India including compliance with the *due process of law*. The right of search and seizure of documents, property, bank accounts, attachment of securities are draconian powers affecting the right of privacy and confidentiality of a individual, and the right to property provided in the Constitution.

The adverse affect on the use of investigative powers against an individual cannot be underestimated or ignored. The use of statutory powers to collect information from an individual interferes with his liberty. While it is uncertain whether an investigation process may result in any disciplinary action and penal orders, the initiation of investigation by itself against an entity may have serious consequences for the market entity. A pending investigation subjects a person to a good deal of physical inconvenience, mental agony and expenses. Adverse effect on his business and reputation are always felt, irrespective of the final outcome of the investigation.

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<sup>42</sup>Any regulatory framework notified under the provisions of a Act are subordinate to the Act and hence are called subordinate regulatory framework or subordinate legislation.



It is, therefore, necessary to reconcile the administrative exigency of holding an investigation into the affairs of an individual with his interests and rights by providing adequate safeguards subject to which the administration may invoke its power of investigation so that the investigations are fair.

Lawmakers are very cautious while granting these powers to any authority within or outside the GOI. A balance between the grant of power of investigation and inquiry and ensuring misuse of the same is achieved by providing procedural safeguards. This involves providing for a procedure specifying the *manner, method and circumstances* in which an investigation and inquiry can be conducted. Initiation of a investigation with the prior approval of a senior officer, control of the investigations and inquiry and thereafter reporting to a senior officer is a *sine qua non* for ensuring fair investigation and inquiry.

Such procedures are aimed at making it difficult for investigations to become a tool in the hands of a officer of a regulator, determined to harass a market player. This results in minimizing the abuse and misuse of investigative powers. Failure to observe the procedural safeguards has resulted in the Supreme Court striking down the very enforcement action.

### **4.3 Administrative adjudication: Quasi Judicial proceedings**

Typically, the function of adjudicating disputes between two entities is vested in a Court. However with backlogs and delays increasingly prevalent in the adjudication process of the Courts, coupled with requirement of adjudication in specialized areas, law makers increasingly empower the regulators to be adjudicators. Here, the regulators end up discharging quasi-judicial functions.

Since the judicial functions are discharged by executives, there is some leeway provided in strict compliance of law by the executives. Strict compliance or requirement of formal procedure, strict laws of evidence and civil procedure code are not required to be followed. In such a setting, it becomes even more crucial and essential that the quasi-judicial functions discharged by the regulator are just and fair so that injustice is not done to any affected party, and that decisions will be fair and unbiased.

1. The person affected should normally be heard before a decision is taken. This is on the basis of the principle *Audi-alteram partem* that is a

person affected has a right to be heard. Right of hearing does not have fixed criteria. Some basic requirements are:

- The noticee gets an adequate notice and an adequate effective opportunity to defend himself.
- The noticee should be given all the evidence on which the adjudicator is relying on. The principles of natural justice are infringed if a adjudicatory body decides a matter on the basis of documents and information unknown to the noticee.

In India, an adjudicating order made without complying or following the principles of natural justice is normally void. However, there are judicially recognized exceptions to the compliance with the principles of natural justice. One recognized exception is a post decisional hearing given to the affected party even after the decision is taken.<sup>43</sup>

2. Fair hearing also requires compliance of:<sup>44</sup>

- The authority deciding the matter should be free from *bias*, of which there can be at least three types.
  - Pecuniary bias,
  - Personal bias and
  - Policy bias.

While a pecuniary and a personal bias may not require any deliberation, a policy bias arises when the adjudicator has been associated with the office for so long that he acquires a interest in the subject of the organization where he is working. An adjudicator can not develop the same kind of neutrality and sole objectivity towards issues and policies being canvassed before the adjudicator. This also leads to what is known as *official bias* as the officials imbibe some pre-disposition or interest vis-a- vis the proceedings.

- No one should be a judge in his own cause which means that the judge has to be impartial.

The procedure adopted by the authority while taking enforcement action and adopting quasi-judicial proceedings must be such that the affected party gets

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<sup>43</sup>AIR 1978 SC page 598

<sup>44</sup>This is not a position of law, but rather well-recognised category of bias, that is our opinion based on legal commentaries.

a assurance that justice will be done. The procedure should be such that not only is justice done but it is also *seen to be done*.

#### **4.4 Judicial control of administrative action**

While autonomy in a regulator is desirable, regulators are subject to Parliamentary oversight. The executive, administrative and quasi judicial functioning of the regulator is required to be accountable. While the policy decisions of the regulator can be overviewed by the government, the executive functioning of the regulator can also be tested before a judicial authority on the test stone of arbitrariness, discrimination, unfair treatment and violation of fundamental rights. The quasi-judicial proceedings of the regulator is also under the control of a judicial authority.

The recent trend of setting up specialised *Tribunals* with expert members ensures that an aggrieved entity is able to access a quicker, efficacious and less expensive mechanism of ensuring justice is provided. For example, the Securities Appellate Tribunal (SAT) is move in that direction, which has been seen as very successful.

The availability of the writ jurisdiction of a High Court against the decision of a regulator also ensures a judicial remedy in case of violation of the fundamental rights of a citizen by the regulator.

#### **4.5 Examples from the international experience**

##### **International Organization of Securities Commission (IOSCO)**

The IOSCO is an international organization with securities market regulators as its members has enumerated eight principles<sup>45</sup> which are to be kept in mind while defining the role of the regulator in the securities market. These are listed below as:

1. The responsibilities of the Regulator should be clear and objectively stated.
2. The Regulator should be operationally independent and accountable in the exercise of its functions and powers.

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<sup>45</sup>Available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf>

3. The Regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.
4. The Regulator should adopt clear and consistent regulatory processes.
5. The staff of the Regulator should observe the highest professional standards, including appropriate standards of confidentiality.
6. The Regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate.
7. The Regulator should have or contribute to a process to review the perimeter of regulation regularly.
8. The Regulator should seek to ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed or otherwise managed.

These principles are fundamental to the functioning of any regulator. They are so fundamental in nature that they could be made uniformly applicable to any regulator irrespective of their area of functioning.

### **The UK Financial Services and Markets Act (FSMA)**

The FSMA in the U.K. empowers the Financial Services Authority (FSA) to carry out enforcement actions as well disciplinary proceedings against the violations of the said Act.

The procedure followed in both the UK and India are similar. The investigators are empowered to call for documents. After considering the evidence the Investigators prepare a report which is then usually sent to the entity who is alleged to have violated the Regulations. The entity investigated has an opportunity of responding to the report. After considering the response, the investigating team recommends a course of action to the regulatory decision committee of the FSA. This committee is the decision maker for the FSA. In case the entity alleged to have violated the Regulations does not agree with the recommendations of the committee, then the entity has an option of approaching the tribunal, which is a judicial body independent of the FSAs. The tribunal can then direct the FSA to take action, not to take action or to take a different action. Thereafter, the disciplinary proceedings are initiated against the entity alleged to have violated the Regulations.

## **The Securities and Exchange Commission (SEC), U.S.**

The SEC is required to issue a formal order of investigation. The staff of the commission can compel the witnesses to testify and produce books, records and the documents. The investigation findings are submitted to the Commission for review. The SEC can authorize staff to file a case in Federal Court, or to bring an administrative action by filing proceedings before the Administrative Law Judges (ALJ).

The ALJ are individuals who are independent of the commission and whose salary is not paid by the commission. They give a public hearing in which SEC representative and the alleged violator can remain present, and make submissions before the ALJ. The ALJ recommends sanction after recording findings of fact. The decision of the ALJ can include suspension of registration of the intermediary, disgorgement of illegal gains. The SEC can then appeal to the ALJ, who can affirm, reverse or remand the matter.

It is also open to the SEC to file a complaint with the district court. The complaint can also request the district court to pass an order including a prohibitory order prohibiting the entity for violating the law. The civil court can also impose monetary fines and order disgorgement.

Class action suits are another striking feature of the US judicial system wherein a representative proceedings on behalf of the investors and or persons adversely affected can be preferred before a court in the US. However, in India, the class action suite as preferred in the US are not legally permissible.

## **5 Some proposals for change**

In this section, a set of proposals are offered for strengthening the SEBI enforcement process. Some of these can be implemented by SEBI, while others require amendments to law. Some amendments have been suggested in order to ensure that the policy changes are irreversible and are suggested out of abundant caution.

### **5.1 Rule making process by the Central Government**

Even though the SCR Act contains provisions for delegating powers of the GOI, the government does retain powers for rule making in some areas of

the securities markets. For example, the GOI is empowered to make rules regarding:

- The manner in which the applications for grant of recognition to stock-exchanges.
- Conditions to be imposed for grant of recognition of stock-exchange.
- Documents which should be preserved by stock-exchanges.
- The manner in which an enquiry can be made by stock-exchange.
- Requirements to be complied with for a company seeking listing of securities.
- Grounds of delisting of securities.<sup>46</sup>

However, there is a strong case to be made at this stage of securities market development, to consider changing the above provision of the Act to shift more regulatory responsibility onto the regulator. This rests on a three-part argument:

1. Under the 22 years that SEBI has been the regulator of the securities market, there has been considerable progress in market development and the reach of equity market among both investors as well as firms. SEBI has shown itself to be capable of a more comprehensive regulatory and supervisory role in the securities markets. During this phase, there have only been a few instances where the GOI has been required to step in and use supervisory powers to notify rules affecting the operations of securities market.

Typically, the rule making process involves matters related to the markets, regarding which the regulator is likely to have a better understanding compared with the GOI given their continuous interaction with the market and market participants. For example, one effort about rule-making from the GOI was to move public shareholding in listed firms to a minimum of 25%. The decision as to how much public float should be available is an operational matter which should be left to the regulator, and what the GOI should not concern itself with.

2. Further, unlike the SEBI process of rule making for the securities, the GOI process is neither transparent nor does it follow any consultative

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<sup>46</sup>Section 8 of the SC(R) Act, 1956.

process while notifying the rules under the SEBI Act. There have only been one or two instances when such a process has been followed.

There is no rationale justifying the secrecy in the rule making process of the GOI.

3. Finally, a more explicit shift of regulatory responsibility also means a more explicit accountability.

*Proposed changes:* The SC(R) Act should be amended to delete the provisions wherein the GOI is empowered to make rules relating to the operations of the securities market. SEBI should be empowered to make regulations for all operational matters under the SC(R) Act. The Act should also be amended to ensure that, irrespective of which government is in power or the bureaucrat in charge, a consultative transparent process is always followed in the rule making process.

## **5.2 Regulation making process by SEBI**

As pointed out earlier, the rule making process of SEBI has a high degree of transparency when it puts up its consultative papers and committee reports in public domain and seeks comments and suggestions on the same. SEBI was the first of the regulators that started this process, and stood out in stark comparison with the process followed either by the GOI or any of the other regulators.

This consultative process can be further enhanced if the public hearings held on the draft regulations are put on the web-site. Presently SEBI does not have a formal system of public hearing before the rules are enacted by SEBI, unlike in the U.S. where public hearings on the proposed rules are held.

Other than through media reports, the Indian public do not have access to the comments and suggestions received on a proposed draft. Theoretically, draft regulations can be opposed by each and every single public comment that it receives. Yet, the regulator can still notify the same, since the public need not necessarily come to know what the public opinion about the draft regulations are.

If public hearing is not feasible given the size and scope of the Indian investor base, then the comments received can be put out in public domain through the SEBI website. The present process at SEBI involves the preparation of a tabular chart collating all the suggestions, that is circulated to the Board members before the regulations are amended and/or notified.

*Proposed changes:* It would be optimal for consistency, that Act be amended to make it mandatory for SEBI to follow the highest level of transparency in the consultative process. This has to be a irreversible process making it legally impossible for SEBI Board to stop the transparent consultative process, or to adopt a facade of a consultative process.

### 5.3 Constitution of SEBI

SEBI is a statutory regulator that has the autonomy to enact a regulatory framework applicable to the whole country, as well as to discharge quasi-judicial functions which affects the fundamental rights of a citizen. It would be prudent that the regulator has at least one full time member who has had practical experience in the field of law.

Regulators all over the world appoint people, who practiced law at some point of time in their profession, as the chairperson of the organisation. It is unusual that SEBI does not have a whole time legal member to guide the regulator. The quality of legal advise differs when it is given by a person who has practiced law vis-a-vis a person who has acquired the knowledge of law, incidently or theoretically, and not out of practical application.

A whole time legal member, besides giving advice, can be in charge of quasi-judicial proceedings of SEBI. SEBI has historically always appointed a *operational department* non-legal WTM to be in charge of legal affairs and enforcement as well as quasi-judicial proceedings. The portfolio of the WTM can change any time by one replacing the other. This becomes a more complicated issue since the whole time operational member has never practised law, but acts as a quasi-judicial member for the operational decisions of the other WTMs. SEBI faces legal issues day in and day out. In-house professional expertise is essential.

*Proposed changes:* It is recommended that the SEBI Act be amended so that the SEBI Board consists of at least one WTM with adequate practical experience in law and legal practise. The presence of a dedicated whole time legal member, and a separate set of officers in charge of quasi-judicial functions, at SEBI will not only give the feeling that justice is done but also that justice is seen to be done.



## 5.4 Informal guidance

A large number of the ruling from SEBI are done through the mechanism of “informal guidance”. This informal guidance scheme of SEBI requires to be made formal. As of today, it gives the impression of being half hearted, that it gives the regulator the ability of being bound while, at the same time, being able to say that the guidance is not binding.

It is most probably because of the absence of statutory power and specific provisions in the SEBI Act that SEBI may not be able to notify the *advance ruling* procedure as is found in other statutes. Presently, guidance is given by the executive directors of SEBI. It is not binding on the SEBI Board. It then becomes a *guidance ruling*, rather than an *advance ruling*.

It is presently possible for the SEBI Board to take a position which is contrary to the position taken in the informal guidance. The SEBI board can be bound by a guidance that is given by a person authorized to give advance rulings. Hence the constitution of persons authorized to give the advance ruling has also to change.

*Proposed changes:* Amendments to SEBI Act will be required in order to introduce a whole hearted advance ruling system binding on SEBI, and all concerned by law and not practice. Even the constitution of the advance ruling authorities will have to be provided in the Act to make it binding on the SEBI Board.

## 5.5 Recommendations for the enforcement process

### Multiplicity of proceedings

It has been observed that while the WTM issues notices for determining whether the noticee is guilty of an offence, at the same time an adjudicating officer can also issue a notice for determining whether the noticee is guilty or not. For example, the WTM issues a show cause notice to the noticee as to why an order under Section 11 B or Section 11 D should not be passed, i.e., restraining the noticee from buying selling or dealing in the securities market. At the same time, the adjudicating officer issues a show cause notice as to why monetary penalty up to 25 crores should not be imposed for the same violation. Hence, on the same facts, there is a multiplicity of proceedings initiated by the SEBI.

Besides there being an harassment to the noticee, it also raises a question as to whose conclusion will be final, in case of conflict of opinion between a decision of the WTM and the adjudicating officer. In case the WTM finds a noticee guilty, whether an adjudicating officer who is junior to the WTM, will disagree with the findings of the fact recorded by WTM.

*Suggested amendments:* The SEBI Act, 1992, requires to be amended to ensure that the above situation is prevented. It is suggested that the Act be amended so that SEBI can appoint one officer who is empowered to issue orders imposing monetary penalty and or order of suspension and cancellation of certificate as well as pass orders under Section 11B or 11/4 of the SEBI Act.

Pending amendments to the Act, SEBI can to an extent avoid the above situation by adopting the following policy decisions:

1. Section 11 (including 11B, 11/4 etc.) should be used in an emergency situation and when no other legal action is provided for in the Act in case of default by any person.
2. Even if recourse to Section 11 is taken, then to the extent possible (unless an emergency situation arises) ex-parte orders under Section 11 are to be avoided.
3. Pending proceedings under Section 11 before the WTM, an adjudicating officer or an inquiry officer should not be appointed.

### **The review process**

A review of the decision given by the WTM passing a quasi-judicial proceedings or by the adjudicators should be permissible. The power of review enables the quasi-judicial authorities to correct mistakes, apparent from the record, made by them while passing a order. The scope of review can be defined. However, the review is permissible only if it is specifically provided for.

*Suggested amendment to the Act:* Amendment of the SEBI Act providing for review is required.

## **Circulars: scope and maintenance**

Frequent amendments to the regulations adversely affect the transactions which are in pipe line besides creating uncertainty. SEBI is known to issue circulars under the regulations. It is extremely difficult to keep track of the circulars issued by SEBI.

Further, the effect of the circulars or the interpretations of the regulations adopted by SEBI sometimes has quite contrary or dilutes the provisions of the regulations. For example, in SEBI (Mutual Fund Regulations) 1996, Regulation No.7 provides that a person holding 40 percent stake in the mutual fund will be deemed to be a sponsor (50) who then will have to comply with the eligibility criteria for the sponsors. However, SEBI has taken a decision that instead of 40 percent, the 10 percent stake holder will be treated as sponsor. Here, the decision traverses beyond the provisions of the regulations.

*Suggested change:* There is a need to categories circulars in a consistent manner and track it in the public domain so that there is maximum clarity in regulations. This could be facilitated with a central system that is created within SEBI, so that all the original circulars are centrally catalogued and the sequencing of these is preserved. Further circulars which go beyond the scope of regulations should not be issued, nor should the regulations be interpreted in a manner which is contrary to the very provisions of the regulations.

## **Investigations by SEBI**

The investigating process of SEBI is another area that is clouded with uncertainty whereby the investors, or the market participants, are not aware of the length of time within which the investigations will either be initiated, or kept pending, or completed. Within SEBI, there is no policy of limitation and hence investigations can be initiated at anytime and can be kept pending for any number of years. Market participants in the year 2009 are receiving notices from SEBI for the offence allegedly committed in the 90's.

*Implementation:* A system needs to be put in place whereby any investigation that is initiated would automatically come up for review within the organisation, after the predefined length of time. This would ensure that investigations are not kept pending for unreasonable point of time, which would eradicate any misuse on this account. This does not require an amendment to the Act, but rather can be implemented by a policy decision.

### **Appointment of adjudicating/enquiry officer**

SEBI does not have a cadre of adjudicating/enquiry officers. Instead, SEBI is known to appoint officers from the operational department to function as enquiry/adjudicating officers. The powers of the enquiry officer are wide-ranging. For example, they can recommend cancellation of certification of registration of an intermediary and impose fines as mentioned in Section 3.4.2. It is therefore desirable that separate independent cadre of officers could be appointed for exercising such quasi judicial powers. The officers should be well trained in the principles of law as well as being experts only in the securities market.

The knowledge of administrative law, the constitution, specific relief acts are a few examples of the law which an enquiry or adjudicating officer has to possess. They should be readily able to access information of the decisions of the Supreme Court not only on securities market but also on the enquiry process. This coupled with structured annual refresher courses will enable SEBI to ensure a high level of delivery of justice.

*Proposed changes:* Amendments to the Regulations notified by SEBI and applicable for the appointment of the adjudicating officer and enquiry officer should be amended to provide for the above.<sup>47</sup>

### **Process of conducting adjudication/enquiry/inquiry**

The procedure followed for issuing directions under Section 11 and 11(B) of the SEBI Act, 1992, passing punitive orders against an intermediary, and imposing monetary penalty are different under the Act. Three different procedures are prescribed under the Act, rules and regulations when taking disciplinary proceedings. This often becomes a cause for confusion to investors and noticees as to what procedure which will be followed by SEBI to pass orders under the SEBI Act, 1992.

For example, when enquiry proceedings are initiated and an enquiry officer is appointed, the noticees are not aware that the enquiry officer is only a fact finding authority and will only recommend the penalty. Or that the final orders will be passed by the WTM only after issuing a second show-

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<sup>47</sup>Section 15-I of the SEBI Act, 1992, read with Rule 5 of Securities and Exchanges Board of India (Procedure for Holding Inquiry and Imposing Penalties by Adjudicating Officer) Rules, 1995; Rule 5 of Securities and Exchanges Board of India (Procedure for Holding Inquiry by Enquiry Officer and Imposing Penalties) Regulations, 2002.

cause notice which offers an opportunity of hearing. While for the purpose of issuing directions under Sec 11 or Sec 11B, there is only one stage proceedings wherein the WTM is a fact finding authority and also the final authority issuing directions like directing the notice not to access the securities market, not to buy or sell any securities, etc.

When monetary penalty has to be imposed, an adjudicating officer is appointed. The adjudicating officer is the final authority within SEBI for those proceedings. Neither the enquiry officer nor the WTM has a role to play in the penalty.

The sophisticated market operator who can afford to pay legal fees educates himself on the procedure. However, not every market participant or investor can afford to get legal advice; Even if the investor can afford legal advice, the procedure should be such that even a small investor can understand the same.

A uniform procedure provided under the SEBI Regulations for disciplinary proceedings will make the proceedings more discernable and simple for all the noticees to understand.

*Proposed changes:* Amendment in the rules for adjudicating procedure and regulations for intermediaries requires to be amended.

### **Procedures followed by the adjudicating officers**

While conducting enquiries and adjudication, the enquiry officers and the adjudication officers do not follow uniform procedure. While the enquiry officers and adjudicating officers have a discretion regarding the conclusions to be arrived at, the procedure adopted should be uniform irrespective of the officer who is conducting the enquiry or adjudication.

It is desirable that when discretion and powers are given to an inquiry/adjudicating officer, these are not exercised in a dis-similar fashion. There may be a lack of commonness in their approach or different standards adopted by different officers deciding on similar questions. This may lead to inconsistent decisions creating dissatisfactions in the mind of the public. It therefore becomes necessary to evolve a mechanism by which the vagaries of the decision making by the adjudicating/enquiry officer is reduced and that the element of certainty in the decisions is introduced so that their decisions become more objective fair and consistent.

*Proposed changes:* A system has to be introduced whereby it will be

ensured that a uniform procedure is adopted. For example, a departmental disciplinary proceedings manual can be prepared.

### **Orders of the quasi-judicial authority**

After the personal hearing is over and the written submissions are received, a reasoned order should be expeditiously passed by the authority. Formerly, the regulations had a provision whereby Orders were required to be passed by the authority within one month of the receipt of the reply. However, this provision has been deleted.<sup>48</sup> This provision needs to be re-introduced to meet the ends of justice and also prevent potential misuse of powers by the enquiry/adjudicating officer.

One mechanism to prevent misuse of powers is through enhanced transparency. Presently, SEBI uploads orders passed by the enquiry/inquiry/adjudicating authority on its web-site, where it can be publicly viewed. However, there have been instances when the orders have not been put on the web-site.

*Suggested implementation:* To ensure that this does not happen, and that there is accountability in case the orders are not posted on the web-site, it is necessary that there is a mandatory provision requiring SEBI to mandatorily upload all the orders on the web-site.

### **Maintaining a digest of case-laws**

SEBI is party to all litigations where not only SEBI has passed orders but also where the constitutional validity of the SEBI Act is challenged. A comprehensive digest cataloguing the interpretation of each definition, of each regulation by SEBI, SAT, High Court and the Supreme Court would be of tremendous help to facilitate understanding of issues in each case, or any decision that has to be taken on questions regarding these. Such a digest would also ensure that the officers of SEBI takes decisions in accordance with the law which has been interpreted and upheld.

*Suggested implementation:* SEBI should create a compendium of all the decisions rendered by various judicial authorities.

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<sup>48</sup>For example, Regulation 29 of the SEBI (Underwriter) Over Regulations, notified in 1993.

## Securities Appellate Tribunal (SAT) benches

Presently, the SAT is situated in Mumbai. A person anywhere in the country has to approach the SAT if they are aggrieved by a decision of SEBI and stock-exchanges. Litigants all over the country are required to travel to Mumbai in case they want to appeal.

*Suggested implementation:* In case the number of appeals from a particular region before the SAT are above some previously set number<sup>49</sup> the Tribunal can then hold these hearings by establishing benches at a city in that region. It is known procedure under law and benches of a particular forum in various cities other than the capital are constituted. For example, the High Court of Bombay has a bench at Goa, where the High Court Judges sit and dispense justice. This will be an investor friendly measure and will also ensure that the proceedings are not all Mumbai-centric.

## 6 Conclusion

The SEBI has been operating now as the securities markets regulator for a decade and a half, and has appeared to have done a commendable task in upholding the mandate it was charged with, in a period of high growth and reasonably heightened levels of economic volatility.

The principles based on which the entity was created has stood it in good stead. Some of these principles include a clarity on the mandate it was to deliver on, non-interference from the government, statutory powers to issue subordinate legislation which can be notified expeditiously to accommodate the rapid changes that takes place in the equities markets in India and the powers to enforce the regulatory mandate. The credibility of SEBI as a regulator also appears to have been facilitated hugely by the creation of specialised courts with specialised domain knowledge that can rapidly review regulatory actions. In the process of ensuring that the markets develop in such a way that the objective of securities markets continue to be met, the legal processes at SEBI have also continued to evolve along the lines of higher levels of transparency of processes, clarity of actions and credibility of legal action.

In order that the regulator continues to evolve and bridge any gaps between

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<sup>49</sup>This can be determined on the basis of expenditure to be incurred by the appellant vis-a-vis the Tribunal.

current process and what the principles driving a good regulatory functioning would suggest, we suggest that SEBI continues to fine-tune the legal processes, particularly in enforcement, to achieve better levels of clarity on regulation and the legal process.