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How to train your dragon – Discretion in SEBI's penalty orders

By **Uma Lohray**

This article seeks to question the penal powers of the Securities and Exchange Board of India (SEBI), regulator of the Indian securities market. SEBI has been vested with powers to impose heavy penalties on companies indulging in activities that hamper investor interests and securities market. Despite that it enjoys the image of 'a friend to the investors' it is argued that its punitive powers are unbridled. It is common to see companies facing huge penalties for omissions that seem to be of a comparatively harmless nature. One might wonder if the powers vested with SEBI are to be used in proportion with the gravity of the matter, or mechanically in straitjacketed application of the statute.

The levy of penalty

The SEBI has levied penalty almost invariably when there is a securities law violation. In this context it is often stated that once statutory regulations are violated, imposition of penalty becomes *sine qua non*. There is no denying that the Supreme Court has in *SEBI* v. *Shriram Mutual Fund* [68 SCL 216 (SC)], *Bharjatiya Steel Industries* v. *Commissioner, Sales Tax, Uttar Pradesh* reported in 2008 (1) SCC 617 and *Swedish Match AB* v. *SEBI* [122 CompCas 83 (SC) (2004)] held the contravention of statutory obligations to be the threshold of imposition of penalty:

> "…penalty is attracted as soon as the contravention of the statutory obligation as contemplated by the Act and the Regulation is established and hence the intention of the parties committing such violation becomes wholly irrelevant."

However, the decisions do not go on to throw light on the quantum of penalty for each kind of offense. Many would argue that the purpose of adjudication is not mere assessment of factual circumstances, establishing whether or not an offence is made out thereby. Ideally, a judicial or quasi-judicial proceeding must also determine the gravity of the offence while sifting the facts and impose a penalty accordingly.

It follows that the gravity of an offence is to be assessed not on arbitrary or whimsical grounds on the caprices of the regulator, but on established factors - guiding principles provided by statute or developed jurisprudence of the particular sector. While Section 15J of SEBI Act, 1992 provides for certain factors such as amount of disproportionate gains and the past history of default to be considered in determining penalties, it still so happens that the quantum of penalty imposed is often disproportionate to the nature of the offence. Based on these factors, the SAT, in *JM Mutual Fund* v. *SEBI* [(2005) 3 CompLJ 544 SAT] reduced the penalty, as there were no disproportionate gains or loss to investors.

The SAT's DLF IPO decision

The most recent occurrence which brings these issues to light is the decision of the Securities Appellate Tribunal (SAT) dated

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March 13, 2015 in the *DLF IPO* Case [Appeal No. 331 of 2014] where the issue of proportionality of penalties was specifically avoided. A penalty of ₹860 million was imposed along with a 3 year ban from the market under Section 15HA of the Act which provides for imposition of penalty of ₹25 crores or three times the amount of profits made out of such practices, whichever is higher.

The SAT made its displeasure clear with certain observations against SEBI's exercise of punitive powers. SEBI called into question the adequacy of disclosures in the IPO prospectus in a series of investigations. While there is a need to penalize such non-disclosure, admittedly there was no observation to the effect that non-disclosure of the transactions in question adversely affected the interests of the shareholders. At this stage the question is whether the proportion of penalty levied was justifiable or not.

The two members of SAT observed that SEBI has been conferred upon with wide discretionary powers and this is all the more reason why it has to apply its mind to every set of facts dispassionately without any influence:

> "It is pertinent to mention here that while SEBI was being conferred with vast powers in the year 2000 by way of a thorough amendment of the SEBI Act, 1992, the Dhanuka Committee, which had recommended the conferment of such powers, had itself warned against their abuse in clear terms by stating that SEBI and its officers are often called upon to act both as Regulators and adjudicators of the first instance and consequently there is a considerable scope of mixing up of these rules and for enthusiastic interpretation and enforcement."

Does discretion require regulation?

In the light of the undue delay in passing of the impugned order that is considered to hamper the fairness of the judicial process, is it fair to impose a humungous penalty, the biggest ever imposed in a single case? The above observation made by the Members serves as an alarm bell for those harboring similar concerns but naturally hesitant to voice them, in the light of the favorable public opinion enjoyed by SEBI as a savior of the investors penalizing those who jeopardize the market and the investments. The same may explain the wide berth given to this issue by the legal body, the financial sector and even the SAT and courts. The Tribunal, despite coming extremely close to this topic has carefully avoided this question and left it be considered in the future. But do we intend to keep this question unanswered? Especially when India doesn't fare well among the nations with ease of doing business and we intend to attract investments? Let us not forget that the teeth we gave SEBI after incidents like the Harshad Mehta scam might come back and bite our investments in companies, listed or unlisted.

In cases involving Sections 15A, 15B, 15C, 15D, 15E, 15F, 15G, 15H, 15HA and 15HB of the SEBI Act, various penalties have been prescribed. However, in the interest of justice, the adjudicator must be given the discretion to reduce it based on the factors listed in Section 15J. The Securities Law (Amendment) Bill,

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2014 brings hope of positive changes in this respect. While imposing monetary penalties, adjudicating officers will have discretion to impose minimum penalties, which will not be less than ₹1 lakh for most offences and not less than ₹10 lakh for insider trading and non-disclosure. This has been clarified as a move to streamline the penalty regime reining in the discretion of adjudicating officers as opposed to giving them complete freedom.

A penalty in the discretion of a judicial or quasi-judicial authority must be imposed with qualification. The quantum must be in proportion to the gravity of the lapse based on mindful discretion, not at a flat rate in a mechanical, "automatic" manner. These long-established canons of law surely apply to the admittedly more fluctuating sector of the financial market which invites stringent and pervasive regulation.

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An economic perspective on environmental jurisprudence in India

By **Smita Bhatia**

Over the past few decades, the Supreme Court of India has taken environmental degradation very seriously. The Supreme Court has proactively incorporated advanced legal principles such as polluter pays, precautionary principles, absolute liability and public trust-doctrine to revive India's environmental laws. The environmental jurisprudence in India has matured and is ahead of many developed countries.

The National Green Tribunal Act enacted in 2010, deals specifically with environmental litigation in India. The independent National Green Tribunal (NGT) comprising of scientific and judicial experts to exclusively deal with environmental issues is only the third of its kind in the world following Australia and New Zealand. The NGT provides a techno-legal framework to address the complex science and technology issues in environmental disputes. The NGT's jurisdiction spans all environmental law violations and can provide various remedies including compensation, injunctive relief and restoration of the ecology.

As a result, public interest litigations have become less complex and more affordable. In less than five years, since its establishment, the NGT has received over 7,000 environmental complaints and has shut down or challenged industries as well as government agencies that are not in compliance with the environmental regulations.

Even though the National Green Tribunal Act is new, protection of environment is deeply rooted in the Indian philosophy. Ancient Indian societies have revered nature and its resources. Water, land, air and animals were treated with utmost respect. In fact, provisions for the environment were stated in Book Two of Kautilya's Arthashastra with clearly laid out penalties for breaking forest and wildlife laws.

Deforestation and environmental degradation increased with the advent of colonial rule in India and industrial revolution in England.

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During this period, natural resources were over-used to support the raw material demands of the nascent industries. With the establishment of railway networks, environmental degradation was further intensified to satiate the ever-increasing manufacturing requirements. Special laws, such as the Forest Act of 1894, were enacted to serve the interests of the industrial revolution economy at a severe cost to the environment. These pre-Independence policies and laws continued in independent India and environmental degradation went unchecked due to lack of environmental regulations and poor implementation/enforcement mechanisms.

As the Indian economy opened to the world and globalization took firm root, environmental abuse escalated to alarming levels as India became a pollution haven for the world. In a free market economy, the pursuit of profit segregated economy from ecology, environment becomes merely an unexploited natural abundance. In India, environmental governance and regulations were relegated to obscure agencies that only increased red tape and served the license raj.

The Bhopal gas tragedy and the oleum gas leak in Delhi underscored the abysmal state of affairs. However, these events also served as catalysts to energize the public and the judiciary to bring environmental issues into sharp focus. The Supreme Court rejected the existing laws as archaic and incongruous with the recent advances in science and technology as well as the aspirations of the society. The Supreme Court equated the right to a healthy environment to the fundamental right to life and took *suo motu* action to protect and enforce the right.

From an economic perspective, environmental laws since the industrial revolution were framed by the economic requirements or demands of the time. The Forest Act of 1894 enabled indiscriminate deforestation to provide lumber for burgeoning industries and served to boost the bottom line of corporations at the cost of the environment. More recently, environment and social justice aspects are shaping economic policies. For instance, regulators shut down a soft drink major's bottling plant for failure to obtain clearance to extract groundwater which resulted in depletion of groundwater for community drinking as well as for farmers. The closure caused a $25 million loss since the company had already invested in plant expansion that could not become operative.

This is an indicator to businesses that environmental issues have to be an integral part of any business strategy. Costs of regulatory compliance and anticipated benefits will need to be balanced against potential risks of non-compliance given NGT's *suo motu* initiatives. The impact of non compliance or inadequate compliance may result in significant financial consequences for any firm.

Environmental compliance has become more significant with the Indian Government's "Make in India" initiative. As many companies are looking to invest in India, a successful business strategy would have to proactively understand, anticipate and plan for environmental compliance. This will help the companies to not only mitigate potential legal and financial

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expenses, but also help derive much social mileage as trendsetters in environmental stewardship. While environmental regulations may seem challenging, proper planning and strategy can turn potential losses into pleasant economic gains.

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Notifications & Circulars

SSI – List of items reserved for exclusive manufacture by small enterprises, omitted: Department of Industrial Policy and Promotion under the Ministry of Commerce and Industry has omitted 20 of the last remaining serial numbers in the list of items reserved for exclusive manufacture by micro and small enterprise sector. By Notification S.O. 998(E), dated 10-4-2015, Notification No. S.O. 477(E), dated 25-7-1991 has been amended in this regard. Items now de-reserved from this category and which can now be manufactured by other companies cover pickles, bread, mustard oil, groundnut oil, wooden furniture, exercise books and registers, wax candles, laundry soap, safety matches, fireworks, agarbatties, glass bangles, rolling shutters, steel almirah, steel furniture, stainless steel utensils, padlocks and aluminium domestic utensils.

Companies (Acceptance of Deposits) Rules, 2014 not effective retrospectively: The Ministry of Corporate Affairs has clarified that the amounts received by private companies from their members, directors or their relatives prior to 1st April, 2014 shall not be considered as deposits under the Companies Act, 2013, as such amounts were not treated as 'deposits' under the erstwhile Section 58A of the Companies Act, 1956. General Circular No. 5/2015, dated 30-3-2015 however states that the relevant private company shall disclose, in the notes to its financial statement for the financial year commencing on or after 1st April, 2014, the figure of such amounts and the accounting head in which such amounts have been shown in the financial statement. It has also been clarified that renewal or acceptance of fresh deposits on or after 1st April, 2014 shall be in accordance with the provisions of Companies Act, 2013 and rules made thereunder.

Companies (Acceptance of Deposits) Amendment Rules, 2015: The MCA has, with effect from, 31-3-2015 amended the Companies (Acceptance of Deposits) Rules, 2014. Earlier, in terms of Section 74(1)(b) of Companies Act, 2013, all companies were required to refund deposits by March 31, 2015, however the amended rules have given a respite to companies till 1st June, 2015 for either return of deposits from whom the money was received or allot shares, stock, bonds or debentures to the person against whom the application money was received as deposit. However, it is to be noted that this relief is available only to application money which had been accepted before April 1, 2014 and disclosed in the balance sheet for the FY on or before ending March 31, 2014.

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Further, every "eligible company" as defined in the rules shall now be required to obtain credit rating every year and submit a copy of the same to the Registrar of Companies along with the return of deposits in DPT-3. Companies have also been allowed time till 31st March, 2016 to accept deposits without deposit insurance.

Companies (Share Capital and Debentures) Amendment Rules, 2015:

Companies making a private placement offer to its existing members shall not be required to issue an offer letter in terms of PAS 4. Since the requirement of PAS 4 has been done away with, the requirement of filing the same with PAS-5, has consequently been omitted. Companies (Share Capital and Debentures) Rules, 2014 has been amended in this regard by the Ministry of Corporate Affairs by Notification dated 18-3-2015 in F.No.1/4/2013-CL-V (Pt I), dated 18-3-2015 and it carves out an exception for cases wherein preferential offer is made by the companies to its existing members.

Companies (Auditor's Report) Order, 2015 issued: Ministry of Corporate Affairs in consultation with the Institute of Chartered Accountants of India has issued the Companies (Auditor's Report) Order, 2015 mandating the auditor to mention in his report whether the company has an adequate internal control system commensurate with the size of the company and the nature of its business. Paragraph 3 of this order enumerates a list of questions that the auditor shall address in their report, and if any of the questions referred to in to in paragraph 3 is unfavourable or qualified, the auditor's report shall also state the reasons for such unfavourable or qualified answer, as the case may be. This order is applicable to every company including a foreign company, but shall exclude a banking company, an insurance company, a company licensed to operate under Section 8 of the Companies Act, 2013, an one person company as well as a private limited company with a paid up capital and reserves not more than Rs. 50 lakhs and which does not have loan outstanding exceeding Rs. 25 lakhs from any bank or financial institution and does not have a turnover exceeding Rs. 5 crores at any point of time during the financial year. Notification to bring this order into force has been issued by the MCA vide File No. 17/45/2015-CL-V, dated 10-4-2015 in supersession of the Companies (Auditor's Report) Order, 2003.

Loans and investment by company – Section 186(7) when not violated:

Ministry of Corporate Affairs has clarified that in cases where the effective rate of return on the tax free bonds is greater than the prevailing yield of government security closest to the tenure of the loan, there is no violation of Section 186(7) of the Companies Act, 2013. This section provides that no loan shall be given under Section 186 at a rate of interest lower than the prevailing yield of govt. security closest to the tenor of the loan. General Circular No. 6/2015, dated 9-4-2015 has been issued in this regard.

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Ratio Decidendi

Transaction of government business - Validity of minutes of meeting:

Supreme Court of India has held that minutes of the meeting, in the nature of an executive decision finalized merely at the level of officers/ representatives of Civil Aviation, Central Board of Excise and Customs, etc., allowing for release of aircrafts detained for non-payment of requisite fees, is not correct. The appellant had challenged the decision of Delhi High Court which had allowed release of aircraft on the basis of the said minutes of meetings, contending that the same curtailed their statutory power to detain the aircrafts for non-payment of fees and that said minutes of meeting cannot override Regulation 10 of the Airport Authority of India (Management of Airports) Regulations, 2003. Regulation 10 provided that in the event of non-payment of the requisite fee or charges, the Competent Authority shall have a right to detain or stop departure of the aircraft till the fees or charges are paid to Authority.

The Apex Court in this regard noting that alleged minutes of the meeting, stated to be an order in writing by Central Government and later communicated to all concerned, were not disposed of in pursuance of Rule 4 of the Government of India (Allocation of Business) Rules, 1961, i.e. neither the decision was sanctified by Cabinet nor the concurrence of Finance Department was taken. It was noted that after concurrence of the Finance Ministry, minutes of the meeting ought to have been placed before the concerned minister as per the Rules of Business, and that sanctification by the concerned ministry and the concurrence of Finance Department was a mandatory condition in order to hold the minutes of the meeting as "a general or special order in writing by the Central Government". The appellant was allowed to invoke the bank guarantee and to recover arrears of landing, parking or housing fees charges in accordance with law. [*Delhi International Airport Ltd.* v. *International Lease Finance Corpn.* - Civil Appeal No. 2932 of 2015, decided on 17-3-2015, Supreme Court of India]

De-notification of SEZ area – Rule 8 of the SEZ Rules to be followed:

Calcutta High Court has set aside the order of the Development Commissioner communicating the view of the Approval Committee that it was not possible to de-notify the Special Economic Zone. The court in this regard noted that proviso to Rule 8 of the Special Economic Zone Rules, 2006 provides for de-notification of an SEZ and also gives the procedure in this regard. It was noted that Development Commissioner on receiving an application has to forward it to the Board of Approval with his recommendation within 15 days of receipt of such application, and such Board has to make its own recommendation and forward the same to the Central Government, which would take a decision. The High Court also granted liberty to the petitioner to make a fresh application to the Commissioner for de-notification. [*Sen Pet (India) Limited* v. *Development Commissioner* - WP NO.1013 OF 2008, decided on 20-3-2015, Calcutta High Court]

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News Nuggets

International Financial Services Centre – RBI, SEBI & IRDA issue guidelines

In a major move to bring more meaning to SEZs in India, the Reserve Bank of India has notified Foreign Exchange Management (International Financial Services Centre) Regulations 2015, according to which a financial institution or a branch thereof set up in the International Financial Services Centre (IFSC) and permitted or recognised as such by the government or a regulatory authority shall be treated as person resident outside India. According to RBI Circular issued on 31-3-2015, financial transaction in this context shall mean making or receiving payment, drawing, issuing or negotiating bills of exchange or promissory note, transferring any security or acknowledging any debt. Simultaneously, similar guidelines have also been issued by SEBI on 27-3-2015, to facilitate and regulate financial services relating to securities market in an IFSC. It may be noted that any Indian recognised stock exchange or any stock exchange of a foreign jurisdiction is allowed to form a subsidiary to provide the services of stock exchange in IFSC. Further, in order to regulate insurance business in IFSCs, the Insurance Regulatory Development Authority of India (IRDAI) has also issued certain guidelines on 7-4-2015 according to which all Indian insurers are eligible to set up IFSC Insurance Office and an insurer registered with a foreign regulatory or supervisory authority will be permitted to set up such office based on certain criteria.

Foreign Trade Policy for next five years announced

Indian Ministry of Commerce and Industry has, on 1-4-2015, announced the new Foreign Trade Policy 2015-20. The earlier Policy 2009-14 which was effective only till 2014, but was extended later is no more in force. With the vision to make India a significant participant in world trade by the year 2020, the new Policy seeks to accelerate exports through various schemes intended to exempt and remit indirect taxes on inputs physically incorporated in the export product, import capital goods at concessional duty, stimulate services exports and focus on specific markets and products. In its first step towards providing stable and sustainable policy environment for growth of foreign trade in merchandise and services, the new FTP announces two new export promotion schemes – one for promotion of export of goods and another for promotion of export of services. Notifications have also been issued by the Ministry of Finance to operationalise various schemes as announced by the Commerce Ministry. FTP 2015-20 further

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announces host of trade facilitation and ease of doing business measures like online filing of documents, online inter-ministerial consultations, simplification of various procedures, digitization, etc. While Export Oriented Units (EOUs) have been given few incentives, the new FTP also includes specific measures to revitalise SEZs.

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