Securities Watchdog Gets More Teeth

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The Securities Laws (Amendment) Act, 1995, while amending the SEBI Act, 1992, to confer additional powers on SEBI has no doubt enlarged the jurisdiction of SEBI and had reinforced the autonomy of the watchdog body. But at the same time the Amending Act has resulted in introducing certain anomalies in the scheme of punishment and also suffers from certain other deficiencies. This article highlights these aspects

THREE sets of factors interact with one another to cause market failure in the capital market. These are: *(a)* Human characteristics—people are self-interested, they value consumption and dislike effort, they are risk averse and they have bounded rationality, *(b)* Economic environment—economic transactions take place without perfect information the collection, maintenance and use of which require formidable cost, property rights are not well defined and the production technology is lumpy and indivisible. *(c)* Capital market features—the capital market is information driven, the transactions are carried through intermediaries, the scale of operations of most of the players is very small, the various players are spatially dispersed and there is high degree of risk and uncertainty. For example, the flow of information in capital market is not instantaneous and all the participants in the market do not possess the same quality and quantity of information at any point of time. Some have access to additional information, some get information after a lapse of time, some have only misinformation and disinformation and some others never get information. This happens because the spatially dispersed small operators fail to break the information barrier raised by a group of sophisticated operators. As the various players in the market act and react on the basis of full and accurate information, inadequate information or misinformation and the self-interested players operate opportunistically in guile, the prices of securities, both in primary and secondary market, do not reflect the fundamentals of the issuer. The asymmetry of information, thus, makes market imperfect, transaction costs high and prices fail to allocate the resources efficiently.

This inherent tendency of the capital market to fail necessitate the existence of a regulatory body to regulate the conduct of all the participants in the market, to arrange for maintenance of property rights, to make provision of full, accurate and up to date information, to develop insurance and future markets to hedge against risk and uncertainty and to provide an institutional framework to minimise transaction costs. The need for regulation is further strengthened by the fact that the trade and industry nowadays all over the world depend on capital market substantially for resources to finance their modernisation and expansion programmes. If the capital market is to continue to be a major source of finance for the growth of corporate sector, it is necessary that all the players (issuers of securities, investors and the intermediaries) behave in a responsible manner. If they do not behave on their own, the regulatory body should make them behave in a desirable manner. It is in this context that all the countries have set up a regulatory body and armed them with powers to effectively develop and regulate capital market, although the style and banner of regulation vary quite considerably across the economies. In India, such a regulatory body was set up with the name and style of Securities and Exchange Board of India (SEBI) on 12th April, 1988. SEBI acquired statutory status on 21st February, 1992. The Securities and Exchange Board of India (SEBI) Act, 1992, enjoined upon SEBI to protect the interests of investors in securities and to promote the development of, and to regulate, the securities market. The functioning of SEBI over last few years revealed that SEBI has not been adequately armed to carry out entrusted duties efficiently. In 1995, the Securities Laws (Amendment) Act (henceforth referred to as amendment Act) was passed to amend, *inter alia,* SEBI Act, 1992 to confer additional powers on SEBI for ensuring the orderly development of the capital market. This paper is an attempt to examine the amendments effected in the SEBI Act, 1992.

COMPOSITION OF SEBI BOARD

Section 6(1)(d) of the SEBI Act made it obligatory for the Central Government to remove a member from the Board of SEBI if he was appointed as a director of any company. This was so presumably to ensure that a person would not be able to do justice to his roles as member of SEBI Board and as a member of Board of directors of a company simultaneously. His interests as member of SEBI Board may clash with that of a director of a company. After all the members of SEBI Board, which is a quasi judicial body, are not just expected to be impartial, they should also appear impartial. This was precluding the appointment of people with adequate knowledge and experience in the area of securities market to SEBI Board as many of them are also involved with corporate management in various capacities. The amendment Act has now deleted the provision relating to disqualification of a member of SEBI Board on his being appointed as a director of a company from the statute. It has inserted section 7A which makes it obligatory for a member of SEBI Board, who is director of any company and who has any direct or indirect pecuniary interest in any matter coming up for consideration at a meeting of the SEBI Board, to disclose the nature of interest and refrain from participating in the deliberations or decisions of the Board with respect to that matter. Now the Government can appoint people of eminence with experience in matters relating to securities market to the SEBI Board. This would improve the decision making potential of SEBI and enable SEBI Board to lead and guide more effectively the team of professionals working for SEBI.

THE JURISDICTION OF SEBI

The jurisdiction of SEBI has been enlarged by insertion of few more intermediaries and other persons associated with the securities market in sections 11 and 12 of the SEBI Act, 1992. The amendment Act has empowered SEBI to register and regulate the working of the intermediaries like depositories, custodians for securities and also certain other persons associated with the securities market like foreign institutional investors, credit rating agencies, venture capital funds etc. SEBI has also been given blanket authority to regulate other intermediaries or persons, not named specifically in the statute, by specifying them through a notification. This would obviate the need for amending SEBI Act every now and then to deal with a particular type of intermediary or a person associated with the securities market that may emerge in future.

Not only the ambit of SEBI has been expanded, but also, SEBI has been armed with better weapons to regulate various participants in the securities market. It has now been provided that henceforth the conditions of registration shall be determined by Regulations and not under Rules as used to be before the amendment. The enactment of Rules under the Act is the prerogative of the Central Government and is a very time consuming process in contrast to Regulations which is now the exclusive domain of SEBI. Before the amendment, the Regulations required prior approval of the Central Government under section 30 of the Act. This requirement has also been dispensed with. Now SEBI can notify its Regulations without prior approval of the Central Government. This would enable SEBI to expeditiously notify and modify regulations to keep pace with rapidly changing market conditions, facilitate maintenance of capital market discipline, prudence and transparency and thereby strike on time.

MONETARY PENALTIES

Section 12 of the SEBI Act originally provided for penalty of suspension and cancellation of a certificate of registration of an intermediary. Such suspension/cancellation leads to cessation of business and affects innocent third parties, often adversely, who were dealing with the intermediary. Besides there are many persons other than intermediaries associated with the securities market on whom the penalty of suspension/cancellation has no bearing. In order to tackle this, the amendment Act has inserted a new Chapter VI A in the SEBI Act which provides for monetary penalties as an alternative mechanism to deal with capital market violations.

SEBI has been empowered to adjudicate a wide range of violations and impose monetary penalties on any intermediary or other participants in the securities market. Chapter VI-A has listed out a wide range of violations along with maximum penalties leviable. It provides for a highest penalty of Rs. 10 lakhs and the violations listed are failure to submit any document, information or furnish any return, failure to maintain required books of accounts or records, carrying on any collective investment scheme without registration, failure to enter into agreement with clients, insider trading, failure to redress the grievances of investors, failure to issue contract notes, charging excessive brokerage by brokers, failure to disclose substantial acquisition of shares and take-overs etc. The amendment Act provides for three types monetary penalties, *viz.,*—*(a)* a lump sum penalty for a specific violation of the Act, *(b)* a penalty for every day during which the violation continues, and *(c)* a multiple of the amount involved in the violation. The amount of penalty is determined, subject to the ceiling, by the adjudicating officer who will be guided by the factors including amount of disproportionate gain or unfair advantage wherever quantifiable made as a result of the amount of loss caused to an investor or any group of investors as a result of default, and the repetitive nature of the default.

The adjudicating officer is required to be appointed by SEBI. He shall not be an officer below the rank of a division chief of SEBI. He will hold an enquiry after giving a person reasonable opportunity of being heard for the purpose of determining if any violation has taken place and imposing penalty. To ensure fair enquiry and penalty, it has been provided that appeal against the orders of adjudicating officers would lie to the securities appellate tribunal which has also been constituted by the amendment Act.

Now SEBI can intervene to stop certain actions of intermediaries or other persons associated with the securities market by cancelling/suspending their certificates of registration, if any, or by levying sufficiently punitive penalties as civil offences. However, suspension or cancellation would be regulated by regulations (SEBI has the power to determine by Regulations the circumstances under which the suspension or cancellation may be imposed), imposed by SEBI Board only and appeal from the orders of the Board would lie to Central Government. But the monetary penalties would be imposed only in cases of violations listed in Chapter VI A by an adjudicating officer as per the Rules prescribed by the Central Government. Appeals from the orders of an adjudicating officer can be preferred to the securities appellate tribunal and against the orders of Securities appellate tribunal is the High Court.

INVESTOR PROTECTION

Before the Amendment Act, SEBI was being perceived as ineffective and toothless in protecting the interests of investors. This was essentially because SEBI did not have any power to control or regulate the issuers of securities. Section 11(2)(b) of the SEBI Act listed all kinds of intermediaries to be registered and regulated by SEBI, but excluded the issuer of securities. As a result SEBI could not directly regulate the issuers (companies) on matters relating to issue and transfer of securities. In the absence of clear statutory mandate to SEBI to regulate issuers of securities which are governed by the Companies Act, 1956, SEBI was not able to compel the issuers to make adequate disclosures. It was rather directing its efforts only at the lead managers and merchant bankers who are intermediaries and signatories to prospectus requiring them to make adequate disclosures. Even this was being challenged in courts of law as this was perceived beyond the jurisdiction of SEBI. This debilitating infirmity has been done away with by the amendment Act which incorporated the following provisions in the SEBI Act—*(a)* Section 11A now inserted extends SEBI's regulatory powers over corporates in the issuance of capital, transfer of securities and other related matters. SEBI can specify by regulations the matters to be disclosed and the standards of disclosure required for the protection of investors in respect of issues made by bodies corporate; *(b)* Section 11B now inserted empowers SEBI to issue directions to all intermediaries and other persons associated with the securities market: *(i)* in the interest of investors, *(ii)* in the interest of orderly development of the securities market, *(iii)* to prevent the affairs of any intermediary including a mutual fund from being conducted in a manner detrimental to the interest of investors or of the securities market, or *(iv)* to secure the proper management of any such entity; *(c)* SEBI has been empowered to call for and furnish to any other agency such information as necessary for efficient discharge of its functions; *(d)* SEBI has been vested with powers of a civil court under the Code of Civil Procedure, 1908 in respect of the following: *(i)* summon and enforce attendance of persons and examine them on oath, *(ii)* inspect any books, register and other documents, *(iii)* discover and enforce production of books of account and other documents. These would help SEBI considerably to carry out investigations, conduct inquiries and inspections and levy fines against the erring intermediaries, issuers of securities and other persons associated with the securities market; *(e)* SEBI can conduct enquiries, audits and inspection of mutual funds, stock exchanges, self-regulatory organisations and other intermediaries and persons in the securities market; *(f)* Listing rules have been given statutory status by amendments to sections 21 and 23 of Securities Contracts (Regulations) Act, 1956. Any violation of listing agreement now would be punishable under the said Act.

AUTONOMY OF SEBI

The autonomy of SEBI has been reinforced by the following provisions: *(i)* SEBI has been vested with powers of a civil court, *(ii)* Section 20A now inserted bars the jurisdiction of civil courts in respect of actions or orders passed by SEBI. One can, however, prefer an appeal to the Central Government against the orders of SEBI and the jurisdiction of the High Court has not been barred. This would make SEBI's functioning independent of the lower civil courts and allow quick disposal of cases by SEBI without being hamstrung by stay orders from civil courts, *(iii)* Section 23A has been amended to extend the immunity from suit, prosecution or other legal proceeding to SEBI in respect of actions taken in good faith, *(iv)* Section 24, as amended, provides that non-payment of penalty would be an offence punishable with fine or imprisonment under the Act, *(v)* Section 26 now permits SEBI to file complaints in courts under section 24 in respect of offences under SEBI Act without previous sanction of the Central Government which was mandatory so far even for filing routine prosecutions, *(vi)* By amendment to section 28, the power of last resort of the Central Government to exempt any person or class of persons dealing with securities market from the requirement of registration with SEBI has been surrendered, *(vii)* Section 29, as amended, provides that the conditions for grant of registration would be determined by Regulations and not by Rules, *(viii)* Section 30 has been amended to provide the SEBI can notify regulations without approval of the Central Government. These would enable SEBI to respond speedily to changing market conditions.

MARKET DISCIPLINE

All players in the securities market have been brought under regulatory framework of SEBI. If any body has been left out or a new type of player emerges in the future, SEBI has been given authority to bring that player to its jurisdiction by a notification only. Armed with authority to impose monetary penalty as well as suspension or cancellation of certificates of registration of erring players, SEBI can effectively prevent a player from repeating a violation and prevent other players from indulging in violation for fear of attracting deterrent penalty.

SECURITIES APPELLATE TRIBUNAL

An efficient and effective system of regulation calls not only for firmness, but also for fairness. The amendment Act seeks to establish one or more securities appellate tribunals to hear the appeals from the orders of the adjudicating officers. Any body not satisfied with the orders of the tribunal can prefer an appeal to the High Court. This would ensure fairness in the process of adjudication.

Thus, by the amendment Act, the Government has effectively vested SEBI with all the powers required to discipline securities market and conferred quasi judicial status on it. This has put SEBI on the firing line. SEBI has no more excuses for inaction. The outcome should be greater transparency and speed in operations and an end to insider trading, crony deals and payments and delivery problems all of which contribute to the market failure. It may be mentioned that the powers conferred on SEBI are concurrent with those enjoyed under the Companies Act by the Department of Company Affairs.

DEFICIENCIES

All said and done, the amendment Act has introduced a lot of anomalies in the scheme of punishment and failed to harmonise and consolidate laws relating to securities market.

Anomalies in the scheme of punishment

The SEBI Act, as amended, provides for two alternative types of punishment for violations of the provisions of the Act. They are—*(a)* suspension or cancellation of certificates of registration to be imposed by SEBI Board only as per Regulations framed by SEBI, or *(b)* monetary penalty to be imposed by an adjudicating officer, appointed by SEBI, as per Rules framed by the Central Government. These two types of punishments are mutually exclusive, not and/or punishments. If a violation is assigned to an adjudicating officer for adjudication or monetary penalty is imposed, penalty of suspension or cancellation of certificate of registration can not be imposed and vice versa. It is possible that a violation attracts both the types of punishment, but it is the SEBI Board which would predetermine the type of punishment to be imposed for the violation. As per the scheme of the Act, SEBI shall appoint an officer to adjudge if some body has contravened any of the provisions of sections 15A to 15F of the Act. Once such an adjudicating officer is appointed, the SEBI Board loses control over the case and the adjudicating officer decides the case on merit. The adjudicating officer can at best impose monetary penalty even if he finds that the violation really warrants suspension or cancellation of registration. Similarly, if SEBI Board initially considers a case for suspension or cancellation, it can not impose monetary penalty even if it concludes that the violation warrants monetary penalty. This happens because the SEBI Board does not have power to impose monetary penalty and the adjudicating officer does not have power to suspend or cancel a certificate of registration.

A corollary of the above is that mind is made up about the type of punishment to be imposed on the erring party when the alleged violation is referred to adjudicating officer for adjudication or taken up by SEBI Board for imposition of suspension or cancellation of registration, that is, at a stage when the nature and gravity of the violation has not been ascertained. When a case is referred to an adjudicating officer, it implies that SEBI has taken an irreversible decision to levy at best monetary penalty.

Normally, monetary penalty is perceived less grievous in comparison to suspension or cancellation of registration. It is generally expected that a more rigorous process is followed before imposing a grievous punishment. But in the scheme of the SEBI Act, a more regiorous process is followed for imposing a lighter punishment. A light punishment, that is, monetary penalty is imposed only after the process of adjudication by an adjudicating officer under the circumstances enumerated in the statute and the adjudicating officer would follow Rules framed by the Central Government. Again, a securities appellate tribunal has been constituted to hear appeals from orders relating to monetary penalty and further appeal from the orders of the securities appellate tribunal would lie to the High Court. The more serious punishment of suspension or cancellation of registration can be awarded by SEBI Board as per Regulations framed by itself. Appeals can be preferred from the orders of SEBI Board to the Central Government where the designated officer to hear the appeal is a Special Secretary (Insurance), Department of Economic Affairs.

Any adjudicating authority has the power to issue interim order during the pendency of a case, whereas SEBI does not seem to have any such power. SEBI Board can pass, under the circumstances specified in the Regulations, final orders for suspension or cancellation of registration. Strangely, suspension, which is normally an interim order, is a final order under the SEBI Act. If a violation *prima facie* warrants cancellation of registration, the SEBI Board would take up the case. Until a final view is taken after complying with the due process of law as provided in the Regulations, SEBI can not stop the business of the erring party who can continue to do further damage. Further, the Act is silent as to what happens to existing contracts/business/assets of an intermediary, if the certificate of registration is cancelled.

The alternative punishments of monetary penalty and suspension or cancellation are available to SEBI in respect of intermediaries which are required to be registered under the SEBI Act. The alternative of suspension or cancellation is not available to SEBI in case of persons associated with the securities market who are not required to be registered with SEBI.

The maximum penalties prescribed appear at times too low where it should be high and too high where it should have been low. For example, the maximum penalty SEBI can levy for insider trading is a meagre Rs. 5 lakhs which an insider would be too happy to pay after making a killing on the stock market with price sensitive information. On the other hand, the failure of a broker to issue, even if negligently, a contract note visits a fine as high as five times the contract value. Thus a broker who fails to issue a contract note for Rs. 20 lakhs, has to cough up Rs. 1 crore.

SEBI has the power to suspend/cancel registration or impose monetary penalty only if an intermediary is registered with it. It can only prosecute if an intermediary carries on business (except collective investment scheme) without registration.

Harmonisation of laws

While the amendment has increased SEBI's ambit, it has not correspondingly reduced the ambit of the Department of Company Affairs in matters relating to securities market and investor interest. As a result the responsibility for supervision and development of the securities market is fragmented among different agencies. As the roles of various agencies overlap, they may at times work at cross purposes and result in extensive, duplicate and inconsistent regulations. The role and jurisdiction of various agencies that have supervisory and regulatory authority over various aspects of the securities market need to be clearly defined. Still better if only one agency is given exclusive authority over the securities market.

There are four basic pieces of legislation that provide regulatory framework for the securities market. These are—*(a)* The Companies Act, 1956, which deals with issue, allotment and transfer of securities and disclosures to be made for public issues, *(b)* The Securities Contracts (Regulation) Act, 1956, which provides for regulation of transactions in securities through control over stock exchanges, *(c)* The Securities and Exchange Board of India Act, 1992, which provides for the establishment of a regulatory authority to protect the interest of investors in securities and to promote the development of and to regulate the securities market, and *(d)* The Depositories Ordinance, 1995, which provides a legal basis for establishment of depositories to maintain the ownership records of securities in a book entry form and effect the transfer of securities. In addition, there are a number of other legislations (The Income-tax Act, The COPRA, The Indian Trust Act, The Reserve Bank of India Act, The Unit Trust of India Act, The MRTP Act) which have substantial bearing on the securities market. All these have caused a lot of confusion not only in the minds of investors, but also among the various agencies who administer these legislations. The investor is still left high and dry despite a plethora of legislation that purportedly protect his interests. He still runs after civil courts for redressal of his grievances. The amendment Act also does not do enough to protect the interest of investors from the whims of corporate management which holds up share transfer on slightest of pretexts. It has only enlarged the jurisdiction of SEBI over the Depositories which paved the way for Depositories legislation and made the securities of public companies freely transferable. There is a need to harmonise and consolidate all the laws relating to securities market into one piece of legislation to be administered by one agency.

Securities market supervision is labour intensive and relies for success on the commitment, judgement and skill of the personnel involved. Given the size and spread of the securities market, SEBI must increase its staff strength which is now quite inadequate for the tasks assigned to it. Staffing pattern of SEBI also needs to be changed to recruit professionals. SEBI must recruit experts who thoroughly understand the functioning of Indian as well as international financial system. Extensive training, retraining and staff supervision are also required to achieve the necessary level of professionalism.

RECOMMENDATIONS

(I) It would be better if all the violations under the SEBI Act are adjudicated, as per Rules framed by Central Government in this regard, by an adjudicating officer who should have authority to impose monetary penalty and/or cancellation of certificate of registration. The adjudicating officer should have power to pass an interim order to suspend the business of an intermediary pending adjudication. All the orders of the adjudicating officer should be appealable to the securities appellate tribunal. SEBI Board should direct its efforts for development of the market rather than waste its precious time in trying violations of the Act.

(II) Various laws governing the securities market should be consolidated into a single piece of legislation and only one authority (SEBI) should be made responsible for its administration. This agency should professionally competent enough to play both developmental and regulatory role effectively. □