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# Streamlining the disciplinary process

*There is a need for consistency in the adjudicating frameworks of Sebi and other market regulators to ensure fair financial market outcomes*

M S Sahoo | Sumit Agrawal |


Illustration: Ajay Mohanty

On November 6, in the case of *Choice Equity Broking Private Limited vs. Multi Commodity Exchange of India Limited*, the Securities Appellate Tribunal (SAT) set aside an order of a market infrastructure institution (MII), imposing a monetary penalty on a trading member. The SAT ruled the order was in gross violation of the principles of natural justice, as it was issued without issuing a show cause notice and without an opportunity for a hearing. It directed the MII to institute a procedure for penalty proceedings against its members. This has a lesson for MIIs. All of them have scope for improving the adjudication process on some count or other.

MIIs are institutions. They are of three classes, namely, exchanges (stock, commodity, and currency), clearing corporations, and depositories. They provide infrastructure for the market. A set of licensed users access the infrastructure of MIIs to assist investors in undertaking transactions. Trading members trade

securities for investors using the infrastructure of an exchange, depository participants record the ownership of securities of investors using the infrastructure of a depository, clearing members settle trades of investors using the infrastructure of a clearing corporation, and issuers issue securities to investors using the infrastructure of exchanges and depositories. MIIs regulate the conduct of their users to protect the interests of investors and market integrity.

Of the MIIs, stock exchanges have been in existence for centuries. For a long time, they exclusively regulated the securities markets and the conduct of their users. In recent decades, they have lost their primacy due to recurring conflicts between their commercial aspirations and the regulatory mandate, as well as the search for new turfs by the statutory regulator, the Securities and Exchange Board of India (Sebi). MIIs now play frontline regulators, as an extension of Sebi as the principal regulator. Regulatory literature considers them as delegates of Sebi, while law considers them as "State" under Article 12 of the Constitution. Both Sebi and MIIs have similar responsibilities, such as protecting the interests of investors in securities, and developing and regulating the securities market. They also have similar quasi-legislative, executive, and quasi-judicial powers, though they vary in breadth and depth.

Over time, Sebi has imbibed several best governance practices, often voluntarily and at times with a nudge. To bridge the democratic deficit, it adopted public consultation for making regulations voluntarily decades ago. It commenced the review of regulations recently on a nudge from the government. The law, however, mandates several best practices for the exercise of powers, given their potential to infringe on the rights of stakeholders. For example, only the governing board can exercise quasi-legislative powers, that too, following a sacrosanct process. Such practices, as mandated for the exercise of powers by Sebi, should also apply to MIIs when they exercise similar powers.

Recall the discussion in the early 1990s about empowering Sebi to impose monetary penalties, as other options were not always helpful. It was then unthinkable to allow an agency outside the government to levy such penalties. Thanks to the persistent efforts of a few champions of regulatory governance, it was agreed subject to the conditions: (a) the statute lists various contraventions and the associated monetary penalties, (b) an adjudication process determines the amount of penalty, to be credited to the Consolidated Fund of India, (c) an appellate forum considers appeals against adjudication orders, and (d) statutory rules provide for the detailed adjudication process. This solution, over time, has been replicated across regulatory statutes.

Fast forward to 2023. Both Sebi and MIIs have the authority to adjudicate contraventions and issue a range of penalties. The word "penalty" embraces such directions as necessary to protect the interests of investors, as reiterated by the SAT on December 15 in Edelweiss Custodial Services Ltd Vs NSE Clearing Ltd & Others. These include monetary penalties, suspension/ withdrawal/termination of user rights, and even directions like restitution. MIIs initiate proceedings against an estimated 10,000 users/ listed companies, every year, which end up with a variety of directions/ penalties. Not all of them pass through an adjudication process or the test of principles of natural justice.

Adjudication may end up condemning a person and snatching away their livelihood. Therefore, worldwide, the legal framework explicitly provides for adjudication and prescribes a sacrosanct process to ensure fair outcomes. Since adjudication by Sebi and MIIs has the same objectives and the same consequences, and they are arms of the State, there is no reason why the legal provisions for adjudication, and the process for adjudication, as they apply to adjudication by Sebi, should not be replicated for adjudication by MIIs.

For sound adjudication by MIIs, the statute should require (a) a listing of contraventions along with associated monetary penalties, specifying contraventions that warrant suspension or cancellation of user access or suspension of trading/delisting of an issuer (b) an adjudicating authority, preferably a senior officer or a panel of officers (not a Board Committee of the MII) who is trained in adjudication and not associated with the fact-finding process, to conduct adjudication, (c) a mechanism to enforce recovery of penalties and credit the same to the Consolidated Fund of India, instead of the investor protection fund or settlement guarantee fund (d) a facility to settle contraventions, and (e) an external appellate authority (and not the Board of Directors of MII) to consider appeals of persons aggrieved by adjudication orders.

Sebi Regulations should provide for (a) the issue of a show cause notice detailing the alleged conduct, which is a contravention, following a fact-finding process, and the proposed direction, if the contravention is established, (b) supply of all relevant material in possession of the MII that either establishes or undermines the allegation, (c) opportunity to the delinquent to rebut the allegation in writing and in person before the authority, (d) obligation to dispose of the show cause notice by reasoned order, considering mitigating and aggravating factors and principle of proportionality, (e) the dissemination of every adjudication order in the public domain, as in the case of Sebi and SAT orders, and (f) timelines for

various tasks for the authorities and the parties in the disposal of the show cause notice.

The MIIs should voluntarily prescribe adjudicatory discipline in their internal regulations, pending statutory provisions. They may even consider using a specialised agency for dispensing penalties, like SMARTODR, a common agency for arbitration. This will enhance trust in adjudication, deter potential miscreants, and build the institutional legitimacy of MIIs.

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*The writers are, respectively, distinguished professor, National Law University Delhi, and founder & partner, Regstreet Law Advisors*



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