

SEBI 'warns' wrongdoers — to what effect?

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SEBI issues warnings by way of quasi-judicial orders after inspections or investigations. It also issues administrative warnings, deficiency letters, or other advices, post inspection/audit. It issues observation/warning/caution letters even otherwise for contravention of specific regulations/circulars such as those relating to advertisements by asset management companies.

Obviously, a warning is issued for contravention of, or non-compliance with, some provision of law. Administrative warnings were issued to Sameer Relia in 2007 for structured and synchronised deals, and to Vedanta Ltd in 2021 for executing a related-party transaction without approval of its audit committee. Quasi-judicial warnings were issued to Bama Securities in 2004 for non-co-operation with inspecting officials and to Tata Motors and others in 2022 in the matter of backward transactions in certain shares.

The rising numbers

The incidence of administrative warnings has been increasing over time. The SEBI Annual Report for 2020-21 reports approval of administrative warnings in respect of 214 entities during the year. It also reports enforcement actions, which include a few quasi-judicial warnings, but exclude 456 administrative warnings/warning letters/caution letters, 45 deficiency observations, and 83 advice letters issued by operational departments of SEBI.

On occasion, the Securities Appellate Tribunal modifies the penalty in quasi-judicial orders to warning. It substituted, for example, the penalty of ₹5 lakh to a warning in Bharti Goyal vs SEBI in 2020. The powers of the Tribunal to convert penalty into a warning is, however, under examination of the Supreme Court.

Warnings — administrative and quasi-judicial — are also issued by other regulatory authorities. It seems to be a widely prevalent regulatory action against registered as well as unregistered entities for a variety of contraventions. Given the language of the warning and the underlying contraventions, many warnings, wherever available in public domain, make newspaper headlines.

The statute usually lists the contraventions/non-compliances and prescribes corresponding penalties such as monetary penalty, suspension or cancellation of registration, or even imprisonment. It also has a residuary provision that provides for a penalty for contravention for which no separate penalty has been prescribed. It does not typically provide for warnings for any contravention. Except for a mention in a few regulations like the SEBI Fraudulent and Unfair Trade Practices Regulations, there is not much legal backing to the warnings.

Issuing administrative warning does not necessitate any notice, hearing or other facets of principles of natural justice. These are not usually issued in the public domain by the regulator. There is no requirement on the offender to disclose such warnings either, except where a listed company is instructed to disseminate the same to the stock exchange(s).

Since these are not publicly available, neither the market benefits by way of informed decisions in respect of the offender nor do the offenders have any incentive to mend their ways. Quasi-judicial warnings, however, pass through due process and are available in the public domain. Since warning arise from the same cause of action and serve the same regulatory purpose, the rationale for having two tracks for warnings is not evident.

The warning letters typically use words: "...The aforesaid non-compliance is viewed seriously. You are hereby warned and advised to ensure compliance with applicable provisions of SEBI Regulations. Any such aberration in future would be viewed seriously and appropriate action would be initiated" (Letter dated June 24, 2022 to Aurobindo Pharma Ltd). Warning orders use: "The Noticee ... is hereby warned to be more careful in their future dealings in the securities market" (Order dated June 9, 2022 in Global Telesystems Ltd). However, there is no evidence of such warnings being tracked or followed up by enforcement actions if the warning is not heeded.

There is no publicly available framework, statutory or otherwise, that guides what kind of contraventions warrant a warning, to enable the market to factor in the risk of warning in their business decisions. This leaves a wide room for arbitrariness, and potential abuse of power, inviting at times media criticism that serious offenders are being let off through warning. The Tribunal modifies penalty to warnings mostly on the ground that warnings are being meted out for similar contraventions (Example: Shri Kamlesh R Shah vs the Whole Time Member).

Legal backing needed

Warnings have been in vogue for about two decades. It is time to assess and demonstrate their utility and effectiveness. If the assessment finds it worth continuing, it should find a place in the law, along with a list of contraventions that may warrant a regulatory warning, and an objective framework to govern the process of issue of warnings.

Different contraventions/non-compliances, which may lead to a warning, should have an associated numeric score. A public register should display all warnings issued to an entity in its lifetime, along with the cumulative aggregate score, to help the market take informed decisions.

For the warning to be effective, it should add to the cost of doing business to discourage potential offenders/non-compliances of law and to nudge desired conduct of market participants. A higher aggregate score should invite higher obligations in terms of higher regulatory fees, more frequent inspections and audits, more frequent filings of compliances, additional compliance requirements, etc.

If the aggregate score exceeds x, the obligations should increase by a certain percentage, and the entity should face penal proceedings when the score exceeds a threshold. This will be something similar to the SEBI Intermediaries Regulations, which allow at best five censures to an intermediary.

A parallel is found in CIBIL Scores, which lenders use to evaluate loan applications. In fact, the SEBI Investment Advisers Regulations require CIBIL score to be submitted as part of the registration process. Several commercial apps like Uber, Swiggy, and Urban Company use a scoring system to rate service providers as well as customers. There are consequences where the score exceeds a certain threshold for a driver or a restaurant.

A somewhat similar practice is found in the Social Credit System in China, which tracks the conduct of citizens in terms of scores, and a citizen having low scores faces certain disadvantages.

In the interest of credibility and effectiveness of warning as a regulatory tool, it needs to be formalised and standardised, and dispensed in a transparent manner that adds to the cost of doing business for habitual offenders of specified contraventions.

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