INVESTOR PROTECTION

AS A PRACTICE, DISGORGEMENT NEEDS FINE-TUNING TO ENSURE UNWAVERING INVESTOR TRUST

Disgorging market miscreants

MS SAHOO
SUMIT AGRAWAL

Respectively, distinguished professor, NLU Delhi and founder & partner, Regstreet Law Advisers
Views are personal

DISGORGEMENT HAS BEEN hogging headlines in the recent months for a very good reason—on August 17, 2023, the Securities and Exchange Board of India distributed the third tranche of ₹15 crore from the disgorged amount to investors who had lost money to IPO irregularities in 2003-05; and for a not so good reason—several high-profile disgorgement orders are hitting roadblocks.

Regulatory jurisprudence witnessed history in 2006 when Sebi, through an interim order, directed several parties to disgorge an unlawful gain of ₹126 crore after unearthing IPO irregularities, one of the most sophisticated scams in the securities market. The order was, however, set aside as there was no final determination that the parties did something wrong and they made unlawful gain from. On final determination of the matter, Sebi directed the miscreants to disgorge the unlawful gains. Both the Securities Appellate Tribunal (SAT) and the apex court upheld the direction, though the statute then did not explicitly provide for it.

A regulator usually penalises a miscreant for a contravention through suspension or the cancellation of registration or monetary penalties. These sanctions are necessary, but are not sufficient to pacify victims. Sebi created history again in 2010, when it distributed ₹23 crore from the disgorged amount to victims of IPO irregularities. Subsequently, in July 2013, Parliament conferred on Sebi explicit powers to direct disgorgement and regulations enabled it to use the disgorged amount for restitution. Sebi disgorged further sums from the miscreants of IPO irregularities and distributed the second tranche of ₹18 crore to aggrieved investors in 2015.

Disgorgement is an equitable remedy that aims to restore the parties to the financial position they had before the contravention by making the wrongdoer disgorge the unjust gain it has made and, if possible, using the disgorged amount to compensate the victims. Probably, Sebi is the only regulator that has explicit power to seek disgorgement and even recover the same by coercion. It has used the said power successfully and even distributed the disgorged amount to victims of contravention. It issued disgorgement orders against 115 entities in 2022-23, indicating the growing popularity of disgorgement as a regulatory remedy for contraventions.

Disgorgement serves several purposes—fairness, deterrence, restitution, public interest, etc. Regulators must utilise it to compensate their innocent constituents

Now, the roadblocks. They arise mostly from non-adherence to procedural fairness. First, disgorgement typically takes away the wrongful gain made or loss averted by a person through contravention. Therefore, a regulator can ask for disgorgement only if there is a final determination that there has been a contravention. The law envisages an enquiry for this purpose. While the enquiry is on or contravention is yet to be established, an interim order could be issued to give several directions, including impounding, but not disgorgement. The very first disgorgement order was set aside as it was an interim one.

Second, persons who made illegal gains alone from the contravention could be asked to disgorge the same. In a recent study, Renuka Sane finds that in the case of 9% of disgorgement orders issued between January 2018 and July 2021, it was not found that miscreants made a benefit or avoided a loss. Recently, Sebi ordered the disgorgement of 25% of the salary of two executives of an entity. The SAT set it aside on the ground that the salary was neither unlawful gain nor loss averted by the contravention, but earned for the services rendered by them.

Third, who should disgorge in case several parties have a role in a contravention? There is a tendency to hold them liable *en bloc* for the contravention and ask them to disgorge jointly and severally. In case the parties did not act in concert or did so with contravention by each of them being distinct or the profit made/loss averted by each of them being verifiable, a party should be liable for its role and disgorge the amount attributable to its action.

Fourth, the onus is on the regulator to adopt a uniform and transparent methodology to work out the amount it seeks to disgorge that reasonably approximates the amount of unjust enrichment. For want of such a methodology, subjectivity and discretion creep in, leading to the remand of several matters for reconsideration. In its 2020 report, Sebi's high-level committee on strengthening the enforcement mechanism stressed that unless the manner of quantification is laid down, it would be difficult to justify why a particular amount should be disgorged.

Fifth, the final determination of a contravention may take years, during which the miscreant continues to enjoy unjust enrichment. Since money has time value, the miscreant should disgorge the unlawful gain along with interest. A wide range of interest rates from 4-12% are being applied to capture the time value. This often adds to avoidable litigation and remand of matters. Guidelines could provide a fixed rate or a formula-driven variable rate for this purpose, similar to the specification of 9% in the Settlement Regulations.

Sixth, imagine the confidence of investors if they have assurance of restitution for their loss that they may suffer from any contravention. This requires distribution of the disgorged amount to victims. There are several difficulties: recovering the unlawful gain from the miscreant, identifying the victims and estimating their loss, the amount of gain made by the miscreant may fall short of the loss suffered by victims, etc. Yet, Sebi did it with great élan for IPO irregularities and few other matters, but it needs to do so more often.

Disgorgement serves several purposes—fairness, deterrence, restitution, public interest, etc. Regulators must use disgorgement to compensate their innocent constituents—consumers, clients, investors and the like. They could use their inherent powers or seek explicit powers for the purpose. This would substantially enhance the legitimacy of the regulator in its constituency and promote market integrity and vibrancy.