

**HIGH LEVEL COMMITTEE UNDER THE  
CHAIRMANSHIP OF  
JUSTICE ANIL R. DAVE, RETIRED JUDGE, SUPREME  
COURT OF INDIA**

**A REPORT ON THE MEASURES FOR STRENGTHENING  
THE ENFORCEMENT MECHANISM OF THE BOARD  
AND INCIDENTAL ISSUES**

## **PREFACE**

The Securities and Exchange Board of India was set-up with the following mandates, -

- (i) to protect the interest of investors in securities;
- (ii) to promote the development of the securities market; and
- (iii) to regulate the securities market.

Protection of investors' interest is the primary and one of the most important responsibilities of the Board. The Board regulates the manner of raising monies from the public and in case of any default, it protects the investors' interest by initiating several measures including suspending and cancelling the certificate of registration, debarring, penalizing, prosecuting defaulters, ordering recovery and directing disgorgement and refund to identifiable investors. The Board also regulates trading of securities and ensures that the same is carried out in tune with investors' interest. The Committee has considered various issues pertaining to the enforcement mechanism of the Board and made recommendations thereon to make it more robust and efficient. These recommendations seek to introduce tactical, strategic and systemic changes in the enforcement process spread over a period of few years, to enhance and improve the capabilities of the Board in protecting the investors and indicting the defaulters.

### **Part-A: Review of Intermediaries Regulations:**

The securities market is largely built on the infrastructure and services provided by the intermediaries. A deficiency in the functioning of an intermediary may possibly impact the functioning of the securities markets and erode investors' trust. The Board regulates intermediaries through:

- (i) substantive Regulations which are entity specific and which specify the eligibility criteria for obtaining the certificate of registration and lay down the operating standards for providing financial services to clients, and

- (ii) the SEBI (Intermediaries) Regulations, 2008 which regulate the manner of holding enquiry against them in case they violate the substantive regulations.

In order to protect the interests of the investors, the Board should be able to initiate remedial and punitive action against the delinquent intermediaries efficiently and in a timely manner for the effective regulation of the securities market. On the basis of experience gained in the enforcement proceedings against the intermediaries so far, it is felt that the current process under the SEBI (Intermediaries) Regulations, 2008 is unjustifiably drawn-out and hence needs to be reviewed. The fact that intermediaries owe a fiduciary duty to the investors unlike other market participants, underscores the need for proceedings against the intermediaries to be conducted and concluded in a timely fashion.

Hence, to enable efficient regulation of intermediaries, the Committee has proposed rationalization of processes in the SEBI (Intermediaries) Regulations, 2008 to avoid duplicity of proceedings before the Designated Authority and the Designated Member. SEBI is required to adhere to the principles of natural justice in the course of its proceedings against an intermediary but such adherence cannot be meant to extend the application to such an extent that permits holding the system hostage at the cost of compromising the very interest of the investors. It is thus proposed that once the Designated Authority has provided personal hearing to the intermediary and submitted the report to the Designated Member, in the second stage of enquiry, the Designated Member shall, after issuing a notice to show cause and granting an opportunity of written submission to the noticee, proceed to pass an appropriate order in the matter in the interest of justice, equity and good conscience.

### **Part-B: Recovery of monies due under the securities laws :**

Prior to July 2013, the Board was not empowered to recover amounts such as fees, penalty, disgorgement amounts or monies ordered to be refunded. Initiation of criminal proceedings for default in the payment of penalty levied by the adjudicating officer was

the only action available to the Board. The results were not satisfactory, since the said proceedings were stalled for a considerable period of time due to the absence of Special Courts. Nor did they ensure actual recovery. In any case, this power did not extend to instances where the dues were not in the nature of penalties (amount due as refunds to investors, monies ordered to be disgorged and unpaid fees).

After the promulgation of two Ordinances and the Securities Laws (Amendment) Act, 2014, the Board has been vested with the power to recover the monies due under securities laws. The mechanism relating to the 'Recovery Officer' under the Income Tax Act, 1961 and the Rules made thereunder were made applicable with '*necessary modifications as if the said provisions and the rules made thereunder were provisions of securities laws*'. However, the '*necessary modifications*' are not clarified anywhere, even in the Rules made by the Central Government. Over a period of time, on the basis of experience gained, it is noted that the mechanism of Recovery Officer needs several modifications considering that, -

- (i) monies due under securities laws may be due to several persons and not just to the Central Government as is the case under the Income Tax Act, 1961;
- (ii) some of the provisions of recovery inserted in the securities laws enactments are more suited for recovery in case of 'clubbing of income' which are not applicable in securities laws.;
- (iii) the existing provisions do not take into account positive developments in law such as '*e-auction*' which has been recognized by the Punjab and Haryana High Court in *Dr. Mandeep Sethi v Union Bank of India & Ors* (AIR 2013 P&H 82) and other courts subsequently.

Securities laws empower the Board to frame 'regulations' which are consistent with the securities laws and the Rules made thereunder and to carry out the purpose of the securities laws. Since the relevant provisions of the Income Tax Act, 1961 and the Rules thereunder have been incorporated as part of the securities laws enactments itself, the Committee is of the view that in so far as the modifications may be provisioned by way of subordinate legislation, the Board is competent to frame regulations relating to recovery while certain other modifications may be carried out by way of amendments in the

securities laws enactments. Accordingly, the Committee has recommended the issuance of comprehensive Regulations for Recovery, to clarify issues relating to recovery in the context of the securities laws. The Committee is also of the view that amending the securities laws enactments to clarify the power of the Board to make regulations relating to recovery would also obviate any unnecessary challenges in this regard.

### **Part-C: Quantification of profit and loss and related issues:**

In the Report on the Settlement mechanism of the Board, this Committee has dealt with the factor relating to the '*repetitive nature of the default*'. In the present report, the Committee shall deal with the factors relating to disproportionate gains made and losses caused to investors by a defaulter and attempt to lay a roadmap to enable quantification of gains and losses and other incidental aspects, which are of material significance to the enforcement processes of the Board, including the settlement mechanism. The Committee had *inter alia* recommended that broad list of defaults which could not be settled under the previous 2014 settlement regulations could be made principle based in view of the Committee's impending report on quantification which would enable the Board to arrive at a fair settlement. As the 2018 settlement regulations is in line with the recommendations of the Committee, this Report deals with the quantification of profit and loss due to various defaults, to the extent possible. Further, the Committee has taken note of the present non-public guidelines for quantification of profit (which do not pertain to quantification of loss to investors) used by SEBI and appear to be applicable to a limited number of 'simple' scenarios and do not capture the full capabilities of the technical resources available with the Board.

The Committee notes that over a period of time, securities laws violations have become complex. The Board should therefore prepare in advance for the challenges of the future and in order to do so, must also develop its technical resources to adequately assess and punish defaulters. In view of the same, the Committee advocates the use of financial economics as used in other securities jurisdictions and has re-worked the manner of

quantification of profit and also provided for quantification of loss caused to the investors along those lines.

In 1897, Justice Oliver Wendell Holmes Jr. of the US Supreme Court in his seminal essay *'The Path of Law'* mentioned that, *"For the rational study of law the black-letter man may be the man of the present, but the man of the future is the man of statistics and the master of economics."* The statistical methods used by global regulators, such as event study methodologies, have their foundation in the efficient markets hypotheses – that security prices reflect all publicly available information (fraudulent or otherwise). The 2013 Nobel Prize for Economics was awarded to Eugene Fama and others for the *'development of the efficient-market hypothesis and the empirical analysis of asset prices.'* These techniques were first developed and applied in the context of stock price reaction to stock splits by Eugene Fama and others in their seminal work published in the *International Economic Review* in 1969. In the late 1980's the USA's Securities and Exchange Commission began the use of financial economics in securities litigation; now their use has become the gold standard in enforcement globally. The Commission wholeheartedly recommends the adoption of such methods by the Securities and Exchange Board of India in the similar disclosure based market regime of India.

With international investors coming into the Indian markets and Indian investors investing in international markets, Indian companies issuing ADR/GDRs, global and Indian companies seeking listing in dual jurisdictions, the economic world has become flat and the principles for determining the profits made by and losses caused to investors by defaulters need to have a universally sound foundation if investors are to be protected across jurisdictions. A situation where manipulation in a security is investigated by more than one securities regulator, is not too far away. It is desirable that various securities regulator's methods of quantification are aligned to ensure consistency, avoid conflict and the latest techniques of financial economics be used to penalize defaulters.

Securities market is a unique market. *Quantification of profit made from a securities laws violations and loss caused to investors is not always a 'zero' sum game.*

*E.g.* while profit may be derived from a particular transaction, the defaulter may employ a ‘pump and dump’ scheme and end up depressing the entire market price of the security manipulated, thus causing loss to the entire market and not just the person with whom the defaulter may have traded. Potential losses may dwarf potential profits and be beyond the paying capacity of most defaulters because profit made from a securities laws violations and loss caused to investors need not always correspond with each other. Separate principles have been recognised globally for their quantification and have been taken note of by this Committee. Similarly, in respect of ‘victim-less defaults’ (where there may be no easily identifiable investor who may have suffered legal damages) such as insider trading, the profit to a defaulter may arise without any ‘quantifiable legal loss’ to any shareholder.

In view of this, existing securities laws provide for disgorgement rather than compensation. The disproportionate gain is directly relevant in the levy of penalty, in addition to disgorgement and settlement, whereas loss quantification is only used as a guidance tool for determining suitable penalty within the range specified by law or for the purposes of settlement. If loss caused to investors is not quantified, then the perpetrators of securities laws violations would enjoy a windfall as the penalty imposed may be disproportionate to the fraud.

Quantification in the context of a dynamic securities market is both a science and an art; based on defined principles drawn from law, economics, accounting and mathematics, while being imprecise at the same time. To the extent possible, the Board should attempt to quantify the unlawful gains made and losses caused to investors, though the exact amounts may never be ascertainable with certainty, since uncertainty is a necessary feature of any dynamic securities market and investors and defaulters are subject to it alike. Investors and defaulters willingly subject themselves to market risks while making trading decisions for making lawful or unlawful gains, sometimes turning it to their advantage or disadvantage. They must therefore be subjected to the same market risks when being judged for their unlawful activities. Different securities regulators and courts over the world have been able to establish working principles for

different scenarios. This Report takes note of them and to the extent possible modifies them for the purposes of the Indian securities markets.

The parameters for determining profits made and losses caused are an essential complement for proving the violation of securities laws and in fact supplement the fact-finding inquiry. A separate inquiry to determine the profits made and losses caused is not required to be conducted after the inquiry that proves guilt, they are two sides of the same coin. Hence, investigation, inspection, inquiry and audit processes of the Board should require the relevant authority to examine the relevant aspects that are necessary to quantify during the investigation, inspection, inquiry and audit process itself, as doing so will also serve as an *aperçu* to form the line of inquiry.

The Committee hopes that in the coming years there would be further development in the jurisprudence relating to gains made and losses caused to the investors and the suggestions made by the Committee would be adopted and developed further by all stakeholders as is the case in other jurisdictions abroad.

The Committee, during the course of its deliberations, held detailed discussions and consultations with the Members of the Board and their officers, including the officers from the Department of Investigation as well as the officers of Enforcement Department and Department of Economic and Policy Analysis. These discussions and consultations have been immensely useful to the Committee in taking a considered decision. The Committee has also noted the difficulty that may be experienced by the officers of the Board in applying its recommendations in the ongoing matters and therefore, *inter alia*, recommends that its suggested methods be utilised after a certain period of advance notice to all market participants and in future matters through internal guideline in the later days where the investigating and inspecting authorities have gathered the materials required for quantification.



## **Part-D: Interface between securities laws and insolvency law:**

It is usual for entities against whom proceedings have been initiated, including recovery, to be facing insolvency and winding up proceedings. In such cases, insolvency laws and securities laws become closely interlinked. It is in the Board's mandate to protect the interest of the investors who are involved in such proceedings. The Insolvency and Bankruptcy Code, 2016 introduced landmark changes in the insolvency regime in India. The Code is still a work in progress as can be seen from the various amendments that have been made in the past few years. Of particular concern, is the manner in which certain provisions of that Code have been interpreted and applied, as it is not aligned with the fundamental objective of the Board i.e. protecting investors in the securities market.

This part of the Report explores and lays bare the *law of trusts* that underpins fund raising activities in the securities markets. It is the *law of trusts* which forms the shield around the investors' interest when the entities they have invested into, fall into a debt trap. The position of investors in securities as beneficiaries of a trust rather than as mere creditors needs to be recognised by the Code and the rules and regulations made thereunder.

Another concern is the manner in which the moratorium provisions of the Code are being interpreted. This has the potential to curtail the ability of the Board to protect the interest of investors since defaulters of securities laws may use the Code as a refuge from legal proceedings at the cost of public interest. This impacts the determination of guilt of not only the entities that are under the bankruptcy refuge but also of those co-accused who may have incurred a secondary liability due to the acts of the insolvent entity.

The Committee has also taken note of the intentions of the Government of India to bring into operation the provisions of the Code relating to individual insolvency. This could have a huge impact on the liability of promoters, directors and other individual defaulters of securities laws. Unless certain changes are made in the Code, such individuals may be able to use the Code to defeat public interest. Some recent changes to the Code by way of Insolvency and Bankruptcy Code (Amendment) Ordinance, 2019 have

also been analysed. The Committee has examined the insolvency, recovery and securities laws jurisprudence of India and abroad and suggested suitable changes in the Code to ensure that insolvency law is not used as a refuge by defaulters, thereby protecting the interest of investors.

The Committee expresses its gratitude to **Mr. Ajay Tyagi**, Chairman, SEBI for constituting the Committee and entrusting it with the task of reviewing the aforesaid issues for improving the enforcement mechanism of SEBI. I would once again like to place on record my deep appreciation of the valuable inputs of Shri Pratap Venugopal, who has assisted me as member of the committee. The Committee is grateful to all the participants for sharing their expertise. The Committee is also grateful to the senior leadership of SEBI for taking time to share their expertise during several days of interaction with them.

The Committee also expresses its appreciation for the invaluable support and work on this project to the legal officers of the Board viz.-

- Mr. Chaudhary Suraj;
- Mr. Durgesh Kumar Thakur;
- Mr. T. Vinay Rajneesh;
- Mr. G Vijayakrishnan; and
- Ms. Babitha Rayudu;

- as well as the contribution of the other officers of the legal department of SEBI in setting the agenda, identifying and interacting with the participants, conducting the briefings and producing this Report. The Committee is also grateful to the Board for providing the administrative and programmatic support.

**JUSTICE ANIL R. DAVE,**  
Judge (Retd.), Supreme Court of India,  
CHAIRMAN  
Mumbai, March 2, 2020

## **TERMS OF REFERENCE**

The Committee was formed on December 14, 2017 under the Chairmanship of Justice A. R Dave (Retd.). The terms of reference of the Committee are as follows:

1. Review of the Securities and Exchange Board of India (Settlement of Administrative and Civil Proceedings) Regulations, 2014;
2. Review the enforcement mechanism of the Board, in particular, the Recovery mechanism under the securities laws;
3. Explore means of legislating a methodology for quantification of the factors indicated in Section 15J of the Securities and Exchange Board of India Act, 1992, Section 19I of the Depositories Act, 1996 and Section 23J of the Securities Contracts (Regulation) Act, 1956; and
4. Any other matter, as the Committee deems fit relating to the terms of reference.

### **APPROACH TO THE REPORT ON STRENGTHENING THE ENFORCEMENT MECHANISM**

The Report on Settlement Mechanism was submitted in respect of the first Term of Reference on August 10, 2018. This Report sets out the recommendations of the Committee *inter alia* in respect of the remaining terms of reference. The Committee's approach to the recommendations has been driven by the primary objective of strengthening the enforcement process and the ensuing recovery by the Board while balancing the interest of the investors in securities and that of the securities laws defaulters. In this regard, the Committee also believes that there are certain recommendations which may require implementation by authorities other than SEBI. Therefore, the Committee has also suggested that SEBI take up such recommendations with the relevant authorities.

### GLOSSARY OF TERMS USED IN THE REPORT

<b>Sr. No.</b>	<b>Terms Used</b>	<b>Meaning</b>
1.	AO	Adjudicating Officer
2.	Board	The Securities and Exchange Board of India
3.	Depositories Act	Depositories Act, 1996
4.	DA	Designated Authority
5.	DM	Designated Member
6.	FCA	Financial Conduct Authority
7.	IBBI	The Insolvency and Bankruptcy Board of India
8.	IBC	Insolvency and Bankruptcy Code, 2016
9.	SAT	Securities Appellate Tribunal
10.	Settlement Regulations	Securities and Exchange Board of India (Settlement Proceedings) Regulations, 2018
11.	Intermediaries Regulations	Securities and Exchange Board of India (Intermediaries) Regulations, 2008
12.	SCRA	Securities Contracts (Regulation) Act, 1956
13.	SEBI	Securities and Exchange Board of India
14.	SEBI Act	The Securities and Exchange Board of India Act, 1992
15.	SEC	US Securities and Exchange Commission
16.	WTM	Whole Time Member

**PART-A**

**REVIEW OF THE INTERMEDIARIES REGULATIONS**

## I. INTRODUCTION

Intermediaries operate as the bridge between capital providers and capital seekers in the securities market. The capital providers i.e. the investors, especially retail investors, do not have adequate information, knowledge or expertise and the capital seekers i.e. the issuers do not have adequate resources to reach out to individual investors spread across the world. Therefore, intermediaries play a very crucial role in making the market matrix, and ensuring smooth working of anonymous order-driven trading platforms.

### DEFINING INTERMEDIARIES

The Committee notes that although only Chapters V, V-A and VI of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008 ("Intermediaries Regulations") have been notified and are in force, the definition of an intermediary under regulation 2(1)(g) is not yet operative. For the purpose of the Report, it may be referred to in order to understand the concept from a regulatory perspective since the other statutes do not offer any principle based definition of the term "intermediary". The Intermediaries Regulations has defined the term "intermediary" as follows:

**“Regulation 2 (1) (g) - “intermediary” means a person mentioned in clauses (b) and (ba) of sub-section (2) of section 11 and sub-section (1) and (1A) of section 12 of the [SEBI] (supplied) Act and includes an asset management company in relation to the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, a clearing member of a clearing corporation or clearing house, foreign portfolio investors and a trading member of a derivative segment or currency derivatives segment of a stock exchange but does not include foreign venture capital investor, mutual fund, collective investment scheme and venture capital fund;”**

The intermediaries mentioned in clauses (b) and (ba) of sub-section (2) of section 11 and sub-section (1) and (1A) of section 12 of the SEBI Act are given below:

- i) stock brokers;
- ii) sub-brokers (this category has since ceased to exist);
- iii) share transfer agents;
- iv) bankers to an issue;
- v) trustees of trust deeds;
- vi) registrars to an issue;
- vii) merchant bankers;
- viii) underwriters;
- ix) portfolio managers;
- x) investment advisers;
- xi) depositories and their participants;
- xii) custodians of securities;
- xiii) foreign institutional investors;
- xiv) credit rating agencies
- xv) such other intermediaries who may be associated with the securities markets in any manner or such other intermediaries as the Board may, by notification, specify in this behalf.

The definition of “intermediary” is inclusive although the term “intermediary” as defined in the Intermediaries Regulations, specifically includes and excludes certain types of persons associated with the securities markets. Thus, even other market participants, which provide services akin to that of an intermediary, albeit not specifically included in the definition, would come under the purview of Intermediaries Regulations.

Several other players in the securities market are required to register under the specific regulations governing them and their activities such as, -

- (a) The Securities and Exchange Board of India (Mutual Funds) Regulations, 1996;
- (b) The Securities and Exchange Board of India (Collective Investment Schemes) Regulations, 1999;

- (c) The Securities and Exchange Board of India (Public Offer and Listing of Securitised Debt Instruments) Regulations, 2008;
- (d) The Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012;
- (e) The Securities and Exchange Board of India (Infrastructure Investment Trusts) Regulations, 2014;
- (f) The Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014.

### **LEGISLATIVE HISTORY OF THE INTERMEDIARIES REGULATIONS**

Between 1992 and 2002, separate regulations dealing with each intermediary were framed which provided for the process of registration, laid down obligations and responsibilities of the intermediary, specified the procedure for inspection and stipulated action in case of default by the intermediary.

In 2002, the Securities and Exchange Board of India (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002 ("Enquiry Regulations") were notified. These regulations consolidated the procedure for action to be taken in case of default by any of the intermediaries. The remaining provisions pertaining to registration, procedure for inspection and those pertaining to obligation and responsibilities of the intermediaries were retained in the respective Regulations.

Thereafter in 2008, the Securities and Exchange Board of India (Intermediaries) Regulations, 2008 were framed, which provided for a consolidated approach while dealing with registration of intermediaries, their general obligations, inspection and disciplinary proceedings and action in case of default as well as the manner of the suspension or cancellation of certificate of all intermediaries. However, only Chapter V dealing with action in case of default and manner of suspension or cancellation of the certificate of all intermediaries, Chapter VA dealing with the summary procedure and



Chapter VI dealing with miscellaneous issues of the Intermediaries Regulations were brought into effect after due notification.

#### **REGISTRATION OF INTERMEDIARIES**

Section 12 of the SEBI Act prohibits a stock broker, sub-broker, share transfer agent, banker to an issue, trustee of trust deed, registrar to an issue, merchant banker, underwriter, portfolio manager, investment adviser and such other intermediary who may be associated with the securities market, from buying, selling or dealing in securities, except under, and in accordance with, the conditions of a certificate of registration obtained from the Board under the regulations made under the SEBI Act. Therefore, any intermediary which is required to obtain a certificate of registration, for acting as an intermediary in the securities market may be referred to as an “Intermediary” for the purpose of this Report and the proposed amendment to the Intermediaries Regulations.

## **II. NEED FOR PRESENT REVISION**

### **Historical Perspective**

In the past three decades, SEBI has notified more than a dozen regulations, each with the objective of regulating a different category of intermediary. The current two tier process of enquiry proceedings against intermediaries in the Intermediaries Regulations traces its origin to the procedure contemplated in the Securities and Exchange Board of India (Stock Brokers and Sub-Brokers) Regulations, 1992 (“Stock Broker Regulations”). In 2002, provisions similar to those contained in Stock Brokers Regulations and other respective Regulations pertaining to other intermediaries were amended by the Securities and Exchange Board of India (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002, to enable SEBI to take action on the basis of investigation and inspection report.

However, later in 2008, it was decided that since there is a considerable overlap in the regulations pertaining to intermediaries, a consolidated regulation could be enacted. Eventually, when SEBI published Intermediaries Regulation in 2008, due various practical difficulties, only the process for holding enquiry against intermediaries by the Board was notified. Even though 12 years have elapsed since the publication of Intermediaries regulations, most of its provisions have not come into effect. Thus, the Committee feels that Intermediaries Regulations need to be examined from the viewpoint of their practical applicability.

### **Pendency of Enquiry Proceedings**

The SEBI Annual Report details the data pertaining to actions initiated by the Board including initiation of enquiries and adjudication proceedings against various intermediaries. As per the latest data available with SEBI, almost 408 enquiry proceedings are pending with the Board.

**Two Tier Enquiry Proceedings:**

Enquiry proceedings are initiated against the registered intermediaries and involve a two-step process under the Intermediaries Regulations. The two tier enquiry system has been borrowed from the Enquiry Regulations which in turn was borrowed from the respective regulations pertaining to various intermediaries. In the first step, the fact-finding proceedings are conducted by the DA, and in the second step, quasi-judicial proceedings are conducted before the DM of the Board on the basis of the recommendation of the DA. A two stage process adds to the time required in disposing off the proceedings.

**Time Taken for disposal of enquiry cases**

The analysis of the time taken between the date of action approved for each proceeding to the date of the final order passed in an enquiry case during the financial year 2018-19 and the current financial year, indicates that considerable amount of time is taken for completion of a case which hampers the regulatory effectiveness of the enquiry proceedings.

In light of the above, it becomes imperative to examine options to ensure that the time consumed in the enquiry proceedings be reduced and that the same may be effected by simple and necessary amendments to the applicable provisions.

### **III. REGULATION OF INTERMEDIARIES – GLOBAL SCENARIO**

#### **UNITED STATES OF AMERICA**

In the United States, the US Securities and Exchange Commission (US-SEC) is required to register broker dealers under section 15 of the Securities Exchange Act, 1934. The primary regulation of broker dealers is done through the Financial Industry Regulatory Authority, Inc. (FINRA), a private corporation, acting as a self-regulatory organization (SRO) for intermediaries. It is a non-governmental organization that regulates member brokerage firms and exchange markets. The government agency which acts as the ultimate regulator of the securities industry, including FINRA, is the US-SEC. Other intermediaries such as Investment Advisers are required to be registered with the USA SEC under the Investment Advisers Act, 1940 and Investment companies under the Investment Company Act of 1940. FINRA provides the first line of oversight for broker-dealers and the first line of defense for investors by virtue of its comprehensive oversight program. FINRA regulates both the firms and professionals selling securities in the United States and the U.S. securities markets. In this capacity, FINRA writes and enforces its own rules, as well as enforces federal securities rules and laws.<sup>1</sup>

FINRA has the authority to fine, suspend or bar brokers and firms from the industry. FINRA may also take disciplinary action through two separate procedures: a settlement or a formal complaint. With a settlement, a firm or broker may opt to settle with FINRA through a Letter of Acceptance, Waiver and Consent (AWC).<sup>2</sup>

When FINRA determines that a violation of the securities rules has occurred and formal disciplinary action is necessary, the Enforcement Department or the Market Regulation Department files a complaint with the Office of Hearing Officers (OHO).

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<sup>1</sup> <<http://www.finra.org/industry/oversight>>

<sup>2</sup> <<http://www.finra.org/industry/enforcement>>

The OHO is an office of impartial adjudicators of disciplinary cases brought by FINRA's Department of Enforcement against FINRA members. The OHO maintains strict independence from FINRA's regulatory programs and is physically separated from other FINRA departments.

The OHO arranges a three-person Panel to hear the case. The Panel is chaired by a hearing officer who is an employee of the OHO. The Chief Hearing Officer appoints two industry panellists, drawn primarily from a pool of current and former securities industry members of FINRA's District Committees, as well as its Market Regulation Committee, former members of FINRA's National Adjudicatory Council (NAC) and former FINRA Governors.

Hearing officers are not involved in the investigative process. Employment protection exist for hearing officers to further ensure their independence. They may not be terminated except by the FINRA Chief Executive Officer, with a right to appeal to the Audit Committee of FINRA's Board of Governors.<sup>3</sup> At the hearing, the parties present evidence for the panel to determine whether a firm or individual has engaged in conduct that violates FINRA rules, SEC regulations or federal securities laws. In reaching its decision, the hearing panel also considers previous decisions of the court, the SEC, and the National Adjudicatory Council (NAC) to determine if violations occurred. The NAC is the national committee which reviews initial decisions rendered in FINRA disciplinary and membership proceedings.

For each case, the hearing panel issues a written decision explaining the reasons for its ruling and consults the FINRA Sanction Guidelines to determine the appropriate sanctions if violations have occurred. FINRA may also, when feasible and appropriate, order firms and individuals to provide restitution to harmed customers.

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<sup>3</sup> *Ibid.*

## **Appeal Process**

Under FINRA's disciplinary procedures, a firm or individual has the right to appeal a hearing panel decision to the NAC or the NAC may on its own initiate a review of a decision.

While a decision is on appeal, the sanction is not actively enforced against the firm or individual. The NAC may affirm, dismiss, modify, or reverse any finding, or remand for further proceedings. The NAC may affirm, modify, reverse, increase, or reduce any sanction or impose any other fitting sanction.<sup>4</sup>

On appeal, the NAC will determine if a hearing panel's findings were legally correct, factually supported and consistent with the Sanction Guidelines of FINRA. Unless the Board of Governors of FINRA decides to review the NAC's appellate decision, that decision represents FINRA's final action. A firm or individual can appeal FINRA's decision to the SEC and then to federal court.<sup>5</sup>

The amount of fines in 2018 that the FINRA Enforcement Division ordered against its member firms increased slightly to \$74 million from \$68 million in 2017. While the amount increased nearly nine percent, the total number of fines decreased to 209 in 2018, compared to 318 in 2017.<sup>6</sup>

## **THE UNITED KINGDOM**

The Financial Services and Markets Act, 2000 of the United Kingdom created the Financial Conduct Authority (FCA) as a regulator for insurance, investment business and banking, and the Financial Ombudsman Service. The FCA operates independently of the UK Government, and is financed by charging fees to the members of the financial services industry. The FCA regulates financial firms providing services to consumers and

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<sup>4</sup> <<http://www.finra.org/industry/nac>>

<sup>5</sup> <<http://www.finra.org/industry/decisions>>

<sup>6</sup> <<https://www.acacompliancegroup.com/blog/summary-finra-regulatory-actions-2018>>

maintains the integrity of the financial markets in the United Kingdom. It focuses on the regulation of conduct by both retail and wholesale financial services firms. Like its predecessor (the FSA), the FCA is structured as a company limited by guarantee.

Section 42 of the Financial Services and Markets Act, 2000 provides that the FCA may grant permission to the applicant to carry on regulated activities. Granting permission in UK is akin to providing registration under section 12 of the SEBI Act, 1992.

Section 42 of the Financial Services and Markets Act, 2000 reads as follows:

***“Permission Giving***

**S. 42.**—(1) *“The applicant” means an applicant for permission under permission section 40.*

(2) *The Authority may give permission for the applicant to carry on the regulated activity or activities to which his application relates or such of them as may be specified in the permission.*

(3) *If the applicant—*

(a) *in relation to a particular regulated activity, is exempt from the general prohibition as a result of section 39(1) or an order made under section 38(1), but*

(b) *has applied for permission in relation to another regulated activity, the application is to be treated as relating to all the regulated activities which, if permission is given, he will carry on.*

(4) *If the applicant—*

(a) *in relation to a particular regulated activity, is exempt from the general prohibition as a result of section 285(2) or (3), but*

(b) *has applied for permission in relation to another regulated activity, the application is to be treated as relating only to that other regulated activity.*

(5) *If the applicant—*

(a) *is a person to whom, in relation to a particular regulated activity, the general prohibition does not apply as a result of Part XIX, but*

- (b) has applied for permission in relation to another regulated activity, the application is to be treated as relating only to that other regulated activity.*
- (6) If it gives permission, the Authority must specify the permitted regulated activity or activities, described in such manner as the Authority considers appropriate.*
- (7) The Authority may—*
- (a) incorporate in the description of a regulated activity such limitations (for example as to circumstances in which the activity may, or may not, be carried on) as it considers appropriate;*
  - (b) specify a narrower or wider description of regulated activity than that to which the application relates;*
  - (c) give permission for the carrying on of a regulated activity which is not included among those to which the application relates.”*

Section 40 of the Financial Services and Markets Act, 2000 provides that an application for permission to carry on one or more regulated activities may be made to the FCA by—

- (i) an individual;
- (ii) a body corporate;
- (iii) a partnership; or
- (iv) an unincorporated association.

Further section 45 of the Financial Services and Markets Act, 2000 provides that if the authorised person is failing or is likely to fail to satisfy the condition of permission, the Authority may vary or cancel the permission. Furthermore, section 56 specifies that if the Authority is satisfied that an individual is not a fit and proper person to perform functions in relation to a regulated activity carried on by an authorised person, the Authority may prohibit any individual from performing as a specified function.



## **Hearings and Appeals**

The order passed by the Authority may be referred to the Financial Service and Markets Tribunal (the Tribunal). During the period that the reference is pending before the Tribunal, the Authority cannot take the action specified in the decision notice. On determining a reference, the Tribunal is required to remit the matter to the Authority with such directions (if any) as the Tribunal considers appropriate for giving effect to its determination. Further, a party to a reference to the Tribunal may appeal to the Court of Appeal or in Scotland, to the Court of Sessions. After taking a leave from the Court of Appeal or House of Lord (now UK Supreme Court) the decision of the Court of Sessions or Court of Appeal may be appealed.

## **IV. KEY RECOMMENDATIONS AND RATIONALE**

### **PROPOSED PROCESS FOR ENQUIRY PROCEEDINGS**

#### **Current provisions**

In the present system, the first tier of enquiry is conducted by the DA. As per regulation 24(1) of the Intermediaries Regulations, when the DM (Chairman or a WTM of the Board designated for the purpose) is satisfied that an intermediary has failed to comply with the conditions subject to which a certificate of registration was issued to him or has contravened any of the provisions of the securities laws, or any directions or circular issued thereunder, the DM may appoint an officer not below the rank of a Division Chief, as a DA. The regulations further provide that pursuant to the appointment, the DA shall issue a notice to the concerned intermediary requiring it to show cause as to why the certificate of registration granted to it should not be suspended or cancelled or why any other action provided in the Intermediaries Regulations should not be taken against the noticee. Upon conclusion of the enquiry the DA, submits a recommendation to the DM on the basis of material available before him.

On receipt of the recommendation from the DA, the DM considers these recommendations and issues a show cause notice to the noticee enclosing a copy of the report submitted by the DA calling upon him to submit its reply as to why an order as deemed appropriate should not be issued. After considering the report of the DA, the reply of the noticee and other material available before it, and providing the person with an opportunity of being heard, the DM passes the final order.

The two tier proceedings in the Intermediaries Regulations traces its origin to the procedure contemplated in the Securities and Exchange Board of India (Stock Brokers and Sub-Brokers) Regulations, 1992 (“Stock Broker Regulations”). It is also worth mentioning that the provision dealing with investigation under section 11C was inserted in the SEBI Act w.e.f. October 29, 2002 vide the Securities and Exchange Board of India (Amendment) Act, 2002.

The Stock Broker Regulations in its original form, even before its amendment vide the Enquiry Regulations, 2002, provided for inspection of Stock Brokers. Further, regulation 23 of Stock Broker Regulations provided that after considering the explanation of the stock broker on the findings of inspection report, the Board may call upon the stock-broker to take such measures as the Board may deem fit in the interest of the securities market<sup>7</sup>. After the amendment of these regulations in 2002, regulation 23 provided that the Board shall, after considering the inspection or investigation report, take such action as it may deem fit and appropriate, including action under the Enquiry Regulations (now chapter V of the Intermediaries Regulations). Similar amendments were also carried out in the other regulations dealing with the respective intermediaries.

Accordingly, it may be inferred that before the year 2002, when investigation and inspection reports may not necessarily have been the basis for action in case of default by the intermediaries, it was logical to have in place the two tier enquiry for taking action in case of default by the intermediaries where, the first tier enquiry served as a primary fact finding authority collecting documents and evidence, as well as for analysis of all the relevant facts of the case and submissions made by the Intermediaries.<sup>8</sup> It is also noteworthy that the notice issued by the enquiry officer under regulation 28 (since repealed) of the Stock Broker Regulations to call for explanation, reply, information, documents or evidences, was not a show cause notice. Instead the report of the enquiry was used to form the basis of the show-cause notice issued by the Board which constituted the first step of the second tier enquiry process. After considering the reply to the show-

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<sup>7</sup> Regulation 23 of the Stock Broker Regulations before September 27, 2002 read as follows:

***Communication of findings etc.***

23. (1) *The Board shall after consideration of the inspection report communicate the findings of the stock-broker to give in an opportunity of being heard before the action is taken by the Board on the findings of the inspecting authority.*

(2) *On the receipt of the explanations, if any, from the stock – broker, the Board may call upon the stock-broker to take such measure as the Board may deem fit in the interest of the securities market and for due compliance with the provisions of the Act, rules and regulations.*

<sup>8</sup> Read now repealed regulation 28 and 29 of the Securities and Exchange Board of India (Stock Broker and Sub-Broker) Regulations, 1992.

cause notice, if received, the Board was mandated to pass such orders as it deemed fit in the second tier process.

It is observed that although provisions similar to those contained in regulation 23 of Stock Brokers Regulations and other respective Regulations pertaining to other intermediaries, were amended by the Enquiry Regulations, enabling SEBI to take action on the basis of investigation and inspection report, the same two tier enquiry process as originally contained in the regulations pertaining to the respective intermediaries was carried forward to the Enquiry Regulations.

However, when in 2008, the Intermediaries Regulations replaced the Enquiry Regulations, the two tier enquiry procedure was once again adopted, albeit with certain modifications such that regulation 25 of the Intermediaries Regulations mandates both the DA and the DM to issue show-cause notices. That is even after submission of the report by the DA, the DM was once again required to issue a show cause notice to the entity, granting personal hearing during which time the DM is required to consider the submissions made by the intermediary.

Given the time consumed in the duplication of the process even without a cost benefit analysis of the process, the Committee is of the opinion that such a two tier enquiry process does not add much value and in fact causes further delays in the completion of the enquiry proceedings.

Most of the enquiry matters originate post the inspection or investigation processes. Only after analysis of the facts and laws, does the Board determine if it is a fit case to initiate enquiry proceedings.

The present two-stage inquiry envisages a process similar to that followed in a 'domestic inquiry' by an employer against an employee. Such long winding procedures are acceptable in employment matters since the employer may like to grant the employee maximum opportunities to explain the alleged misconduct.

In the context of the securities markets, an enquiry proceeding against the intermediary is recommended after a first-level investigation or inspection has already been carried out. Hence, adopting a long winding process as in a domestic inquiry to enquiry against market intermediaries may unduly work against public interest with the enquiry losing relevance over the period of time in which it is conducted and finally concluded.

However, a two tier enquiry does have certain advantages such that it entails a deeper examination of facts and applicable laws which may presumably lead to better dispensation of justice. The Committee examined the possibility of proposing continuing with a two tier enquiry system for the intermediaries which handle funds of clients, and a single tier enquiry system for the intermediaries which do not handle funds of clients. However, with the increase in various categories of intermediaries recognised by the Board (such as research analysts and investment advisers) it may not be advisable to clog the enforcement mechanism by continuing with the two tier enquiry mechanism only for a certain class of intermediaries. The Committee considered the proposal that the two tier mechanism for intermediaries which do not handle funds of the clients namely, share transfer agent, registrars to an issue, merchant bankers, underwriters, investment advisors and credit rating agencies may be moved to the one tier enquiry process. However, the Committee is of the view that such a classification may not be a reasonable classification and provide a potential ground for challenge before a Court of Law.

Therefore, the Committee then considered the proposal for a two tier enquiry process of registration for intermediaries to be replaced with an enquiry process, as is the case in Adjudication or section 11/11B proceedings such that the person authorized to conduct such single tier enquiry be called “Enquiry Authority”. The Board may appoint any officer not below the rank of Division Chief to be an “Enquiry Authority” who would be equal or senior in rank to the officer, to whom the power to grant registration to such intermediary, has been delegated by the Board. In case of multiplicity of proceedings, a single stage inquiry would also enable the same authority to be appointed for various single-stage proceedings which would allow simultaneous and expeditious disposal of such cases since

the grounds of inquiry in multiple proceedings would remain the same, but the sanction to be imposed would be different.

After considerable debate on the merits of the processes discussed above, the Committee arrived at the view that the process may be simply reworked by reducing the time taken in concluding the proceedings without compromising application of the principles of natural justice or any of the process envisaged therein. This could be enabled by completion of all processes at one level followed by the submission of the report to the DM. Thereafter, the DM may grant opportunity of written representation to the noticee, pursuant to which he may pass the final order.

#### **RECOMMENDATION No. 1**

The Committee noted that the Intermediaries Regulations do not mandate the DA to grant personal hearing to the noticee. As per the present scheme in the Intermediaries Regulations, after the show cause notice is issued by the DA, if the noticee does not reply to the show cause notice, the DA may proceed with the matter ex-parte after recording the reasons for doing so and make suitable recommendations. On the other hand, on receipt of the report recommending measures from the DA, the DM is required to issue a show cause notice to the noticee and only after providing them with an opportunity of being heard, does the DM pass an appropriate order.

Since the opportunity of personal hearing is granted by the DM, issues relating to inspection of documents and/or cross-examination increases at this stage of the enquiry proceeding. Currently only four WTMs (who also function as the DM) have been appointed to the Board by the Central Government. Due to such work getting concentrated before the WTMs, the chances of more time being consumed at the second tier of enquiry becomes high. On the other hand, the Board is not constrained by the number of officers who may be appointed as a DA.

In light of these constraints, it is proposed to provide for the opportunity of personal hearing to be given by the DA and not by the DM.

The Committee also notes that judicial processes differ from the administrative adjudicatory process in an important aspect. While the judicial/quasi-judicial authority is exclusively engaged in adjudication, the administrator–adjudicator discharges adjudicatory functions along with other administrative duties. Similarly, in the case of WTMs who apart from adjudicating as the DM also discharge other administrative functions.

It has however been experienced that pure institutional decisions give rise to two main issues.<sup>9</sup> Firstly, the authorship of such a decision may not be known as it is reached through several officers in the concerned department. Secondly, there may be divisions in the decision-making process in that while one person may hear, another may decide.

The Hon'ble Supreme Court in the matter of *Travancore Rayons Vs India*<sup>10</sup> held that the procedural safeguards in case of an institutional decision should be such that the party affected is informed of the official who has considered the matter. The Committee notes that this requirement is fulfilled by the Intermediaries Regulations and hence keeping the same in mind, the Committee recommends similar amendments to the Intermediaries Regulations.

The decision of the Hon'ble Supreme Court in *Gullapalli Nagewara Rao vs. A. P. State Road Transport Corporation*<sup>11</sup> that personal hearing enables the authority concerned to watch the demeanour of the witnesses and clear up any doubts during the course of the argument and of the party appearing to persuade the authority by reasoned argument to accept their point of view is also noted by the Committee. If

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<sup>9</sup> M P Jain & S N Jain, Principles of Administrative Law, Fourth Edition, p . 273

<sup>10</sup> A.I.R. 1971 S.C. 862

<sup>11</sup> A.I.R. 1959 S.C. 308

one person hears and another decides, then a personal hearing would become a mere formality. Therefore, it has to be ensured that the opportunity of personal hearing by the DM entails a reasonable must grant an effective opportunity to the noticee to defend his case and the same may be effected by way of a written representation, which is to be considered before passing of the final order in the case.

Such a proposal emanates from the principle that oral hearing is not essential to comply with the principles of natural justice which do not necessarily predicate an oral hearing to be provided unless the context requires otherwise.<sup>12</sup> The only requirement of natural justice in such cases is that the quasi-judicial bodies do not arrive at adverse finding without giving the noticee an effective opportunity of defending any allegations. Such an opportunity may be effected even through a written representation. The opportunity of making a written representation is equally efficacious and also amounts to a hearing. The Hon'ble Supreme Court in several judgements has reiterated its view that in quasi-judicial proceedings, an opportunity to make representation need not necessarily be provided by way of personal hearing; it can also be done by granting an opportunity to make written representation.<sup>13</sup>

The right of oral or personal hearing is, however, often demanded by affected persons since it is believed that they are in a position to effectively persuade the authorities to countenance their point of view. Occasionally, not affording oral hearing could itself prejudice the proceedings and render the order invalid or ineffective.<sup>14</sup> Yet oral hearing is not mandatory, except in cases where a provision of law or a rule specifically provides for an opportunity of oral hearing. Under those circumstances the oral hearing is required to be provided in strict compliance of the law.

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<sup>12</sup> *Gopalan Vs. Madras*. AIR., 1960 S.C.

<sup>13</sup> *Madya Pradesh Industries Ltd. Vs Union of India and others* 1966 AIR 671, 1966 SCR (1) 466

<sup>14</sup> *M. Sadasiva Sekhar vs District Collector and Ors.* 203 (2) ALD843, 2003 (3) ALT 68



After considering all the above and the various judgments of the Hon'ble Supreme Court, the Committee is of the view that in a two tier process as specified in the Intermediaries Regulations, the requirement of natural justice stands adequately complied with if the DA grants an opportunity to make written representation and grant an oral hearing to the noticee and the DM grants an opportunity to the noticee to only submit written representation after providing the copy of the Report of the DA.

The Committee is also cognizant of the fact that a WTM, in the course of institutional decision-making process also discharges duties as a DM. Due to the change in WTMs, who are appointed by Central Government from time to time, a fresh oral hearing needs to be granted to the noticee by the new DM in case the erstwhile DM was unable to pass the order before demitting office. The aforesaid proposal would, thus, enable SEBI to conclude enquiry proceedings in a timely manner by avoiding grant of multiple oral hearings. A written representation would enable the other DM to pass final orders without delaying the enquiry proceedings on account of granting fresh oral hearing to the Noticee.

Considering the above factors, the Committee recommends the following process to be adopted in all enquiry proceedings before the Board, which would entail suitable amendments to the Intermediaries Regulations:

- I. The process related to granting of an opportunity of personal hearing, inspection of documents, cross-examination etc., shall be granted by the DA. After conducting a detailed enquiry and after considering all the representation(s) and the facts and circumstances of the case, the DA may submit a report recommending appropriate action as contemplated in the Intermediaries Regulations.
- II. Upon receipt of the report of the DA, the DM may issue a show cause notice calling upon the noticee to submit within 21 days, a suitable response as to why action as recommended by the DA or any other action as contemplated

in the Intermediaries Regulations may not be initiated. The show cause notice may also clearly specify that no opportunity of personal hearing would be granted and all the submission, if any, may be made only in a written form.

## **FACTORS TO BE TAKEN INTO ACCOUNT BY THE DESIGNATED AUTHORITY**

### **Current provisions**

Section 15J of the SEBI Act, provides for relevant factors to be taken into account by the adjudicating officer while adjudging quantum of penalty under section 15-I of the SEBI Act. Such a provision acts as a pole star while deciding the quantum of penalty and guides the officer in prudently exercising the discretion vested upon him by the statute. The Intermediaries Regulations do not have any provision similar to that of section 15J of the SEBI Act to guide the DA and DM while exercising discretion to determine issuance of suitable direction as contemplated in the Intermediaries Regulations.

### **RECOMMENDATION No. 2:**

In view of the above discussion, the Committee also recommends the incorporation of a provisions similar to section 15J of the SEBI Act in the Intermediaries Regulations. The DA and the DM, as the case may be, while making the recommendation and passing the order under the Intermediaries Regulations, shall have due regard to the following factors, namely, —

- the amount of disproportionate gain or unfair advantage, wherever quantifiable, made as a result of the default;
- the amount of loss caused to an investor or group of investors as a result of the default;
- the repetitive nature of the default; and
- any other relevant and just factors.

## **V. DRAFT OF REGULATIONS**

The Committee recommends that regulation 25, 26, 27 and 28 of Chapter V of the Intermediaries Regulations may be substituted with the following regulations, which may be made applicable upon the notification of the proposed amendments, -

### **CHAPTER V**

#### **Holding of enquiry.**

25. (1) The Designated Authority shall issue a notice to a person against whom an enquiry has been initiated, to show cause as to why the action, as contemplated against such person should not be recommended.

(2) The noticee shall be called upon to submit, within a period to be specified in the notice, not exceeding twenty-one days from the date of service thereof, a written reply to the notice, along with documentary evidence, if any, in support of such written reply:

Provided that the Designated Authority may extend the time specified in the notice for sufficient grounds shown by the noticee and after recording reasons in writing.

(3) Every notice under sub-regulation (1) shall specify the contravention alleged to have been committed by the noticee by indicating the provisions of the securities laws or the direction or the order of the Board alleged to have been contravened.

(4) There shall be annexed to the notice issued under sub- regulation (1), copies of documents relied upon by the Board along with the extracts of relevant portions of the reports containing the findings arrived at in an inquiry, investigation or inspection, if any.

(5) If the noticee demands inspection of such documents within the period specified in sub-regulation (2) and the designated authority is of the opinion that the same may be granted, then the DA may issue a notice fixing a date of inspection of documents for the same within thirty days from the date of receipt of such request.

(6) If the Designated Authority is satisfied that there is a need to grant an opportunity of personal hearing, then the DA may issue or cause to issue a notice scheduling a date for hearing the noticee or authorised representative:

Provided that no opportunity of oral hearing may be granted in the cases where the noticee is alleged to have failed to pay the registration fee or any other applicable fees to the Board as per the provisions of the relevant regulations or the noticee has been declared a wilful defaulter or a fugitive economic offender.

(7) If the noticee does not reply to the notice or fails to appear on the scheduled hearing date and the designated authority is satisfied that sufficient opportunity has been given to the noticee, the designated authority may conclude the proceedings after, recording the reasons for doing so, on the basis of the material available on record.

### **Recommendation of action**

26. (1) After considering the reply, if any, and other material available on record, the Designated Authority may by way of a report, where the facts so warrant, recommend –

- (i) cancellation of the certificate of registration;
- (ii) suspension of the certificate of registration for a specified period;
- (iii) prohibition of the noticee from taking up any new assignment or contract or launching a new scheme for the period specified in the order;
- (iv) debarment of an officer of the noticee from being employed or associated with any registered intermediary or other person associated with the securities market for the period specified in the order;
- (v) debarment of a branch or an office of the noticee from carrying out activities for the specified period;
- (vi) issuance of a regulatory censure to the noticee:

Provided that in respect of the same certificate of registration, not more than five regulatory censures under these regulations may be recommended to be issued to any intermediary, thereafter, the action as detailed in clause (i) to (v) of this sub-regulation may be considered.

(2) The designated authority shall endeavour to submit the report within one hundred and twenty days from the date of receipt of reply to the notice or date of last personal hearing, whichever is later.

### **Order**

27. (1) On receipt of the report containing the measures recommended by the designated authority, the designated member shall issue notice to the noticee enclosing therein a copy of the report submitted by the designated authority and call upon the noticee to reply to the notice, in writing, as to why the action recommended by the designated authority considers appropriate, should not be taken.

(2) The noticee shall submit, within a period as specified in the notice, but not exceeding twenty-one days from the date of service thereof, a written reply to the notice, along with documentary evidence, if any, in support of such written reply.

Provided that upon the request of the noticee the designated member may extend the time specified in the notice, after recording reasons in writing.

Provided further that the noticee shall not have any right to seek opportunity of oral hearing before the designated member.

(3) The designated member shall after considering the written submission, if any and other facts and circumstances of the matter, pass an appropriate order within one hundred and twenty days from the date of receipt of the written reply to the notice.

### **Factors to be taken into account.**

28. While making a recommendation or passing an order as under this chapter, the designated authority or designated member, as the case may be, shall have due regard to the following factors, namely, -

- (a) the amount of disproportionate gain or unfair advantage, wherever quantifiable, made as a result of the default;
- (b) the amount of loss caused to an investor or group of investors as a result of the default;
- (c) the repetitive nature of the default;

(d) any other relevant and just factors.

The Committee also notes that only Chapter V, V-A and VI of the Intermediaries Regulations have been notified till date. Hence the Committee recommends that the Intermediaries Regulations may be replaced by new regulations which may only contain provisions with respect to manner of actions in case of defaults by Intermediaries, as proposed below:

**THE GAZETTE OF INDIA  
EXTRA-ORDINARY  
PART –III – SECTION 4  
PUBLISHED BY AUTHORITY  
SECURITIES AND EXCHANGE BOARD OF INDIA**

**NOTIFICATION**

**Mumbai, the ..... day of ....., 2020**

**SECURITIES AND EXCHANGE BOARD OF INDIA (PROCEDURE FOR  
HOLDING ENQUIRY) REGULATIONS, 2020**

*No. .... In exercise of the powers conferred by section 30 read with sub-section (3) of section 12 of the Securities and Exchange Board of India Act, 1992 (15 of 1992), the Board hereby makes the following regulations, namely: -*

**CHAPTER I**  
**PRELIMINARY**

**Short title and commencement**

1. (1) These regulations may be called the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020.
- (2) They shall come into force on the date of their publication in the Official Gazette.

**Definitions**

2. (1) In these regulations, unless the context otherwise requires, -
  - (a) "Act" means the Securities and Exchange Board of India Act, 1992 (15 of 1992);
  - (b) "Board" means the Securities and Exchange Board of India constituted under section 3 of the Act;
  - (c) "Certificate" means a certificate of registration granted to an intermediary under the relevant Regulations;
  - (d) "Designated Authority" means an officer of the Board and includes a bench of such officers;
  - (e) "Designated Member" means the Chairman or a Whole Time Member of the Board designated for the purpose;
  - (f) "Executive Director" means an officer of the Board who is appointed as such by the Board;
  - (g) "Intermediary" means a person who is required to obtain a certificate of registration from the Board and includes an asset management company in relation to the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, an investment manager in relation

to the Securities and Exchange Board of India (Infrastructure Investment Trusts) Regulations, 2014, a manager in relation to the Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014, a manager in relation to the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, a clearing member of a clearing corporation or clearing house, a foreign portfolio investor and a trading member of a derivative segment or currency derivatives segment of a stock exchange.

- (h) “Noticee” means the person to whom a notice has been issued under these Regulations;
- (i) “Securities Laws” includes the Act, the Securities Contracts (Regulation) Act, 1956 (42 of 1956), the Depositories Act, 1996 (22 of 1996), and the rules or regulations or circulars or guidelines made thereunder and includes the provisions of the Companies Act, 2013 (18 of 2013) and the rules made thereunder to the extent administered by the Board.

(2) Words and expressions used and not defined in these regulations, but defined in the securities laws shall have the meanings respectively assigned to them thereunder, as the case may be.

## **CHAPTER II**

### **ACTION IN CASE OF DEFAULT**

#### **Cancellation or suspension of registration and other actions**

3. Where any registered intermediary or its sponsor, trustee, partners, directors or



officers, as the case may be,

- (a) fails to comply with any conditions subject to which a certificate of registration has been granted;
- (b) contravenes or attempts to contravene or abet the contravention of any of the provisions of the securities laws or fails to comply with any of the directions or orders of the Board;

the Board may, without prejudice to any action under the securities laws, by an order, take action in the manner specified under these regulations.

#### **Appointment of the Designated Authority**

4. (1) Where it appears to the Designated Member that any person has committed any default as specified in regulation 3, the Designated Member may approve the initiation of proceedings under these regulations against such person.

(2) The relevant Executive Director shall thereafter appoint an officer not below the rank of a Division Chief, as a Designated Authority:

Provided that the Executive Director may appoint a bench of three officers, each of whom shall not be below the rank of a Division Chief:

Provided further that such bench shall be presided by the senior most amongst them and all the decisions or recommendations of such bench shall be by way of majority.

#### **Holding of enquiry.**

5. (1) The Designated Authority shall issue a notice to a person against whom an enquiry has been initiated, to show cause as to why the action as contemplated against such a person should not be recommended.

(2) The noticee shall be called upon to submit, a written reply to the notice, along with documentary evidence, if any, in support of such written reply within a period to be specified in the notice, not exceeding twenty-one days from the date of service thereof:

Provided that the Designated Authority may extend the time specified in the notice for sufficient grounds shown by the noticee and after recording reasons in writing.

(3) Every notice under sub-regulation (1) shall specify the contravention alleged to have been committed by the noticee by indicating the provisions of the securities laws or the direction or the order of the Board alleged to have been contravened.

(4) There shall be annexed to the notice issued under sub- regulation (1), copies of documents relied upon by the Board along with the extracts of relevant portion of the reports containing the findings arrived at in the inquiry, investigation or inspection, if any.

(5) If the noticee seeks inspection of such documents within the period specified in sub-regulation (2) and the designated authority is of the opinion that the same may be granted, then the Designated Authority may issue a notice fixing a date for inspection of documents for the same within thirty days from the date of receipt of such request.

(6) If the Designated Authority is satisfied that there is a need to grant an opportunity of personal hearing, then the Designated Authority may issue or cause to issue a notice scheduling a date for hearing to the noticee or authorised representative:

Provided that no opportunity of oral hearing may be granted in the cases arising out of a failure of the noticee to pay the registration fee or any other applicable fees to the Board as per the provisions of the relevant regulations or where he noticee has been declared a wilful defaulter or a fugitive economic offender.

(7) If the noticee does not reply to the notice or fails to appear on the scheduled hearing date and the Designated Authority is satisfied that sufficient opportunity has been given to the noticee, the Designated Authority may conclude the proceedings, after recording the reasons for doing so, on the basis of the material available on record.

### **Recommendation of action**

6. (1) After considering the reply if any and other material available on record, the Designated Authority may by way of a report, where the facts so warrant, recommend –

- (i) cancellation of the certificate of registration;
- (ii) suspension of the certificate of registration for a specified period;
- (iii) prohibition of the noticee from taking up any new assignment or contract or launching a new scheme for the period specified in the order;
- (iv) prohibition of a branch or an office of the noticee from carrying out activities for the specified period;
- (v) issuance of a censure to the noticee:

(2) The Designated Authority shall endeavour to submit the report within one hundred and twenty days from the date of receipt of reply to the notice or date of last personal hearing, whichever is later.

### **Order**

7. (1) Upon the receipt of the report containing the measures recommended by the Designated Authority, the Designated Member shall issue a notice to the noticee enclosing therein a copy of the report submitted by the Designated Authority and

call upon the noticee to reply to the notice, in writing, as to why the action recommended by the Designated Authority or any action as considered appropriate, should not be taken.

(2) The noticee shall submit, within a period as specified in the notice, but not exceeding twenty-one days from the date of service thereof, a written reply to the notice, along with documentary evidence, if any, in support of such a written reply. Provided that upon the request of the noticee, the Designated Member may extend the time specified in the notice, after recording the reasons in writing.

Provided further that the noticee shall not have any right to seek an opportunity of oral hearing before the Designated Member.

(3) After considering the written submission, if any and the other facts and circumstances of the matter, the Designated Member shall endeavour, within one hundred and twenty days from the date of receipt of the written reply to the notice, to pass an appropriate order.

### **Factors to be taken into account**

8. While making a recommendation or passing the order, the Designated Authority or Designated Member, as the case may be, shall have due regard to the following factors, namely, -

- (a) the amount of disproportionate gain or unfair advantage, wherever quantifiable, made as a result of the default;
- (b) the amount of loss caused to an investor or group of investors as a result of the default;
- (c) the repetitive nature of the default;
- (d) any other relevant and just factors.

### **Surrender of any certificate of registration.**

9. (1) Any person, who has been granted a certificate of registration under the Act or the regulations made thereunder, desirous of giving up its activity and surrendering the certificate, may make a request for such surrender to the Board and while disposing such a request, the Board shall not be bound by the procedure specified in the foregoing provisions of these regulations.

(2) While disposing of a request under this regulation, the Board may require the concerned person to satisfy the Board with such factors as it deems fit, including but not limited to the following-

- (a) the arrangements made for maintenance and preservation of records and other documents required to be maintained under the relevant regulations;
- (b) redressal of investor grievances;
- (c) transfer of records, funds or securities of clients;
- (d) the arrangements made for ensuring continuity of service to clients;
- (e) completion of pending proceedings or addressing the defaults if any.

(3) While accepting surrender, the Board may impose upon the person such conditions as it deems fit for the protection of the investors or clients or the securities market and such person shall comply with such conditions.

### **Effect of suspension or cancellation or surrender**

10. (1) On and from the date of cancellation or suspension or surrender of the certificate, the concerned person shall -

- (i) not represent that he is an intermediary while such suspension is in force;
- (ii) not undertake any new assignment or contract or launch any new

scheme and during the period of such suspension, it shall cease to carry on any activity in respect of which certificate had been granted;

(2) On and from the date of cancellation or surrender of the certificate, the concerned person shall-

- (a) return the certificate of registration so cancelled or surrendered to the Board and shall not represent itself to be a holder of certificate for carrying out the activity for which such certificate had been granted;
- (b) cease to carry on any activity in respect of which the certificate had been granted;
- (c) transfer its activities to another person holding a valid certificate of registration to carry on such activity and allow its clients or investors to withdraw or transfer their securities or funds held in its custody or to withdraw any assignment given to it, without any additional cost to such client or investor;
- (d) make provisions as regards liability incurred or assumed by it;
- (e) take such other action including the action relating to any records or documents and securities or money of the investors that may be in custody or control of such person, within the time period and in the manner, as may be required under the relevant regulations or as may be directed by the Board while passing order under these Regulations or otherwise.

**CHAPTER III**  
**MISCELLANEOUS**

**Intimation of the order.**

11. (1) A copy of the order passed under these Regulations shall be sent to the noticee and shall be uploaded on the website of the Board.

(2) A copy of the order shall also be sent to the concerned stock exchange, clearing corporation, depository or self-regulatory organization where the noticee is a member.

**Manner of service of notice and order and publication of order**

12. Any notice issued or order passed under these regulations may be served -

(a) by hand delivery to the concerned person or the duly authorized agent;  
or

(b) by delivery, at the address available on the records of the Board and addressed to that person or the duly authorized agent, by registered post acknowledgement due or by speed post or by such courier service or by fax or electronic mail service or by any other means of transmission which affords a record of delivery;

Provided that a notice sent through electronic mail shall be digitally signed by the competent authority.

Provided further that bouncing of the electronic mail shall not constitute valid service;

(c) in case of a stock broker or a sub-broker or a depository participant through the concerned stock exchange or the depository respectively;  
and

(d) if it cannot be served as per clause (a) or (b) or (c), by affixing it on the

door or some other conspicuous part of the premises in which such person resides or is known to have last resided or carries on business or is known to have last carried on business or personally works for gain or is known to have last personally worked for gain.

- (e) if it cannot be affixed on the outer door as per clause (d), by publishing the notice in at least two newspapers, one in an English daily newspaper having nationwide circulation and another in a newspaper having wide circulation published in the language of the region where the intermediary was last known to have resided or carried on business or personally worked for gain.

**Power of the Board to issue clarifications.**

13. In order to remove any difficulties in the application or interpretation of these regulations, the Board may issue clarifications and guidelines in the form of circulars.

**Amendments to other regulations.**

14. The regulations specified in the Schedule I shall be amended in the manner and to the extent stated therein.

**Repeal and savings**

15. (1) With effect from the publication of these regulations in the Official Gazette, the Securities and Exchange Board of India (Intermediaries) Regulations, 2008 shall be repealed.

(2) Notwithstanding such repeal, anything done or any action taken under the Securities and Exchange Board of India (Intermediaries) Regulations, 2008,



including an inquiry commenced or notice issued under the Securities and Exchange Board of India (Intermediaries) Regulations, 2008, before the notification of these regulations in the Official Gazette, shall be deemed to have been done or taken or commenced under the corresponding provisions of these regulations.

(3) After the repeal of the regulations referred to in sub-regulation (1), any reference thereto in any other regulation, guideline or circular shall be deemed to be a reference to the corresponding provisions of these Regulations.

## **SCHEDULE I**

**[See regulation 14]**

### **Amendments to other regulations**

#### **1. Amendment of Securities and Exchange Board of India (Bankers to an Issue) Regulations, 1994.**

(i) For regulation 6A, the following regulation shall be substituted, namely: -

##### **“Criteria for fit and proper person**

6A. For the purpose of determining whether an applicant or the banker to an issue is a fit and proper person, the Board may take into account the criteria specified in Schedule IV of these regulations.”

- (ii) In regulation 22, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.
- (iii) In regulation 23, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.
- (iv) After Schedule III, the following Schedule shall be inserted, namely: -

#### **“SCHEDULE IV**

**(See regulations 6A)**

#### **Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant or the intermediary is a ‘fit and proper person’ the Board may take into account such consideration as it deems fit, including but not limited to the following criteria in relation to the applicant or the intermediary or its sponsor, trustee, partners, the principal officer, director, promoter or the key management persons by whatever name called—

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”

(e) absence of declaration as a fugitive offender

## **2. Amendment of Securities and Exchange Board of India (Collective Investment Schemes) Regulations, 1999**

(i) For regulation 9A, the following regulation shall be substituted, namely: -

### **“Criteria for fit and proper person**

9A. For the purpose of determining whether an applicant or the collective investment management company is a fit and proper person, the Board may take into account the criteria specified in Schedule X of these regulations.”

(ii) In regulation 56, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iii) In regulation 59, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iv) After Schedule IX, the following Schedule shall be inserted, namely: -

## **“SCHEDULE X**

**(See regulations 9A)**

### **Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant or the intermediary is a ‘fit and proper person’ the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation to the applicant or the intermediary, its sponsor, trustee, partners, the principal officer, the director, the promoter and the key management persons by whatever name called–

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

### **3. Amendment of Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999.**

- (i) For regulation 5A, the following regulation shall be substituted, namely:

#### **“Criteria for fit and proper person**

5A. For the purpose of determining whether an applicant or the credit rating agency is a fit and proper person the Board may take into account the criteria specified in Schedule IV of these regulations.”

- (ii) In regulation 33, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.
- (iii) In regulation 34, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.
- (iv) After Schedule III, the following Schedule shall be inserted, namely: -

#### **“SCHEDULE IV**

**(See regulations 5A)**

#### **Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant or the intermediary is a ‘fit and proper person’ the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation to the applicant or the intermediary, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever name called—

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;

- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

**4. Amendment of Securities and Exchange Board of India (Custodian of Securities) Regulations, 1996.**

- (i) For regulation 6A, the following regulation shall be substituted, namely:

-

**“Criteria for fit and proper person**

6A. For the purpose of determining whether an applicant or the custodian of securities is a fit and proper person the Board may take into account the criteria specified in Schedule IV of these regulations.”

- (ii) In regulation 25, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

- (iii) In regulation 26, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

- (iv) After Schedule III, the following Schedule shall be inserted, namely: -

## **“SCHEDULE IV**

**(See regulations 6A)**

### **Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant or the intermediary is a ‘fit and proper person’ the Board may take into account such consideration as it deems fit, including but not limited to the following criteria in relation to the applicant or the intermediary, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever name called—

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

### **5. Amendment of Securities and Exchange Board of India (Debenture Trustees) Regulations, 1993.**

- (i) For regulation 6A, the following regulation shall be substituted, namely:

-

#### **“Criteria for fit and proper person**

6A. For the purpose of determining whether an applicant or the debenture trustee is a fit and proper person the Board may take into

account the criteria specified in Schedule V of these regulations.”

- (ii) In regulation 23, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.
- (iii) In regulation 25, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.
- (iv) After Schedule IV, the following Schedule shall be inserted, namely: -

#### **“SCHEDULE V**

**(See regulations 6A)**

#### **Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant or the intermediary is a ‘fit and proper person’ the Board may take into account such consideration as it deems fit, including but not limited to the following criteria in relation to the applicant or the intermediary, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever name called—

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;



(d) absence of categorization as a wilful defaulter.”

(e) absence of declaration as a fugitive offender

#### **6. Amendment of Securities and Exchange Board of India (Depositories and Participants) Regulations, 2018.**

(i) In regulation 88, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(ii) In regulation 92, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

#### **7. Amendment of Securities and Exchange Board of India (Foreign Venture Capital Investors) Regulations, 2000.**

(i) For regulation 4A, the following regulation shall be substituted, namely: -

**“Criteria for fit and proper person**

4A. For the purpose of determining whether an applicant or the foreign venture capital investor is a fit and proper person the Board may take into account the criteria specified in Schedule III of these regulations.”

(ii) In regulation 23, for the words “Chapter V of the Securities and Exchange

Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iii) After Schedule II, the following Schedule shall be inserted, namely: -

### **“SCHEDULE III**

**(See regulations 4A)**

#### **Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant or the intermediary is a ‘fit and proper person’ the Board may take into account such consideration as it deems fit, including but not limited to the following criteria in relation to the applicant or the intermediary, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever name called—

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

#### **8. Amendment to Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012.**

(i) For sub-regulation (f) of regulation 4, the following sub-regulation shall be

substituted, namely: -

“(f) the applicant, Sponsor and Manager are fit and proper persons based on the criteria specified in Schedule IV of these Regulations.”

(ii) In regulation 35, for the words “the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iii) In clause 7 of Form A of First Schedule, for the words “the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “these Regulations” shall be substituted.

(iv) After Schedule III, the following Schedule shall be inserted, namely: -

#### **“SCHEDULE IV**

**(See regulations 4 (f))**

#### **Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant is a ‘fit and proper person’ the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation to the applicant, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever

name called –

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

**9. Amendment of Securities and Exchange Board of India (Merchant Bankers) Regulations, 1992.**

- (i) For regulation 6A, the following regulation shall be substituted, namely: -

**“Criteria for fit and proper person**

6A. For the purpose of determining whether an applicant or the merchant banker is a fit and proper person the Board may take into account the criteria specified in Schedule IV of these Regulations.”

- (ii) In regulation 33, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

- (iii) For regulation 35, the following regulation shall be substituted, namely: -

**“Liability for action in case of default**

35. A merchant banker who contravenes any of the provisions of the Act, Rules or Regulations framed thereunder shall be liable for one or more

actions specified therein including the action under Chapter V of the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020.”

- (iv) After Schedule III, the following Schedule shall be inserted, namely: -

**“SCHEDULE IV**

**(See regulations 6A)**

**Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant is a ‘fit and proper person’ the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation to the applicant, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever name called –

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

**10. Amendment of Securities and Exchange Board of India (Mutual Funds) Regulations, 1996.**

- (i) For regulation 7A, the following regulation shall be substituted, namely: -

**“Criteria for fit and proper person**

7A. For the purpose of determining whether an applicant or the mutual fund is a fit and proper person the Board may take into account the criteria specified in Schedule XIII of these Regulations.”

- (ii) In regulation 65, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.
- (iii) In regulation 68, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.
- (iv) After Schedule XII, the following Schedule shall be inserted, namely: -

**“SCHEDULE XIII**

**(See regulations 7A)**

**Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant is a ‘fit and proper person’ the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation to the applicant, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever name called –

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

**11. Amendment of Securities and Exchange Board of India (Portfolio Managers) Regulations, 2020.**

- (i) For regulation 8, the following regulation shall be substituted, namely: -

**“Criteria for fit and proper person**

8. For the purpose of determining whether an applicant or the portfolio manager is a fit and proper person the Board may take into account the criteria specified in Schedule VII of these Regulations.”

- (ii) In regulation 39, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

- (iii) In regulation 41, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

- (iv) In clause 10.2 of Form A of First Schedule, for the words “SEBI

(Intermediaries) Regulations, 2008” the words “these Regulations” shall be substituted

(v) After Schedule VI, the following Schedule shall be inserted, namely: -

## **“SCHEDULE VII**

**(See regulations 8)**

### **Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant is a ‘fit and proper person’ the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation to the applicant, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever name called –

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

## **12. Amendment of Securities and Exchange Board of India (Registrars to an Issue and Share Transfer Agents) Regulations, 1993.**

(i) For regulation 6A, the following regulation shall be substituted, namely: -



“Criteria for fit and proper person

6A. For the purpose of determining whether an applicant or the registrar to an issue and share transfer agent is a fit and proper person the Board may take into account the criteria specified in Schedule IV of these Regulations.”

(ii) In regulation 20, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iii) In regulation 22, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iv) After Schedule III, the following Schedule shall be inserted, namely: -

#### **“SCHEDULE IV**

**(See regulations 6A)**

#### **Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant is a ‘fit and proper person’ the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation to the applicant, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever

name called –

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

**13. Amendment of Securities and Exchange Board of India (Stock Brokers and Sub-Brokers) Regulations, 1992.**

(i) For regulation 5A, the following regulation shall be substituted, namely: -

**“Criteria for fit and proper person**

5A. For the purpose of determining whether an applicant or the stock broker, sub-broker, trading member and clearing member is a fit and proper person the Board may take into account the criteria specified in Schedule VII of these Regulations.”

(ii) In regulation 23, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iii) In sub-regulation (ii) of regulation 25, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iv) In regulation 27, for the words “Chapter V of the Securities and Exchange

Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

- (v) After Schedule VI, the following Schedule shall be inserted, namely: -

**“SCHEDULE VII**

**(See regulations 5A)**

**Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant is a ‘fit and proper person’ the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation to the applicant, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever name called –

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

**14. Amendment of Securities and Exchange Board of India (Underwriters) Regulations, 1993.**

- (i) For regulation 6A, the following regulation shall be substituted, namely: -  
**“Criteria for fit and proper person**

6A. For the purpose of determining whether an applicant or the underwriter is a fit and proper person the Board may take into account the criteria specified in Schedule IV of these Regulations.”

(ii) In regulation 23, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iii) For regulation 25, the following regulation shall be substituted, namely:-

**“Liability for action in case of default.**

25. An underwriter who contravenes any of the provisions of the Act, Rules or Regulations framed thereunder shall be liable for one or more actions specified therein including the action under the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020.”

(iv) After Schedule III, the following Schedule shall be inserted, namely: -

**“SCHEDULE IV**

**(See regulations 6A)**

**Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant is a ‘fit and proper person’ the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation to the applicant, its sponsor, trustee, partners, principal officer, the director,

the promoter and the key management persons by whatever name called

- (a) integrity, reputation and character;
- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

**15. Amendment of Securities and Exchange Board of India (Investment Advisers) Regulations, 2013.**

- (i) In sub-regulation (f) of regulation 6, for the words “Schedule II of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “Schedule IV of these Regulations” shall be substituted
- (ii) In regulation 28, for the words “the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.
- (iii) In sub-clause (f) of clause (6) of Form A of First Schedule, for the words “Schedule II of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “these Regulations” shall be substituted.
- (iv) After Schedule III, the following Schedule shall be inserted, namely: -

## **“SCHEDULE IV**

**(See regulations 6)**

### **Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant is a ‘fit and proper person’ the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation to the applicant, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever name called –

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

### **16. Amendment of Securities and Exchange Board of India (Research Analysts) Regulations, 2014.**

- (i) clause (c) of sub-regulation (1) of regulation (2) shall be substituted as follows, namely,-

“associate” means any person controlled, directly or indirectly, by the intermediary, or any person who controls, directly or indirectly, the intermediary, or any entity or person under common control with such intermediary, and where such intermediary is a natural person will include

any relative of such intermediary and where such intermediary is a body corporate will include its group companies (as defined in the Monopolies and Restrictive Trade Practices Act, 1969 (Act No. 54 of 1969) or any re-enactment thereof) or companies under the same management;”

- (ii) In sub-regulation (vii) of regulation 6, for the words “Schedule II of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “Schedule IV of these Regulations” shall be substituted.
- (iii) In regulation 32, for the words “the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.
- (iv) In sub-clause (e) of clause (5) of Form A of First Schedule, for the words “Schedule II of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “these Regulations” shall be substituted.
- (v) After Schedule III, the following Schedule shall be inserted, namely: -

#### **“SCHEDULE IV**

**(See regulations 6)**

#### **Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant is a ‘fit and proper person’ the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation

to the applicant, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever name called –

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

**17. Amendment of Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2019.**

- (i) In sub-regulation (g) of regulation 4, for the words “Schedule II of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “Schedule IV of these Regulations” shall be substituted.
- (ii) In clause (f) of sub-regulation (1) of regulation 11, for the words “Schedule II of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “Schedule IV of these Regulations” shall be substituted.
- (iii) In clause (h) of sub-regulation (1) of regulation 22, for the words “Schedule II of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “these Regulations” shall be substituted.
- (iv) In regulation 40, for the words “Chapter V of the Securities and Exchange



Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(v) In regulation 43, for the words “the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(vi) After Schedule III, the following Schedule shall be inserted, namely: -

#### **“SCHEDULE IV**

**(See regulation 4(g) and regulation 11(f))**

#### **Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant is a ‘fit and proper person’ the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation to the applicant, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever name called

- (a) integrity, reputation and character;
- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

**18. Amendment of Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014.**

- (i) In clause (j) of sub-regulation (2) of regulation 4, for the words “Schedule II of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “Schedule VIII of these Regulations” shall be substituted.
- (ii) In regulation 32, for the words “the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.
- (iii) In sub-clause (b) of clause 8 of Form A of Schedule I, for the words “the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “these Regulations” shall be substituted.
- (iv) After Schedule VII, the following Schedule shall be inserted, namely:

**“SCHEDULE VIII**

**(See regulation 4(2)(j))**

**Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant is a ‘fit and

proper person' the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation to the applicant, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever name called –

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

**19. Amendment of Securities and Exchange Board of India (Infrastructure Investment Trusts) Regulations, 2014.**

- (i) In clause (k) of sub-regulation (2) of regulation 4, for the words “Schedule II of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “Schedule VII of these Regulations” shall be substituted.
- (ii) In regulation 32, for the words “the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.
- (iii) In clause 9 of Form A of Schedule I, for the words “the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words

“these Regulations” shall be substituted.

(iv) After Schedule VI, the following Schedule shall be inserted, namely: -

**“SCHEDULE VII**

**(See regulation 4(2)(k))**

**Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant is a ‘fit and proper person’ the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation to the applicant, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever name called –

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

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**PART-B**

**RECOVERY OF MONIES DUE UNDER SECURITIES LAWS**

## I. GENERAL

The Securities and Exchange Board of India (“SEBI” or “the Board”) is empowered to impose monetary penalties on violators, issue directions for refund to investors of monies raised in deemed public issues and unregistered collective investment schemes and order disgorgements. SEBI is also empowered to levy fees on market intermediaries under various regulations.

In case of default in the payment of such amounts, the SEBI Act, the SCRA and the Depositories Act (collectively referred to as the securities laws) empower SEBI to recover such amounts in the mode and manner as derived from the provisions of the Income-tax Act, 1961 and the Rules made thereunder, with suitable modifications as may be necessary.

However, there remain several challenges in the enforcement of such powers conferred upon SEBI.

An enforcement system without an efficient mechanism for recovering dues may render an agency ineffective. In this backdrop, the reference made to the Committee to suggest suitable changes, if any, to the securities laws and to consider the aggregation of a comprehensive set of rules or regulations that would lay down the procedure for recovery and for matters incidental and connected thereto, in light of the provisions pertaining to recovery of dues under the Income-tax laws and other laws, in the domestic and international space, prompted the Committee to examine a few of the domestic laws that pertain to employees’ provident funds, municipal corporation, insurance and competition laws as well as laws prevalent in certain foreign jurisdictions in the context of recovery of monies due under their securities laws.

The Committee also held extensive deliberations with the officers of the Legal Affairs Department and the Recovery and Refund Department. After considering the concerns raised during the deliberations and suggestions made during such meetings, the Committee has formulated its recommendations for improving the present system of recovery.

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## II. RECOVERY PROVISIONS UNDER VARIOUS LAWS

### INDIAN SCENARIO:

1. The Committee examined the following enactments with provisions for recovery mechanism, as summarized below, -
  - (a) Under the **Employees' Provident Funds and Miscellaneous Provisions Act, 1952**, the arrears of amount mentioned in section 8 (recovery of moneys due from employers) of the said Act shall be recovered in terms of the provisions of the Second and Third Schedules to the Income-tax Act, 1961 (43 of 1961). The Income-tax Certificate Proceedings Rules, 1962, as in force from time to time, is also applicable with necessary modifications. Thus like the SEBI Act, the aforesaid Act also directs the application of the provisions of Income-tax Act and the Rules for recovery of moneys due from employers.
  - (b) Under the state municipal laws such as the **Chennai City Municipal Corporation Act, 1919**, if any tax due from any person in India remains unpaid in whole or in part and if such a person leaves the country or cannot be found, the said tax or such part thereof that remains unpaid together with all sums payable in connection therewith, is recoverable as if it were an arrear of land revenue.
  - (c) Under section 33 of the **Insurance Act, 1938**, all expenses of, and incidental to, any investigation made under the said section shall be defrayed by the insurer, shall have priority over that debts due from the insurer and shall be recoverable as an arrear of land revenue.

In the context of the aforesaid Acts providing for amounts due to be recoverable as arrears of land revenue, the following deserve to be noted:



2. The Revenue Recovery Act<sup>15</sup>, 1890, in section 5 thereof states ‘*Where any sum is recoverable as an arrear of land-Revenue of any public officer other than a Collector or by local authority, the Collector of the district in which the office of that officer or authority is situate shall, on the request of the officer or authority, proceed to recover the sum as if it were an arrear of land-revenue which had accrued in his own district, and may send a certificate of the amount to be recovered to the Collector of another district under the foregoing provisions of this Act, as if the sum were payable to himself.*
3. There are also State enactments for each of the States in India that provide for recovery of arrears of revenue due to the Government.

In the matter of *State Bank of Indore v. Regional Provident Fund*<sup>16</sup>, the Hon’ble High Court of Madhya Pradesh brought out the difference between the terms “arrears of land revenue” and “amount recoverable as an arrear of land revenue” -

“5. In our judgment, the contentions advanced on behalf of the petitioner must be given effect to. Section 8 of the Act provides, inter alia, that any amount due from the employer in relation to an establishment to which a Scheme under the Act applies, may, if the amount is in arrear, be recovered by the appropriate Government in the same manner as an arrear of land revenue. It does not say that the amount may be recovered as an arrear of land revenue. It merely provides the manner of the recovery of the amount mentioned in Section 8. The manner prescribed for the recovery of the amount as an arrear of land revenue does not convert the amount into an arrear of land revenue; nor does it create any charge on any property of the employer for the payment of the amount or give a priority in the manner of payment of the amount. There is no provision in the Act in regard to the creation of any such charge or priority for the payment of the employer's contribution.”

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<sup>15</sup> An Act to make better provision for recovering certain public demands.

<sup>16</sup> AIR 1965 MP 40 (DB), (1965) ILLJ 662 MP; case before the provisions of Income-tax Act and Rules could be applied for recovery under the EPF Act.

4. Competition Act, 2002 read with the Competition Commission of India (Manner of recovery of Monetary Penalty) Regulations, 2011:
- A. The Competition Act, 2002 aims to prevent practices that have an adverse effect on competition, promote and sustain competition in markets, protect the interests of consumers and ensure freedom of trade carried on by other participants in the markets in India, and for matters connected therewith or incidental thereto.
  - B. Chapter VI contains sections 42-48 that provide for the imposition of monetary ‘penalties’ for various contravention.
  - C. Section 64 empowers the Commission to make regulations to carry out the purposes of the Competition Act. Under clause (g) of sub-section (2) of section 64, the Commission is empowered to make regulations for the manner in which penalty shall be recovered under sub-section (1) of section 39<sup>17</sup>.

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<sup>17</sup> “**Execution of orders of Commission imposing monetary penalty.**

**39. (1)** *If a person fails to pay any monetary penalty imposed on him under this Act, the Commission shall proceed to recover such penalty, in such manner as may be specified by the regulations.*

*(2) In a case where the Commission is of the opinion that it would be expedient to recover the penalty imposed under this Act in accordance with the provisions of the Income-tax Act, 1961 (43 of 1961), it may make a reference to this effect to the concerned income-tax authority under that Act for recovery of the penalty as tax due under the said Act.*

*(3) Where a reference has been made by the Commission under sub-section (2) for recovery of penalty, the person upon whom the penalty has been imposed shall be deemed to be the assessee in default under the Income Tax Act, 1961 (43 of 1961) and the provisions contained in sections 221 to 227, 228A, 229, 231 and 232 of the said Act and the Second Schedule to that Act and any rules made there under shall, in so far as may be, apply as if the said provisions were the provisions of this Act and referred to sums by way of penalty imposed under this Act instead of to income-tax and sums imposed by way of penalty, fine, and interest under the Income-tax Act, 1961 (43 of 1961) and to the Commission instead of the Assessing Officer.*

*Explanation 1 – Any reference to sub-section (2) or sub-section (6) of section 220 of the income-tax Act, 1961 (43 of 1961), in the said provisions of that Act or the rules made thereunder shall be construed as references to sections 43 to 45 of this Act.*

*Explanation 2 – The Tax Recovery Commissioner and the Tax Recovery Officer referred to in the Income-tax Act, 1961 (43 of 1961) shall be deemed to be the Tax Recovery Commissioner and the Tax Recovery Officer for the purposes of recovery of sums imposed by way of penalty under this Act and reference made by the Commission under sub-section (2) would amount to drawing of a certificate by the Tax Recovery Officer as far as demand relating to penalty under this Act.*

- D. The Commission is empowered to recover monetary penalty from a defaulter in the manner specified by the regulations or in accordance with the provisions of the Income-tax Act, 1961. It may make a reference to the concerned Income-tax Authority under that Act for recovery of the penalty as tax due under the said Act.
- E. On a reference made to the Income-tax Authority, the person upon whom the penalty has been imposed shall be deemed to be the assessee in default under the income tax laws and recovery shall be initiated accordingly.
- F. Salient features of the Competition Commission of India (Manner of recovery of Monetary Penalty) Regulations, 2011:
- a. Regulation 4: provides for extension of time for payment of dues or allow payment in instalments subject to such conditions as deemed fit by the Commission;
  - b. Regulation 5: If the amount specified in the demand notice is not paid within the period specified by the Commission, the enterprise/defaulters shall be liable to pay simple interest at one and one half per cent. for every month or part of a month comprised in the period commencing from the day immediately after the expiry of the period mentioned in demand notice and ending with the day on which the penalty is paid.

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*Explanation 3 – Any reference to appeal in Chapter XVIII and the Second Schedule to the Income-tax Act, 1961 (43 of 1961), shall be construed as a reference to appeal before the Competition Appellate Tribunal under section 53B of this Act.”*

- c. Regulation 9 (Modes of recovery):
- i. RA person who holds or may subsequently hold money for or on account of the defaulter is required to pay the Commission and in case of failure of such person to pay the money, he shall also be treated in the same manner as an enterprise in default.
  - ii. An application is required to be made to the court which is holding the custody of the defaulter's money.
  - iii. If the defaulter is in a country outside India (being a country with which the Central Government has entered into an agreement for the recovery of penalty under the Act and the corresponding law in force in that country), the Commission may propose to that country to take such action thereon as the Commission may deem appropriate and remit any sum so received to the Commission.
- d. Regulation 10 (Other modes of recovery): Recovery may also be done in accordance with the Rules laid down in the Second Schedule of Income-tax Act, 1961 by attachment and sale of movable/immovable properties of the defaulting enterprise.
- e. Regulations 10 and 11 - Require reference by the Commission to the Income-tax Authority for recovery of penalty.
- f. Regulation 14 – Refund of excess penalty: In case the Competition Appellate Tribunal or the High Court or the Supreme Court of India holds that the enterprise is not liable to pay any penalty or liable to pay penalty less than the amount mentioned in any order or notice,

the demand notice or the recovery certificate shall be withdrawn or modified and the amount of penalty, if paid, shall be refunded.

- g. Regulation 15: The Commission is empowered to determine the procedure in case a situation is not provided for in the regulations.

From the referred provisions of different enactments, it can be seen that under certain laws, the arrears or dues are recovered as if such arrears were arrears of land revenue. In some areas like in the securities markets and the employees' provident fund, the arrears or dues are recovered by resorting to the procedure under the Income-tax laws. However, under the laws administered by the Competition Commission, the said Commission is empowered to frame regulations for the purposes of recovering unpaid penalties imposed under the Competition Act, 2002. Thus, there is a diversity in the manner in which dues are recovered under different laws.

## **INTERNATIONAL SCENARIO:**

In certain advanced jurisdictions, the arrears due to the securities markets regulator of that jurisdiction is recovered as if such dues were a ‘civil debt’, as can be seen from the following examples:

### **A. United States of America**

The US SEC<sup>18</sup>, being a federal agency, is empowered to collect a claim from a defaulter in terms of the **Debt Collection Act** (codified at 31 U.S.C.3716). The said Act requires notice procedures TO be observed by the agency. The claim is recovered against “administrative offset”, “salary offset”, tax refund offset” and “wage garnishment order”.

The Commission may report delinquent debts to consumer reporting agencies (See 31 U.S.C. 3701(a)(3), 3711). Section 13 of the Debt Collection Act (31 U.S.C. 3718) authorizes agencies to enter into contracts for collection services to recover debts owed to the United States of America.

### **B. Australia**

In Australia, the ASIC may pursue<sup>19</sup> actions in the courts to punish a person or entity in response to a misconduct. Actions include –

- a. Criminal penalties (such as imprisonment, fines, community service orders, etc.).

Matters giving rise to criminal penalties are prosecuted by the Commonwealth Director of Public Prosecutions (CDPP), with the exception

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<sup>18</sup> See Code of Federal Regulations, Title 17, Chapter II, Part 204, Rules relating to Debt collection, available at <[https://www.ecfr.gov/cgi-bin/text-idx?node=17:3.0.1.1.5&rgn=div5#se17.3.204\\_15](https://www.ecfr.gov/cgi-bin/text-idx?node=17:3.0.1.1.5&rgn=div5#se17.3.204_15)>; U. S Code, Title 31, Sub-title III, Chapter 37, Sub-chapter II, Section 3716, available at <<https://www.law.cornell.edu/uscode/text/31/3716>>; U. S. Code, Title 26, Sub-title F., Chapter 65, Sub-chapter A., Section 6402, available at <<https://www.law.cornell.edu/uscode/text/26/6402#g>>; Code of Federal Regulations, Title 31, Sub-title B., Chapter II, Sub-chapter A., Part 285, Sub-part A., Section 285.2, available at <<https://www.law.cornell.edu/cfr/text/31/285.2>>; Code of Federal regulations, Title 31, Sub-title B., Chapter IX, Part 901, Section 901.3, available at <<https://www.law.cornell.edu/cfr/text/31/901.3>>.

<sup>19</sup> See ASIC Enforcement Review: Position Paper 7 Strengthening Penalties for Corporate and Financial Sector Misconduct, available at <<https://static.treasury.gov.au/uploads/sites/1/2017/10/c2017-t232150.pdf>>.

of a number of minor regulatory offences which are prosecuted by the ASIC;  
and

b. Civil monetary penalties.

All monetary penalties in these types of actions are payable to the Commonwealth of Australia. Under section 91 of the Australian Securities and Investments Commission Act 2001 (“**ASIC Act**”), the ASIC has the power to pass an order to recover the investigation expenses and costs, if as a result of the investigation, -

- i. a person is convicted of an offence, or
- ii. judgment is awarded, or a declaration or other order is made against a person in a proceeding in a court.

The AISC may pass an order that the person pay or reimburse ASIC, -

- i. for the whole or a specified part, of the expenses of the investigation;
- ii. for the whole or a specified part, of the costs to ASIC of making the investigation, including the remuneration of ASIC staff concerned in the investigation.

ASIC has similar powers under section 319 of the *National Consumer Credit Protection Act 2009* which allows ASIC to pass an order to recover investigation expenses and costs, including, -

- a. salary costs for ASIC staff who have worked on the investigation
- b. travel expenses when required to interview witnesses
- c. costs of external legal counsel, and
- d. costs of employing an expert to perform an analysis.

In terms of sub-section (4) of section 91 of the AISC Act, if the amount payable under an Order made under the said section is not paid, ASIC may then recover the same through a court of competent jurisdiction as a debt due to ASIC.

### C. Singapore

In Singapore, under sections 27C<sup>20</sup>, 148(10)<sup>21</sup> and 177<sup>22</sup> of the Monetary Authority of Singapore Act (“**MAS Act**”), the Monetary Authority of Singapore (“**MAS**”) recovers remuneration, expenses, financial penalty and fees as a civil debt. ‘Debt’ due to MAS is recoverable in terms of the Civil Law Act.

The Committee notes that recovery of penalty or fees in the aforesaid jurisdictions is effected as recovery of a ‘civil debt’ and the general law is invoked to recover the same through a civil court.

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<sup>20</sup> **Inspection of financial institutions for compliance with directions and regulations under sections 27A and 27B. 27C.**—(1) The Authority may, from time to time, inspect under conditions of secrecy the books of —

- (a) a financial institution; or
- (b) any subsidiary, branch, agency or office outside Singapore of a financial institution incorporated or established in Singapore,

for the purpose of determining the extent of compliance by the financial institution with the directions issued and the regulations made under sections 27A and 27B.

(2) The Authority may appoint any person, including an auditor (not being an auditor of the financial institution), to carry out an inspection under this section.

(3) If the inspection is carried out on the ground that the Authority has reason to believe that the financial institution has contravened or is contravening any direction issued or regulation made under section 27A or 27B, and if the Authority so directs, then the financial institution is liable to pay for the remuneration and expenses of any person appointed under subsection (2) for the inspection.

(4) The Authority may recover from the financial institution the remuneration and expenses referred to in subsection (3) as a civil debt due to the Authority.

.....

<sup>21</sup> **Cancellation, etc., of appointment as primary dealer**

**148.** .....

(3) In the case of a failure by a primary dealer to comply with any direction issued by the Authority under section 147, the Authority may, in addition to any order that may be made under subsection (2), order the primary dealer to pay to the Authority, for every day or part thereof of such failure, a financial penalty in accordance with such formula as the Minister may, by notification published in the Gazette, prescribe.

(4) A financial penalty collected by the Authority under subsection (3) shall be paid into the Consolidated Fund.

....

(10) The Authority may recover on behalf of the Government any financial penalty ordered under subsection (3) as though the financial penalty were a civil debt due to the Authority.

<sup>22</sup> **Recovery of fees, expenses, etc.**

**177.** There shall be recoverable as a civil debt due to the Authority from the financial institution concerned —

(a) the amount of any fees payable to the Authority under section 29 or under any rules issued under section 29A; and

(b) any remuneration and expenses payable by the financial institution to —

- (i) a statutory adviser appointed under section 33(2);
- (ii) a statutory manager appointed under section 33(2);
- (iii) the Authority or any person appointed by the Authority under section 13B in relation to the Authority’s assumption of control of any business of the financial institution under section 33; and
- (iv) any person appointed to perform any independent assessment under Part IVA or IVB.



## **RECOVERY UNDER THE INDIAN SECURITIES LAWS**

### **GENESIS OF SECTION 28A OF SEBI ACT, 1992:**

Prior to July 2013, SEBI did not have the power to recover amounts due. The absence of recovery power severely jeopardized its ability to recover unpaid penalties. The Committee is given to understand that many orders directing disgorgement in the IPO scam unearthed in 2005 and 2006 were not complied with. The options available to the regulator was to impose debarment for a longer period or file for prosecution in a criminal court. Such provisions though meant to act as a deterrent, did not enable SEBI to recover the unpaid amounts from the violators. Instead, huge costs were incurred by the regulator in such proceedings including manpower to oversee such action.

Realizing the lacunae in its enforcement tools, SEBI deliberated the issue with the Central Government and sought an amendment to the SEBI Act to empower it to recover unpaid monies due in line with the provisions of the Income-tax Act, 1961.

Finally, through an Ordinance in 2013 i.e., the Securities Laws (Amendment) Ordinance, 2013, with effect from July 18, 2013, an important amendment was brought about by the insertion of a new section 28A in the SEBI Act and in the analogous provisions in the SCRA and the Depositories Act to provide SEBI with the power to recover the amounts due.

An Ordinance route was necessitated since the Parliament was not in session. When the Amendment Ordinance, 2013 lapsed, a Second Ordinance was promulgated on September 16, 2013 and upon the lapse of this Second Ordinance, a third Ordinance was promulgated on March 28, 2014. Subsequently, the Securities Laws (Amendment) Act, 2014<sup>23</sup> was notified on August 25, 2014.

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<sup>23</sup> This included reference to section 220 of the Income Tax Act, 1961 which otherwise was not present in the previous three amendment Ordinances.

The avowed 'Statement of Objects and Reasons' in respect of the power to recover monies due in the Securities Laws (Amendment) Bill, 2014 is as follows, -

*"...to insert a new section 28A so as to empower the Recovery Officer to recover the amount, against the persons who fail to comply with any direction of the Board for refund of monies or fail to comply with a direction of disgorgement issued under section 11B or fail to pay any fees due to the Board."*

Further, the Notes on Clauses provided as under, -

*"Clause 21.—This clause seeks to insert a new section 28A in the SEBI Act, 1992 relating to recovery of amounts. This clause empowers the Board, inter alia, to attach and sell movable and immovable property of the defaulters without recourse to any court of law and attach bank accounts of defaulters, in case a person fails to pay the penalty imposed by the adjudicating officer or fails to comply with any direction of the Board for refund of monies or fails to comply with a direction of disgorgement order issued under section 11B or fails to pay any fees due to the Board."*

#### **POWER TO RECOVER:**

Section 28A of the SEBI Act empowers a Recovery Officer appointed by SEBI to recover unpaid monetary penalties, unpaid monies directed to be refunded to investors, disgorgement amounts and unpaid fees due to SEBI. The provisions of section 28A is reproduced below:

##### **"Recovery of amounts.**

**28A.** (1) If a person fails to pay the penalty imposed [under the Act]<sup>24</sup> or fails to comply with any direction of the Board for refund of monies or fails to comply with a direction of disgorgement order issued under section 11B or fails to pay any fees due to the Board, the Recovery Officer may draw up under his signature a statement in the specified form specifying the amount due from the person (such

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<sup>24</sup> Substituted for the words "by the adjudicating officer" by the Finance Act, 2018. This amendment is not yet brought into force.

statement being hereafter in this Chapter referred to as certificate) and shall proceed to recover from such person the amount specified in the certificate by one or more of the following modes, namely:—

- (a) attachment and sale of the person's movable property;
- (b) attachment of the person's bank accounts;
- (c) attachment and sale of the person's immovable property;
- (d) arrest of the person and his detention in prison;
- (e) appointing a receiver for the management of the person's movable and immovable properties,

and for this purpose, the provisions of sections 220 to 227, 228A, 229, 232, the Second and Third Schedules to the Income-tax Act, 1961 (43 of 1961) and the Income-tax (Certificate Proceedings) Rules, 1962, as in force from time to time, insofar as may be, apply with necessary modifications as if the said provisions and the rules made thereunder were the provisions of this Act and referred to the amount due under this Act instead of to income-tax under the Income-tax Act, 1961.

Explanation 1.—For the purposes of this sub-section, the person's movable or immovable property or monies held in bank accounts shall include any property or monies held in bank accounts which has been transferred directly or indirectly on or after the date when the amount specified in certificate had become due, by the person to his spouse or minor child or son's wife or son's minor child, otherwise than for adequate consideration, and which is held by, or stands in the name of, any of the persons aforesaid; and so far as the movable or immovable property or monies held in bank accounts so transferred to his minor child or his son's minor child is concerned, it shall, even after the date of attainment of majority by such minor child or son's minor child, as the case may be, continue to be included in the person's movable or immovable property or monies held in bank accounts for recovering any amount due from the person under this Act.

Explanation 2.—Any reference under the provisions of the Second and Third Schedules to the Income-tax Act, 1961 (43 of 1961) and the Income-tax (Certificate Proceedings) Rules, 1962 to the assessee shall be construed as a reference to the person specified in the certificate.

Explanation 3.— Any reference to appeal in Chapter XVIIID and the Second Schedule to the Income-tax Act, 1961 (43 of 1961), shall be construed as a reference to appeal before the Securities Appellate Tribunal under section 15T of this Act.

Explanation 4.— The interest referred to in section 220 of the Income-tax Act, 1961 shall commence from the date the amount became payable by the person.

(2) The Recovery Officer shall be empowered to seek the assistance of the local district administration while exercising the powers under sub-section (1).

(3) Notwithstanding anything contained in any other law for the time being in force, the recovery of amounts by a Recovery Officer under sub-section (1), pursuant to non-compliance with any direction issued by the Board under section 11B, shall have precedence over any other claim against such person.

(4) For the purposes of sub-sections (1), (2) and (3), the expression "Recovery Officer" means any officer of the Board who may be authorised, by general or special order in writing, to exercise the powers of a Recovery Officer.”

[Emphasis supplied]

Analogous<sup>25</sup> provisions are also seen in the SCRA and the Depositories Act.

On a clear reading of section 28A(1)<sup>26</sup>, the following is noted,-

- a. Action for “recovery” under section 28A gets triggered when there is a failure to -

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<sup>25</sup> 23JB of the SCRA and section 19-IB of the Depositories Act.

<sup>26</sup> Read with analogous provisions i.e. 23JB of the SCRA and section 19-IB of the Depositories Act.

- i. pay a **penalty** imposed under the Act;
  - ii. comply with a direction of the Board for **refund** of monies;
  - iii. comply with a direction of **disgorgement**; or
  - iv. pay **fees** due to the Board.
- b. In case of defaults mentioned above, the Recovery Officer<sup>27</sup> draws up a **certificate**<sup>28</sup> specifying the amount due from the person (called the “defaulter”) and proceeds to recover the amount specified in his certificate by one or more of the following modes -
  - i. attachment and sale of the defaulter’s movable property;
  - ii. attachment of the defaulter’s bank accounts;
  - iii. attachment and sale of the defaulter’s immovable property;
  - iv. arrest of the defaulter and his detention in prison;
  - v. appointing a receiver for the management of the defaulter’s movable and immovable properties.
- c. For the aforesaid purpose, the provisions of sections 220 to 227, 228A, 229, 231, 232, the Second and Third Schedules to the Income-tax Act, 1961 and the Income-tax (Certificate Proceedings) Rules, 1962, as in force from time to time, shall be applied with necessary modifications as if the said provisions and the rules thereunder were the provisions of the Act.
- d. In terms of sub-section (3) thereof, the recovery of amounts by a Recovery Officer pursuant to non-compliance with any direction issued by the Board under section 11B shall have **precedence** over any other claim against such person.

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<sup>27</sup> Any officer of the Board who is authorized to exercise the powers of a Recovery Officer.

<sup>28</sup> Statement in a specified form under the signature of the Recovery Officer.

## **Procedure for effecting recovery.**

Sub-section (1) of section 28A provides that for the purpose of recovering amounts under the said section, the provisions of the Income-tax Act and the Rules framed thereunder, as mentioned in sub-section (1) of section 28A, shall be applied with necessary modifications.

Accordingly, SEBI has been following the provisions of –

- a. section 220 (*when tax is payable and when an assessee is deemed in default*);
  - b. section 221 (*penalty payable when tax is in default*);
  - c. section 222 (*certificate to Tax Recovery Officer*);
  - d. section 223 (*Tax Recovery Officer by whom recovery is to be effected*);
  - e. section 224 (*validity of certificate and cancellation or amendment thereof*);
  - f. section 225 (*stay of proceedings in pursuance of certificate and amendment or cancellation thereof*);
  - g. section 226 (*other modes of recovery*);
  - h. section 227 (*Recovery through State Government*);
  - i. section 228A (*Recovery of tax in pursuance of agreements with foreign countries*);
  - j. section 229 (*recovery of penalties, fine, interest and other sums*);
  - k. section 231 (*period for commencing recovery proceedings*);
  - l. section 232 (*recovery by suit or under other law not affected*);
  - m. the Second Schedule (*Procedure for recovery of Tax – sections 222 and 276*);
  - n. the Third Schedule (*Procedure for distraint by Assessing Officer or Tax Recovery Officer*);
- of the Income-tax Act, 1961; and

o. the Income-tax (Certificate Proceedings) Rules, 1962<sup>29</sup>, as in force, with necessary modifications, while initiating recovery proceedings under section 28A of the Act.

#### **LEGISLATIVE CHANGES:**

The Finance Act, 2018 inserted a new section (section 28B<sup>30</sup>) in the SEBI Act (similar to the provisions for Legal Representatives found in the Income Tax Act, 1961) to enable the Board to continue with the recovery proceedings against a legal representative in the event the person (i.e. defaulter) dies.

Section 28B reads as follows,-

#### ***“Continuance of proceedings.***

**28B.** (1) *Where a person dies, his legal representative shall be liable to pay any sum which the deceased would have been liable to pay, if he had not died, in the like manner and to the same extent as the deceased:*

*Provided that, in case of any penalty payable under this Act, a legal representative shall be liable only in case the penalty has been imposed before the death of the deceased person.*

(2) *For the purposes of sub-section (1),—*

*(a) any proceeding for disgorgement, refund or an action for recovery before the Recovery Officer under this Act, except a proceeding for levy of penalty, initiated against the deceased before his death, shall be deemed to have been initiated against the legal representative, and may be continued against the legal representative from the stage at which it stood on the date of the death of the deceased and all the provisions of this Act shall apply accordingly;*

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<sup>29</sup> In exercise of powers under section 295(1) of the Income-tax Act, 1961 and rules 91 and 92 of the Second Schedule to the Income-tax Act, 1961

<sup>30</sup> Also see Part-D of this Report for discussion on this provision.

*(b) any proceeding for disgorgement, refund or an action for recovery before the Recovery Officer under this Act, except a proceeding for levy of penalty, which could have been initiated against the deceased if he had survived, may be initiated against the legal representative and all the provisions of this Act shall apply accordingly.*

*(3) Every legal representative shall be personally liable for any sum payable by him in his capacity as legal representative if, while his liability for such sum remains undischarged, he creates a charge on or disposes of or parts with any assets of the estate of the deceased, which are in, or may come into, his possession, but such liability shall be limited to the value of the asset so charged, disposed of or parted with.*

*(4) The liability of a legal representative under this section shall be limited to the extent to which the estate of the deceased is capable of meeting the liability.*

*Explanation. —For the purposes of this section “legal representative” means a person who in law represents the estate of a deceased person, and includes any person who intermeddles with the estate of the deceased and where a party sues or is sued in a representative character, the person on whom the estate devolves on the death of the party so suing or sued.”*

Analogous provisions are made in the SCRA (new section 23JC) and the Depositories Act (new section 19-IC).

By virtue of the insertion of such legislation, the legal representative is now liable to pay the penalty, had the person (original defaulter) not deceased, to the extent of the estate of the deceased that is capable of meeting the liability.



### **III. CONCERNS IN THE PRESENT LAW**

The Committee examined the existing laws, including the provisions relating to recovery of Income Tax as applicable to the Indian securities markets and notes that adoption of the mechanism designed for recovery of income tax for recovery of dues under the securities laws has brought to the surface certain difficulties.

#### **A. CHALLENGES IN THE EXISTING LAW FOR RECOVERY OF SIPHONED OFF MONIES**

One of the commonly practiced securities laws violations involves monies raised through public issue of securities being siphoned off by the issuer/promoters to various sister concerns and individuals. Difficulties arise when the aspects of siphoning of the amounts comes to the notice of SEBI after the passing of the final order but during the pendency of the recovery proceedings.

The Income Tax Act, 1961 has provisions relating to the clubbing of income. Adopting the provisions of recovery under that law to securities markets has led to a unique limitation in the context of SEBI. Explanation-I to Section 28A of the SEBI Act allows the Recovery Officer to deal with transfers made to certain dependent relatives i.e. spouse, son's wife, minor child and son's minor wife- i.e. *persons with whom clubbing of income is allowed under the Income-tax Act*. This provision, however, does not extend to corporate entities, other individuals and sons or grandsons who have already attained the age of majority who may have benefitted from the default. Thus, if one promoter entity transfers the assets to another promoter entity to avoid recovery (and such entity is not one of the enumerated individuals), it becomes difficult for the Recovery Officer to deal with such transfers.

In matters which have invited judicial attention such as those of Arrow Global, Sahara group, etc., the Courts/Tribunal have specifically permitted the sale of assets belonging to third parties *inter alia* to whom monies had been allegedly siphoned off. However, it is doubtful if in the absence of directions from the Court or Tribunal, the Recovery Officer of SEBI could sell off the assets of third parties and draw up a certificate of sale in respect of assets for recovery of the siphoned off monies.

In contrast, the Committee notes that in the USA, SEC *inter alia* does disgorgement of unlawful gains against “*relief defendants*”- i.e. *any persons to whom unlawful proceeds were transferred and who have no legitimate claim to the funds or other assets*. Relief defendants are so-named because their presence in the suit is necessary in order to provide full relief. E.g. in *SEC v George and Ors*,<sup>31</sup> the court *inter alia* explained the concept and liability of relief defendants as follows -

*“57. A relief defendant (sometimes referred to as a nominal defendant) may be joined to aid the recovery of relief” and “has no ownership interest in the property which is the subject of litigation.” (emphasis supplied) *SEC v. Cherif*, 933 F.2d 403, 414 (7th Cir.1991); see also *SEC v. Cavanagh*, 155 F.3d 129, 136 (2d Cir.1998). *“Federal courts may order equitable relief against [such] a person who is not accused of wrongdoing in a securities enforcement action where that person: (1) has received ill-gotten funds; and (2) does not have a legitimate claim to those funds.”* *Cavanagh*, 155 F.3d at 136; see also *Commodity Futures Trading Comm'n v. Kimberlynn Creek Ranch, Inc.*, 276 F.3d 187, 192 (4th Cir.2002); *SEC v. Colello*, 139 F.3d 674, 677 (9th Cir.1998).*

*58. Each of the relief defendants in this instance received ill-gotten funds and had no legitimate claim to those funds. (emphasis supplied) The pricey diamond ring and the \$32,000 that Dzorney received from Thorn came from funds Thorn received from investors. Because Thorn obtained the money through fraud, then gave it to Dzorney as a gift, she has no legitimate claim*

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<sup>31</sup> 426 F.3d 786, available at <https://openjurist.org/426/f3d/786/securities-and-exchange-commission-v-george-e-d-r-e>.

to the funds. To hold otherwise "would allow almost any defendant to circumvent the SEC's power to recapture fraud proceeds by the simple procedure of giving [the proceeds] to friends and relatives, without even their knowledge." (emphasis supplied) Cavanagh, 155 F.3d at 137.

59. Jackson, Harris and George also received ill-gotten funds from the defendants. While each of the three invested his own money in Thorn's investment scheme, the SEC showed that the money they received from the scheme came not from profits on their investments but from the investments of others. (emphasis supplied) Each of these relief defendants fails to rebut this evidence. Before the district court, Jackson came "forward with no evidence to refute the SEC's evidence that the amount Jackson received as purported profits came from other investors." D. Ct. Op. at 39-40. Jackson now claims in his briefs that the money he received back was "clearly traceable to him," Jackson Br. at 13, but he fails to identify anything in the record that supports this assertion. Matters are worse for Harris: Not only does he fail to present any evidence rebutting the SEC's proof of tracing, but he also has "concede[d] that he does not know the source of the funds" he received from Thorn. D. Ct. Op. at 38. And George, who received back more money than he contributed to the investment pool and so cannot claim he received only his own funds back, has also failed to come forward with any evidence rebutting the SEC's tracing evidence. To survive summary judgment in the face of the SEC's evidence, the relief defendants needed to present affirmative evidence, not just affirmative assertions, demonstrating a disputed issue of material fact. *Betkerur v. Aultman Hosp. Ass'n*, 78 F.3d 1079, 1087 (6th Cir.1996). They did not do so."

**Recommendation:** In view of the above, the following suggestions are made for amendments to securities laws -

- a. after the existing Explanation I to Section 11B of the SEBI Act and related provisions in Depositories Act and SCRA, the following may be inserted,-

*“Explanation II. - For the removal of doubts, it is hereby declared that the power to issue directions under this section shall include and always be deemed to have been included, the power to direct any person to whom proceeds involved in violation, of any of the provisions of this Act, or the rules or the regulations, have been transferred to and who has no legitimate claim to such proceeds.”*

- b. the existing Explanation I to Section 28A of the SEBI Act and analogous provisions in the Depositories Act and SCRA may be substituted with the following, namely, -

*“Explanation 1. — For the purposes of this section, the person's movable or immovable property or monies held in bank accounts shall include any property or monies held in bank accounts which has been transferred without adequate consideration, directly or indirectly, on or after the date when the amount specified in certificate had become due, by such person to any other person.”*

#### **B. INTERIM ATTACHMENT THROUGH THE JUDICIAL BRANCH**

The SEBI Act, 1992 has an interesting, extremely potent but seldom used power. It is the power of attachment through the judicial branch to attach any bank account or other property found in Section 11(4) (e). The recent Banning of Unregulated Deposit Schemes Act, 2019 has linked the assets attached under this provision with the mechanism to

recover monies due under section 28A of the SEBI Act, 1992. The provision reads as follows,-

“(4) Without prejudice to the provisions contained in sub-sections (1), (2), (2A) and (3) and section 11B, the Board may, by an order, for reasons to be recorded in writing, in the interests of investors or securities market, take any of the following measures, either pending investigation or inquiry or on completion of such investigation or inquiry, namely:—

(d) impound and retain the proceeds or securities in respect of any transaction which is under investigation;

(e) <sup>32</sup>[attach, for a period not exceeding ninety days, bank accounts or other property of any intermediary or any person associated with the securities market in any manner involved in violation of any of the provisions of this Act, or the rules or the regulations made thereunder:

Provided that the Board shall, within ninety days of the said attachment, obtain confirmation of the said attachment from the Special Court, established under section 26A, having jurisdiction and on such confirmation, such attachment shall continue during the pendency of the aforesaid proceedings and on conclusion of the said proceedings, the provisions of section 28A shall apply:

Provided further that only property, bank account or accounts or any transaction entered therein, so far as it relates to the proceeds actually involved in violation of any of the provisions of this Act, or the rules or the regulations made thereunder shall be allowed to be attached];”

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<sup>32</sup> Substituted by the Banning of Unregulated Deposit Schemes Act, 2019 [No. 21 of 2019] w.e.f 21-2-2019. Prior to its substitution, clause (e) read as follows,-

"(e) attach, after passing of an order on an application made for approval by the Judicial Magistrate of the first class having jurisdiction, for a period not exceeding one month, one or more bank account or accounts of any intermediary or any person associated with the securities market in any manner involved in violation of any of the provisions of this Act, or the rules or the regulations made thereunder:

Provided that only the bank account or accounts or any transaction entered therein, so far as it relates to the proceeds actually involved in violation of any of the provisions of this Act, or the rules or the regulations made thereunder shall be allowed to be attached;”

The difficulty in utilizing this power lies in the pre-condition that only ‘proceeds in respect of a transaction under investigation’ or ‘*only property, bank account or accounts or any transaction entered therein, so far as it relates to the proceeds actually involved in violation of any of the provisions of this Act, or the rules or the regulations made thereunder shall be allowed to be attached.*’

This pre-condition of proving at the interim stage itself that the monies and assets involved in the violation be *traced and identified* makes the use of interim attachment quite limited and self-defeating. Comparatively the Recovery Officer has no such limitation and can order the attachment and sale of all or any property for the purpose of recovering the monies due, whether or not such property relates to the violation of securities laws. However, this is too little too late. By the time recovery begins, the defaulting entity would have by then ensured that his assets are beyond the reach of the enforcement agencies. This prejudicially affects the actual amount of money that can be recovered.

In comparison, the US SEC has no such limitation on its powers. In *Federal Trade Commission v. Bronson Partners, LLC*<sup>33</sup>, the court *inter alia* held that:

“But when a public entity seeks disgorgement it does not claim any entitlement to particular property; it seeks only to "deter violations of the laws by depriving violators of their ill-gotten gains." *Fischbach*, 133 F.3d at 175....In light of this distinction, it is unsurprising that Bronson can point to no case in which a public agency seeking to obtain equitable monetary relief has been required to satisfy the tracing rules. To the contrary, the Federal Reporter is replete with instances in which judges of this Court deeply familiar with equity practice have permitted the SEC to obtain disgorgement without any mention of tracing.”

Though initially US Federal Courts had placed such a limitation on the US SEC; subsequently they realised the inequitable result that such a limitation would place on the SEC and the requirement that funds should be traceable to the violation for granting a

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<sup>33</sup> 654 F.3d 359 (2d Cir. 2011), available at <<https://www.courtlistener.com/opinion/223605/ftc-v-bronson-partners-llc/>>.

temporary asset freeze was removed. The Court in *SEC v Lauer & Ors.*<sup>34</sup>, *inter alia* explained the development of law in this respect as follows,-

“Lauer cites, among other cases, *S.E.C. v. First City Financial Corp., Ltd.*, 890 F.2d 1215, 1230 (D.C.Cir.1989) (“First City”) which states that because “disgorgement primarily serves to prevent unjust enrichment, the court may exercise its equitable power only over property causally related to the wrongdoing.” Several cases have cited First City for this proposition, most notably for our purposes, *CFTC v. Sidoti*, 178 F.3d 1132, 1138 (11th Cir.1999), and *SEC v. Gane*, 2005 WL 90154, \*19 (S.D.Fla. 2005) (Gonzales, J.). The Eleventh Circuit, relying upon First City, held that “the district court may not disgorge profits obtained without the aid of any wrongdoing.” *Sidoti*, 178 F.3d at 1138. The Sidoti Court went on to find that the district court had abused its discretion for ordering disgorgement of profits for a period during which there was no record evidence of fraud.

Subsequent to First City, the Court of Appeals for the District of Columbia reviewed the narrow interpretation Lauer proposes for the holding in First City and held to do so conflicts with longstanding precedent and would lead to a monstrous doctrine that would perpetuate rather than correct an inequity. In *SEC v. Banner Fund Int'l, et al.*, 211 F.3d 602, 617 (D.C.Cir.2000), the Court of Appeals explained: (emphasis supplied)

“Because disgorgement is an equitable obligation to return a sum equal to the amount wrongfully obtained, rather than a requirement to replevy a specific asset, we reject Blackwell's challenge and affirm the district court.

. . . As the SEC points out, the requirement of a causal relationship between a wrongful act and the property to be disgorged does not imply that a court may order a malefactor to disgorge only the actual property obtained by means of his wrongful act. Rather, the causal connection required is between the amount by which the defendant was unjustly enriched and the amount he can be required to disgorge. To hold, as Blackwell maintains, that a court may order a defendant to disgorge only the actual assets unjustly received would lead to absurd results. Under Blackwell's approach, for example, a defendant who was careful to spend all the proceeds of his fraudulent scheme, while husbanding his other assets, would be immune from an order of disgorgement. Blackwell's would be a monstrous doctrine for it would perpetuate rather than correct an inequity. (emphasis supplied)”

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<sup>34</sup> 445 F. Supp. 2d 1362 (S.D. Fla. 2006), available at <<https://www.courtlistener.com/opinion/2499896/sec-v-lauer/>>.

Many district courts faced with this argument agree that "[t]here is no requirement that frozen assets be traceable to the fraudulent activity underlying a lawsuit." *SEC v. Dennis Crowley*, Case No. 0480354-Civ-Middlebrooks, Slip. Op. (S.D.Fla.2004) (order by consent by Magistrate Judge Johnson) [DE 1368, Ex. I]; see also *SEC v. A.B. Financing and Inv., Inc.*, Case No. 02-23487-Civ-Ungaro-Benages, Slip. Op. at 2-3. (S.D.Fla.2003) ("a district court may freeze assets not specifically traced to illegal activity" quoting *Levi Strauss & Co. v. Sunrise Int'l Trading Inc.*, 51 F.3d 982 (11th Cir.1995)) [DE 1368, Ex. J]; *SEC v. Belmonte*, No. 88 6557, 1991 WL 214252 (S.D.Fla.1991) (Roettger, J.) (refusing to release funds from sale of home, even though home had been acquired prior to alleged fraud, because there had been no showing that ill-gotten funds had not been used to subsidize mortgage payments or improve home); *SEC v. Current Financial Svcs.*, 62 F. Supp. 2d 66, 68 (D.D.Cir.1999) (refusing to release personal funds not traceable to the fraud because defendant's liability exceeded total funds frozen); *SEC v. Grossman*, 887 F. Supp. 649, 661 (S.D.N.Y.1995) ("it is irrelevant whether the funds affected by the Asset Freeze are traceable to the illegal activity") (aff'd, 101 F.3d 109 (2d Cir. 1996)); *SEC v. Roor*, No. 99-3372, 1999 WL 553823 at \*2 (S.D.N.Y.1999) (denying motion to release so-called "untainted" funds from mortgage of property that pre-existed alleged fraud); *SEC v. Glauberman*, No. 90-5205, 1992 WL 175270 at \*1 (S.D.N.Y.1992) (rejecting defendant's argument that funds subject to disgorgement must be traced "dollar for dollar" to the illegal activity). (emphasis supplied)

....The amount of assets to be frozen, prior to the finding of liability, is determined not by whether the funds themselves are traceable to the fraudulent activity underlying the lawsuit, but by showing a reasonable approximation of the amount, with interest, the defendant was unjustly enriched. *Id.*; *SEC v. Blatt* 583 F.2d 1325, 1335 (5th Cir.1978). (emphasis supplied)"

**Recommendation:** It may be appropriate to seek amendment to the following provisions of the SEBI Act, 1992, -

- i. Clause (d) of Section 11(4) may be amended as follows,-

“impound and retain the ~~proceeds or~~ securities **or monies not exceeding the value of the proceeds, inclusive of suitable interest thereon**, in respect of any transaction which is under investigation;”



ii. The second proviso to clause (e) of Section 11(4) may be amended as follows,-

“Provided further that only property, bank account or accounts or any transaction entered therein, ~~so far as it relates to~~ **not exceeding the value of the proceeds actually** involved in violation of any of the provisions of this Act, or the rules or the regulations made thereunder, **inclusive of suitable interest thereon**, shall be allowed to be attached.”

**C. ‘MODIFICATIONS’ TO THE FRAMEWORK OF RECOVERY UNDER THE INCOME TAX ACT,  
1961**

While sub-section (1) of section 28A of the SEBI Act (and analogous provisions in the SCRA and Depositories Act) provides leeway for modification, no guidance is provided as to how such “**modification**” is to be effected. The relevant recovery provisions of the Income-tax Act, 1961 and the Income-tax (Certificate Proceedings) Rules, 1962 with necessary modifications are considered to be part of the SEBI Act, the SCRA and Depositories Act. i.e. sections 220 to 227, 228A, 229, 232, the Second and Third Schedules to the Income-tax Act, 1961 and the Income-tax (Certificate Proceedings) Rules, 1962, as in force from time to time, in so far as may be, apply with necessary modifications as if the said provisions and the rules made thereunder *were the provisions of the SEBI Act*.

It is common for enactments to have provisions which expressly provide that delegated legislation shall have effect as ‘if enacted in this Act.’ It is also common for the enactments to declare how the modifications in such cases are to be made. e.g. Section 35 of the Hampi World Heritage Area Management Authority Act, 2002 provides as follows:-

“(1) If any difficulty arises in giving effect to the provisions of this Act, the State Government may by order published in the Official Gazette, as the occasion

may require do anything which appears to it to be necessary to remove the difficulty.

(2) Every order made under sub-section (1) shall as soon as may be after it is published, be laid before both Houses of the State Legislature and shall, subject to any modification which the State Legislature may make, have effect as if enacted in this Act.”

However, Section 28A of the SEBI Act is silent in respect of the various modifications to sections 220 to 227, 228A, 229, 232, the Second and Third Schedules to the Income-tax Act, 1961 and the Income-tax (Certificate Proceedings) Rules, 1962 when applied in the securities markets context. Hence, the Committee is of the view that the delegated legislation made in the ordinary way so as to carry out the purposes of the Act is the mode through which such modifications may be made.

No rules have been prescribed under the SEBI Act in relation to Section 28A and the modifications to the provisions of Income-tax Act, 1961 and the Income-tax (Certificate Proceedings) Rules, 1962 which are deemed to be part of the SEBI Act.

Considering that modifications are to be done while applying the provisions of the Income-tax Act, 1961 and the Certificate Rules, it would be appropriate if such modifications are clarified through regulations since section 30 of the SEBI Act (and analogous provisions in the SCRA and Depositories Act) permits the Board to make regulations consistent with the SEBI Act and the rules made thereunder to carry out the purposes of the Act.

Hence, the Committee is of the view that since the relevant provisions of the Income-tax Act, 1961 and the Income-tax (Certificate Proceedings) Rules, 1962 are deemed to be part of the statute itself, it is possible to frame regulations under the SEBI Act *inter alia* clarifying the modifications in such provisions as well as any enhancements in process within the basic framework relating to a Recovery officer.

**IV. SUITABLE APPLICATION BY MODIFICATION OF CERTAIN PROVISIONS OF THE INCOME-TAX ACT, 1961**

Section 28A of the SEBI Act and the analogous provisions of the SCRA and the Depositories Act refers to the provisions of sections 220-227, 228A, 229 and 232 of the Income-tax Act, 1961. These provisions are substantive in nature. Therefore, the Committee is of the view that in the light of the suggestions made to have comprehensive regulations for the purposes of “recovery” under the securities laws, the aforesaid provisions of the Income-tax Act, 1961 be suitably modified in the securities laws in the context of recovery proceedings intended by the Board.

The Committee suggests the following modifications: -

<b>Sr. No.</b>	<b>Provisions of the Income-tax Act, 1961</b>	<b>Suggested modification for SEBI</b>
<b>I.</b>	<p><b>When tax payable and when assessee deemed in default.</b></p> <p><b>220.</b> (1) Any amount, otherwise than by way of advance tax, specified as payable in a notice of demand under section 156 shall be paid within thirty days of the service of the notice at the place and to the person mentioned in the notice :</p> <p><b>Provided</b> that, where the Assessing Officer has any reason to believe that it will be detrimental to revenue if the full period of thirty days aforesaid is allowed, he may, with the previous approval of the Joint Commissioner,</p>	<p><b>Amounts when payable.</b></p> <p>(1) Any penalty or refund of monies or disgorgement of amounts or fees due to the Board, under the Act<sup>35</sup> or the Securities Contracts (Regulation) Act, 1956 or the Depositories Act, 1996, shall be paid within thirty days of service of notice or in terms of the regulations issued or an order passed by the Board:</p> <p>Provided that where the Recovery Officer has reason to believe that it will be detrimental if the full period of thirty days as aforesaid is allowed, he</p>

<sup>35</sup> ‘Act’ in these suggested modifications means the SEBI Act, 1992.

<p>direct that the sum specified in the notice of demand shall be paid within such period being a period less than the period of thirty days aforesaid, as may be specified by him in the notice of demand.</p> <p>(1A) Where any notice of demand has been served upon an assessee and any appeal or other proceeding, as the case may be, is filed or initiated in respect of the amount specified in the said notice of demand, then, such demand shall be deemed to be valid till the disposal of the appeal by the last appellate authority or disposal of the proceedings, as the case may be, and any such notice of demand shall have the effect as specified in section 3 of the Taxation Laws (Continuation and Validation of Recovery Proceedings) Act, 1964 (11 of 1964).</p> <p>(2) If the amount specified in any notice of demand under section 156 is not paid within the period limited under sub-section (1), the assessee shall be liable to pay simple interest at one per cent for every month or part of a month comprised in the period commencing from the day immediately following the end of the period mentioned in sub-</p>	<p>may, with the previous approval of the Board, direct that the sum specified in the notice of demand be paid within such period being a period less than the period of thirty days, as may be specified by him in the notice of demand.</p> <p>Explanation. – The order imposing penalty, directing refund or directing disgorgement shall be deemed to be a notice of demand.</p> <p>(2) Where any notice of demand has been served upon any person and any appeal or other proceeding, as the case may be, is filed or initiated in respect of the amount specified in the said notice of demand, either by the person or the Board, then such a demand shall be deemed to be valid till the disposal of the proceedings, as the case may be, and any such notice of demand shall have the following effect:</p> <p>(a) where the dues are enhanced in such appeal or proceedings or interest accrues on such monies due to the passage of time; another notice of demand only in respect of the amount by which such dues are</p>
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<p>section (1) and ending with the day on which the amount is paid :</p> <p><b>Provided</b> that, where as a result of an order under section 154, or section 155, or section 250, or section 254, or section 260, or section 262, or section 264 or an order of the Settlement Commission under sub-section (4) of section 245D, the amount on which interest was payable under this section had been reduced, the interest shall be reduced accordingly and the excess interest paid, if any, shall be refunded :</p> <p><b>Provided further</b> that where as a result of an order under sections specified in the first proviso, the amount on which interest was payable under this section had been reduced and subsequently as a result of an order under said sections or section 263, the amount on which interest was payable under this section is increased, the assessee shall be liable to pay interest under sub-section (2) from the day immediately following the end of the period mentioned in the first notice of demand, referred to in sub-section (1) and ending with the day on which the amount is paid:</p>	<p>enhanced, without the service of any fresh notice of demand, shall be continued from the stage at which such proceedings stood immediately prior to such disposal;</p> <p>(b) where the dues are reduced in such appeal or proceedings, an intimation of the fact of such reduction shall be issued to the person;</p> <p>(c) no proceedings in relation to such dues (including the imposition of penalty or charging of interest) shall be invalid by reason only that no fresh notice of demand was served upon the person after the disposal of such appeal or proceeding or that such dues have been enhanced or reduced in such appeal or proceeding:</p> <p>Provided that where any dues are reduced in such appeal or proceeding and the person is entitled to any refund thereof, such refund shall be made in accordance with the provisions of these regulations.</p> <p>(3) For the removal of doubts, it is hereby declared that no fresh notice of</p>
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<p><b>Provided also</b> that in respect of any period commencing on or before the 31st day of March, 1989 and ending after that date, such interest shall, in respect of so much of such period as falls after that date, be calculated at the rate of one and one-half per cent for every month or part of a month.</p> <p>(2A) Notwithstanding anything contained in sub-section (2), the Principal Chief Commissioner or Chief Commissioner or Principal Commissioner or Commissioner may reduce or waive the amount of interest paid or payable by an assessee under the said sub-section if he is satisfied that—</p> <ul style="list-style-type: none"> <li>(i) payment of such amount has caused or would cause genuine hardship to the assessee;</li> <li>(ii) default in the payment of the amount on which interest has been paid or was payable under the said sub-section was due to circumstances beyond the control of the assessee; and</li> <li>(iii) the assessee has co-operated in any inquiry relating to the assessment or any proceeding for the recovery of any amount due from him:</li> </ul>	<p>demand shall be necessary in any case where the amount of dues is not varied as a result of any order passed in any appeal or other proceeding.</p> <p>(4) The person who is liable to pay the dues as specified in sub-regulation (1), shall be liable to pay simple interest at the rate of 18% per annum on amounts in default from the date such amounts became due or from the date of passing of the original order by the Board or the Adjudicating Officer till the date of actual payment or realization of such dues, whichever is earlier:</p> <p>Provided that where the amount of dues has been enhanced or reduced by virtue of any order passed in appeal or proceedings, the interest thereon shall be reduced accordingly.</p> <p>(5) While drawing up any notice of demand or a certificate, the Recovery Officer shall include therein the interest as specified above.</p> <p>(6) Without prejudice to the provisions contained in this regulation, on an application made by the person before the expiry of the due date under sub-regulation (1), the Board or the Recovery Officer on</p>
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<p><b>Provided</b> that the order accepting or rejecting the application of the assessee, either in full or in part, shall be passed within a period of twelve months from the end of the month in which the application is received:</p> <p><b>Provided further</b> that no order rejecting the application, either in full or in part, shall be passed unless the assessee has been given an opportunity of being heard:</p> <p><b>Provided also</b> that where any application is pending as on the 1st day of June, 2016, the order shall be passed on or before the 31st day of May, 2017.</p> <p>(2B) Notwithstanding anything contained in sub-section (2), where interest is charged under sub-section (1A) of section 201 on the amount of tax specified in the intimation issued under sub-section (1) of section 200A for any period, then, no interest shall be charged under sub-section (2) on the same amount for the same period.</p> <p>(2C) Notwithstanding anything contained in sub-section (2), where interest is charged under sub-section (7) of section 206C on the amount of tax specified in the intimation issued under sub-section (1) of section 206CB for any</p>	<p>approval of the Board, for reasons to be recorded in writing, may extend the time for payment or allow payment by instalments, subject to such conditions as may be imposed considering the facts and circumstances of the case:</p> <p>Provided that extension of time or payment by instalments shall not be granted beyond a period of twenty-four months from the date of expiry of the period specified in sub-regulation (1).</p> <p>(7) Where the amount is not paid within the time specified in sub-regulation (1) or extended under sub-regulation (6), as the case may be, the person shall be deemed to be in default.</p> <p>(8) Where payment by instalments is allowed under sub-regulation (6), the person who commits a default in paying any one of the instalments within the time fixed under that sub-section, shall be deemed to be in default as to the whole of the amount then outstanding, and the other instalment or instalments shall be deemed to have been due on the same</p>
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<p>period, then, no interest shall be charged under sub-section (2) on the same amount for the same period.</p> <p>(3) Without prejudice to the provisions contained in sub-section (2), on an application made by the assessee before the expiry of the due date under sub-section (1), the Assessing Officer may extend the time for payment or allow payment by instalments, subject to such conditions as he may think fit to impose in the circumstances of the case.</p> <p>(4) If the amount is not paid within the time limited under sub-section (1) or extended under sub-section (3), as the case may be, at the place and to the person mentioned in the said notice the assessee shall be deemed to be in default.</p> <p>(5) If, in a case where payment by instalments is allowed under sub-section (3), the assessee commits defaults in paying any one of the instalments within the time fixed under that sub-section, the assessee shall be deemed to be in default as to the whole of the amount then outstanding, and the other instalment or instalments shall be deemed to have been due on the same</p>	<p>date as the instalment which is actually in default.</p> <p>(9) Where the persons has preferred an appeal before the Securities Appellate Tribunal, the Board or the Recovery Officer subject to such conditions as he may think fit to impose in the circumstances of the case and for reasons to be recorded in writing, treat the person as not being in default in respect of the amount due, even though the time for payment has expired, as long as such appeal remains undisposed of.</p>
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<p>date as the instalment actually in default.</p> <p>(6) Where an assessee has presented an appeal under section 246 or section 246A the Assessing Officer may, in his discretion and subject to such conditions as he may think fit to impose in the circumstances of the case, treat the assessee as not being in default in respect of the amount in dispute in the appeal, even though the time for payment has expired, as long as such appeal remains undisposed of.</p> <p>(7) Where an assessee has been assessed in respect of income arising outside India in a country the laws of which prohibit or restrict the remittance of money to India, the Assessing Officer shall not treat the assessee as in default in respect of that part of the tax which is due in respect of that amount of his income which, by reason of such prohibition or restriction, cannot be brought into India, and shall continue to treat the assessee as not in default in respect of such part of the tax until the prohibition or restriction is removed.</p> <p><i>Explanation.</i>—For the purposes of this section, income shall be deemed to have been brought into India if it has been</p>	
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	<p>utilised or could have been utilised for the purposes of any expenditure actually incurred by the assessee outside India or if the income, whether capitalised or not, has been brought into India in any form.</p>	
<p><b>II.</b></p>	<p><b>Penalty payable when tax in default.</b></p> <p><b>221.</b> (1) When an assessee is in default or is deemed to be in default in making a payment of tax, he shall, in addition to the amount of the arrears and the amount of interest payable under subsection (2) of <u>section 220</u>, be liable, by way of penalty, to pay such amount as the Assessing Officer may direct, and in the case of a continuing default, such further amount or amounts as the Assessing Officer may, from time to time, direct, so, however, that the total amount of penalty does not exceed the amount of tax in arrears :</p> <p><b>Provided</b> that before levying any such penalty, the assessee shall be given a reasonable opportunity of being heard:</p> <p><b>Provided further</b> that where the assessee proves to the satisfaction of the Assessing Officer that the default was for good and sufficient reasons, no</p>	<p><b>Liability for other action.</b></p> <p>A person in default or deemed to be in default in making payment of dues, in addition to the amount which is due and the amount of interest payable on such dues, may be liable for any other action under the Act or the Securities Contracts (Regulation) Act, 1956 or the Depositories Act, 1996, as the case may be.</p>

	<p>penalty shall be levied under this section.</p> <p><i>Explanation.</i>—For the removal of doubt, it is hereby declared that an assessee shall not cease to be liable to any penalty under this sub-section merely by reason of the fact that before the levy of such penalty he has paid the tax.</p> <p>(2) Where as a result of any final order the amount of tax, with respect to the default in the payment of which the penalty was levied, has been wholly reduced, the penalty levied shall be cancelled and the amount of penalty paid shall be refunded.</p>	
<p><b>III.</b></p>	<p><b>Certificate to Tax Recovery Officer.</b></p> <p><b>222.</b> (1) When an assessee is in default or is deemed to be in default in making a payment of tax, the Tax Recovery Officer may draw up under his signature a statement in the prescribed form specifying the amount of arrears due from the assessee (such statement being hereafter in this Chapter and in the Second Schedule referred to as "certificate") and shall proceed to recover from such assessee the amount</p>	<p><b>Certificate.</b></p> <p>(1) When a person is in default or is deemed to be in default in making a payment of dues, namely, -</p> <p>(a) a penalty imposed under the Act, the Securities Contracts (Regulations) Act, 1956 or the Depositories Act, 1996; or</p> <p>(b) any amount payable on failure of any person to refund any monies as directed by the Board; or</p>

<p>specified in the certificate by one or more of the modes mentioned below, in accordance with the rules laid down in the Second Schedule—</p> <ul style="list-style-type: none"> <li>(a) attachment and sale of the assessee's movable property;</li> <li>(b) attachment and sale of the assessee's immovable property;</li> <li>(c) arrest of the assessee and his detention in prison;</li> <li>(d) appointing a receiver for the management of the assessee's movable and immovable properties.</li> </ul> <p><i>Explanation.</i>—For the purposes of this sub-section, the assessee's movable or immovable property shall include any property which has been transferred, directly or indirectly on or after the 1st day of June, 1973, by the assessee to his spouse or minor child or son's wife or son's minor child, otherwise than for adequate consideration, and which is held by, or stands in the name of, any of the persons aforesaid; and so far as the movable or immovable property so transferred to his minor child or his son's minor child is concerned, it shall, even after the date of attainment of majority by such minor child or son's</p>	<ul style="list-style-type: none"> <li>(c) any amount payable on failure of any person to disgorge monies as directed by the Board; or</li> <li>(d) any fees due to the Board,</li> </ul> <p>the Recovery Officer shall draw up under his signature, a written statement in the form mentioning the amount due from the person (such statement being hereafter referred to as "certificate") and shall proceed to recover from such person, the amount specified in the certificate by one or more of the modes specified in these regulations and in accordance with these regulations.</p> <p>(2) The Recovery Officer may take action under sub-regulation (1), notwithstanding that proceedings for recovery of the arrears by any other mode have been taken.</p>
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	<p>minor child, as the case may be, continue to be included in the assessee's movable or immovable property for recovering any arrears due from the assessee in respect of any period prior to such date.</p> <p>(2) The Tax Recovery Officer may take action under sub-section (1), notwithstanding that proceedings for recovery of the arrears by any other mode have been taken.</p>	
<p><b>IV.</b></p>	<p><b>Tax Recovery Officer by whom recovery is to be effected.</b></p> <p><b>223.</b> (1) The Tax Recovery Officer competent to take action under <u>section 222</u> shall be—</p> <p>(a) the Tax Recovery Officer within whose jurisdiction the assessee carries on his business or profession or within whose jurisdiction the principal place of his business or profession is situate, or</p> <p>(b) the Tax Recovery Officer within whose jurisdiction the assessee resides or any movable or immovable property of the assessee is situate,</p> <p>the jurisdiction for this purpose being the jurisdiction assigned to the Tax</p>	<p><b>Recovery Officer by whom recovery is to be effected.</b></p> <p>(1) The Recovery Officer competent to take action shall be—</p> <p>(a) the Recovery Officer within whose jurisdiction the defaulter carries on his business or profession or within whose jurisdiction the principal place of his business or profession is situate, or</p> <p>(b) the Recovery Officer within whose jurisdiction the defaulter resides or any movable or immovable property of the person is situate,</p> <p>the jurisdiction for this purpose being the jurisdiction assigned to the</p>

<p>Recovery Officer under the orders or directions issued by the Board, or by the Principal Chief Commissioner or Chief Commissioner or Principal Commissioner or Commissioner who is authorised in this behalf by the Board in pursuance of <u>section 120</u>.</p> <p>(2) Where an assessee has property within the jurisdiction of more than one Tax Recovery Officer and the Tax Recovery Officer by whom the certificate is drawn up—</p> <p>(a) is not able to recover the entire amount by sale of the property, movable or immovable, within his jurisdiction, or</p> <p>(b) is of the opinion that, for the purpose of expediting or securing the recovery of the whole or any part of the amount under this Chapter, it is necessary so to do,</p> <p>he may send the certificate or, where only a part of the amount is to be recovered, a copy of the certificate certified in the prescribed manner<sup>52</sup> and specifying the amount to be recovered to a Tax Recovery Officer within whose jurisdiction the assessee resides or has property and, thereupon, that Tax</p>	<p>Recovery Officers under the orders or directions issued by the Board.</p> <p>(2) Where a person has property within the jurisdiction of more than one Recovery Officer and the Recovery Officer by whom the certificate is drawn up—</p> <p>(a) is not able to recover the entire amount by sale of the property, movable or immovable, within his jurisdiction, or</p> <p>(b) is of the opinion that, for the purpose of expediting or securing the recovery of the whole or any part of the amount under this Chapter, it is necessary so to do,</p> <p>he may send the certificate or, where only a part of the amount is to be recovered, a copy of the certificate certified in the specified manner and specifying the amount to be recovered to a Recovery Officer within whose jurisdiction the person resides or has property and, thereupon, that Recovery Officer shall also proceed to recover the amount under these regulations as if the certificate or a</p>
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	Recovery Officer shall also proceed to recover the amount under this Chapter as if the certificate or copy thereof had been drawn up by him.	copy thereof had been drawn up by him.
<b>V.</b>	<p><b>Validity of certificate and cancellation or amendment thereof.</b></p> <p><b>224.</b> It shall not be open to the assessee to dispute the correctness of any certificate drawn up by the Tax Recovery Officer on any ground whatsoever, but it shall be lawful for the Tax Recovery Officer to cancel the certificate if, for any reason, he thinks it necessary so to do, or to correct any clerical or arithmetical mistake therein.</p>	<p><b>Validity of certificate and cancellation or amendment thereof.</b></p> <p>No person shall be allowed to dispute the correctness of any certificate drawn up by the Recovery Officer on any ground whatsoever, but it shall be lawful for the Recovery Officer to cancel the certificate if, for any reason, he thinks it necessary so to do, or to correct any clerical or mathematical error therein.</p>
<b>V.</b>	<p><b>Stay of proceedings in pursuance of certificate and amendment or cancellation thereof.</b></p> <p><b>225.</b> (1) It shall be lawful for the Tax Recovery Officer to grant time for the payment of any tax and when he does so, he shall stay the proceedings for the recovery of such tax until the expiry of the time so granted.</p> <p>(2) Where the order giving rise to a demand of tax for which a certificate has been drawn up is modified in appeal or</p>	<p><b>Stay of proceedings in pursuance of certificate and amendment or cancellation thereof.</b></p> <p>(1) It shall be lawful for the Recovery Officer to grant time for the payment of any dues and when he does so, he shall stay the proceedings for the recovery of such dues until the expiry of the time so granted.</p> <p>(2) Where the order giving rise to a demand of dues for which a certificate</p>

	<p>other proceeding under this Act, and, as a consequence thereof, the demand is reduced but the order is the subject-matter of further proceeding under this Act, the Tax Recovery Officer shall stay the recovery of such part of the amount specified in the certificate as pertains to the said reduction for the period for which the appeal or other proceeding remains pending.</p> <p>(3) Where a certificate has been drawn up and subsequently the amount of the outstanding demand is reduced as a result of an appeal or other proceeding under this Act, the Tax Recovery Officer shall, when the order which was the subject-matter of such appeal or other proceeding has become final and conclusive, amend the certificate, or cancel it, as the case may be.</p>	<p>has been drawn up is modified in appeal or other proceeding under the Act or the Securities Contracts (Regulation) Act, 1956 or the Depositories Act, 1996, and, as a consequence thereof, the demand is reduced but the order is the subject-matter of further proceeding under the aforesaid Acts, the Recovery Officer shall stay the recovery of such part of the amount specified in the certificate that pertains to the said reduction for the period for which the appeal or other proceeding remains pending.</p> <p>(3) Where a certificate has been drawn up and subsequently the amount of the outstanding demand is reduced as a result of an appeal or other proceeding under the Acts mentioned in sub-regulation (2), the Recovery Officer shall, when the order which was the subject-matter of such appeal or other proceeding has become final and conclusive, amend the certificate, or cancel it, as the case may be.</p>
<p><b>VI.</b></p>	<p><b>Other modes of recovery.</b></p> <p><b>226.</b> (1) Where no certificate has been drawn up under <u>section 222</u>, the Assessing Officer may recover the tax by</p>	<p><b>Other modes of recovery.</b></p> <p>(1) Where a certificate has been drawn up, the Recovery Officer may, without prejudice to the modes of recovery</p>



<p>any one or more of the modes provided in this section.</p> <p>(1A) Where a certificate has been drawn up under <u>section 222</u>, the Tax Recovery Officer may, without prejudice to the modes of recovery specified in that section, recover the tax by any one or more of the modes provided in this section.</p> <p>(2) If any assessee is in receipt of any income chargeable under the head "Salaries", the Assessing Officer or Tax Recovery Officer may require any person paying the same to deduct from any payment subsequent to the date of such requisition any arrears of tax due from such assessee, and such person shall comply with any such requisition and shall pay the sum so deducted to the credit of the Central Government or as the Board directs:</p> <p><b>Provided</b> that any part of the salary exempt from attachment in execution of a decree of a civil court under section 60 of the Code of Civil Procedure, 1908 (5 of 1908), shall be exempt from any requisition made under this sub-section.</p> <p>(3) (i) The Assessing Officer or Tax Recovery Officer may, at any time or</p>	<p>specified in that section (s), recover the dues by any one or more of the other modes provided in these regulation.</p> <p>(2) If any person is in receipt of any income in the nature of salary, the Recovery Officer may require any person paying the same to deduct from any payment subsequent to the date of such requisition any dues from such person, and such person shall comply with any such requisition and shall pay the sum so deducted to the credit of the Board or as directed by the Recovery Officer:</p> <p>Provided that any part of the salary exempt from attachment in execution of a decree of a civil court under section 60 of the Code of Civil Procedure, 1908 (5 of 1908), shall be exempt from any requisition made under this sub-regulation.</p> <p>(3) (i) The Recovery Officer may, at any time or from time to time, by notice in writing require any person from whom money is due or may become due to the defaulter or any person who holds or may subsequently hold money for or on account of the defaulter to pay to the</p>
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<p>from time to time, by notice in writing require any person from whom money is due or may become due to the assessee or any person who holds or may subsequently hold money for or on account of the assessee to pay to the Assessing Officer or Tax Recovery Officer either forthwith upon the money becoming due or being held or at or within the time specified in the notice (not being before the money becomes due or is held) so much of the money as is sufficient to pay the amount due by the assessee in respect of arrears or the whole of the money when it is equal to or less than that amount.</p> <p>(ii) A notice under this sub-section may be issued to any person who holds or may subsequently hold any money for or on account of the assessee jointly with any other person and for the purposes of this sub-section, the shares of the joint holders in such account shall be presumed, until the contrary is proved, to be equal.</p> <p>(iii) A copy of the notice shall be forwarded to the assessee at his last address known to the Assessing Officer or Tax Recovery Officer, and in the case of a joint account to all the joint holders</p>	<p>Recovery Officer either forthwith upon the money becoming due or being held or at or within the time specified in the notice (not being before the money becomes due or is held) so much of the money as is sufficient to pay the amount due by the defaulter in respect of dues or the whole of the money when it is equal to or less than that amount.</p> <p>Provided that wherever the defaulter has a right to demand payment of any amount before such amount becomes payable under any contract, certificate or instrument, it shall be lawful for the Recovery Officer to demand payment of the amount forthwith.</p> <p>(ii) A notice under this sub-regulation may be issued to any person who holds or may subsequently hold any money for or on account of the defaulter jointly with any other person and for the purposes of this sub-regulation, the shares of the joint holders in such account shall be presumed, until the contrary is proved, to be equal.</p> <p>(iii) A copy of the notice shall be forwarded to the defaulter at his last address known to the Recovery</p>
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<p>at their last addresses known to the Assessing Officer or Tax Recovery Officer.</p> <p>(iv) Save as otherwise provided in this sub-section, every person to whom a notice is issued under this sub-section shall be bound to comply with such notice, and, in particular, where any such notice is issued to a post office, banking company or an insurer, it shall not be necessary for any pass book, deposit receipt, policy or any other document to be produced for the purpose of any entry, endorsement or the like being made before payment is made, notwithstanding any rule, practice or requirement to the contrary.</p> <p>(v) Any claim respecting any property in relation to which a notice under this sub-section has been issued arising after the date of the notice shall be void as against any demand contained in the notice.</p> <p>(vi) Where a person to whom a notice under this sub-section is sent objects to it by a statement on oath that the sum demanded or any part thereof is not due to the assessee or that he does not hold any money for or on account of the assessee, then nothing contained in this</p>	<p>Officer, and in the case of a joint account to all the joint holders at their last addresses known to the Recovery Officer.</p> <p>(iv) Save as otherwise provided in this sub-regulation, every person to whom a notice is issued under this sub-regulation shall be bound to comply with such notice, and, where any such notice is issued to a post office, banking company or an insurer, in particular, it shall not be necessary that the pass book, deposit receipt, policy or any other document be produced for the purpose of any entry, endorsement or the like being made before payment is made, notwithstanding any rule, practice or requirement to the contrary.</p> <p>(v) Any claim in respect of any property in relation to which a notice under these regulations has been issued arising after the date of the notice shall be void as against any demand contained in the notice.</p> <p>(vi) Where a person to whom a notice under this sub-regulation is sent objects to it by a statement on oath that the sum demanded or any part thereof is not due to the defaulter or</p>
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<p>sub-section shall be deemed to require such person to pay any such sum or part thereof, as the case may be, but if it is discovered that such statement was false in any material particular, such person shall be personally liable to the Assessing Officer or Tax Recovery Officer to the extent of his own liability to the assessee on the date of the notice, or to the extent of the assessee's liability for any sum due under this Act, whichever is less.</p> <p>(vii) The Assessing Officer or Tax Recovery Officer may, at any time or from time to time, amend or revoke any notice issued under this sub-section or extend the time for making any payment in pursuance of such notice.</p> <p>(viii) The Assessing Officer or Tax Recovery Officer shall grant a receipt for any amount paid in compliance with a notice issued under this sub-section, and the person so paying shall be fully discharged from his liability to the assessee to the extent of the amount so paid.</p> <p>(ix) Any person discharging any liability to the assessee after receipt of a notice under this sub-section shall be personally liable to the Assessing</p>	<p>that he does not hold any money for or on account of the defaulter, then nothing contained in this sub-regulation shall be deemed to require such person to pay any such sum or part thereof, as the case may be, but if it is discovered that such statement was false in any material particular, such person shall be personally liable to the Recovery Officer to the extent of his own liability to the defaulter, or to the extent of the defaulter's liability for any sum due under these regulations, whichever is less.</p> <p>(vii) The Recovery Officer may, at any time or from time to time, amend or revoke any notice issued under this sub-regulation or extend the time for making any payment in pursuance of such notice.</p> <p>(viii) The Recovery Officer shall grant a receipt for any amount paid in compliance with a notice issued under this sub-regulation, and the person so paying shall be fully discharged from his liability to the defaulter to the extent of the amount so paid.</p> <p>(ix) Any person discharging any liability to the defaulter after receipt of a notice under this sub-regulation</p>
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<p>Officer or Tax Recovery Officer to the extent of his own liability to the assessee so discharged or to the extent of the assessee's liability for any sum due under this Act, whichever is less.</p> <p>(x) If the person to whom a notice under this sub-section is sent fails to make payment in pursuance thereof to the Assessing Officer or Tax Recovery Officer, he shall be deemed to be an assessee in default in respect of the amount specified in the notice and further proceedings may be taken against him for the realisation of the amount as if it were an arrear of tax due from him, in the manner provided in <u>sections 222 to 225</u> and the notice shall have the same effect as an attachment of a debt by the Tax Recovery Officer in exercise of his powers under <u>section 222</u>.</p> <p>(4) The Assessing Officer or Tax Recovery Officer may apply to the court in whose custody there is money belonging to the assessee for payment to him of the entire amount of such money, or, if it is more than the tax due, an amount sufficient to discharge the tax.</p>	<p>shall be personally liable to the Recovery Officer to the extent of his own liability to the defaulter so discharged or to the extent of the defaulter's liability for any sum due under these regulations, whichever is less.</p> <p>(x) Where the person to whom a notice under this sub-regulation is sent, fails to make payment in pursuance thereof to the Recovery Officer, he shall be deemed to be a person in default in respect of the amount specified in the notice and further proceedings may be continued against him for the realisation of the amount as if it were arrears of dues from him, in the manner provided for under these regulations, and the notice shall have the same effect as an attachment of a debt by the Recovery Officer in exercise of his powers under these regulations.</p> <p>(4) The Recovery Officer may apply to the court in whose custody money belonging to the defaulter is available for payment to him of the entire amount of such money, or, if it is more than the dues, the amount sufficient to discharge the dues.</p>
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	(5) The Assessing Officer or Tax Recovery Officer may, if so authorised by the Principal Chief Commissioner or Chief Commissioner or Principal Commissioner or Commissioner by general or special order, recover any arrears of tax due from an assessee by distraint and sale of his movable property in the manner laid down in the Third Schedule.	(5) The Recovery Officer may, if so authorised by the Board by general or special order, recover any dues from a defaulter by distraint and sale of his movable property in the manner laid down in these regulations.
<b>VII.</b>	<b>Recovery through State Government.</b> 227. If the recovery of tax in any area has been entrusted to a State Government under clause (1) of article 258 of the Constitution, the State Government may direct, with respect to that area or any part thereof; that tax shall be recovered therein with, and as an addition to, any municipal tax or local rate, by the same person and in the same manner as the municipal tax or local rate is recovered.	<i>(provision may not apply in the context of securities laws, hence no specific modification is suggested)</i>
<b>VIII.</b>	<b>Recovery of tax in pursuance of agreements with foreign countries.</b> 228A. (1) Where an agreement is entered into by the Central Government with the Government of any country	<i>(provision may not apply in the context of securities laws, hence no specific modification is suggested)</i>

<p>outside India for recovery of income-tax under this Act and the corresponding law in force in that country and the Government of that country or any authority under that Government which is specified in this behalf in such agreement sends to the Board a certificate for the recovery of any tax due under such corresponding law from a person having any property in India, the Board may forward such certificate to any Tax Recovery Officer within whose jurisdiction such property is situated and thereupon such Tax Recovery Officer shall—</p> <p>(a) proceed to recover the amount specified in the certificate in the manner in which he would proceed to recover the amount specified in a certificate received from an Income-tax Officer; and</p> <p>(b) remit any sum so recovered by him to the Board after deducting his expenses in connection with the recovery proceedings.</p> <p>(2) Notwithstanding the issue of a certificate under section 222 to the Tax Recovery Officer, where an assessee is in default or is deemed to be in default in making a payment of tax, the Income-</p>	
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	<p>tax Officer may, if the assessee has property in a country outside India (being a country with which the Central Government has entered into an agreement for the recovery of income-tax under this Act and the corresponding law in force in that country), forward to the Board a certificate specifying the amount of arrears due from the assessee and the Board may, take such action thereon as it may deem appropriate having regard to the terms of the agreement with such country.</p>	
<p><b>IX.</b></p>	<p><b>Recovery of penalties, fine, interest and other sums.</b>  <b>229.</b> Any sum imposed by way of interest, fine, penalty, or any other sum payable under the provisions of this Act, shall be recoverable in the manner provided in this Chapter for the recovery of arrears of tax.</p>	<p><i>(section 28A provides the list of dues that could be recovered, however no specific modification is suggested)</i></p>
<p><b>X.</b></p>	<p><b>Recovery by suit or under other law not affected.</b>  <b>232.</b> The several modes of recovery specified in this Chapter shall not affect in any way—</p>	<p><b>Recovery by suit or under other law not affected.</b>  The several modes of recovery specified in these regulations shall not affect in any way the right of the Board to institute a suit for the recovery of</p>



	<p>(a) any other law for the time being in force relating to the recovery of debts due to Government; or</p> <p>(b) the right of the Government to institute a suit for the recovery of the arrears due from the assessee;</p> <p>and it shall be lawful for the Assessing Officer or the Government, as the case may be, to have recourse to any such law or suit, notwithstanding that the tax due is being recovered from the assessee by any mode specified in this Chapter.</p>	<p>the monies due from the defaulter and it shall be lawful for the Board to have recourse to any such suit, notwithstanding that the amount due is being recovered from the defaulter by any mode specified in these regulations.</p> <p>(May be useful especially in the context of foreign persons to enforce demands)</p>
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SEBI may consider incorporating the aforesaid provisions in its regulations to make it comprehensive as the provisions of sections 220 to 227, 228A, 229, 232, the Second and Third Schedules to the Income-tax Act, 1961 and the Income-tax (Certificate Proceedings) Rules, 1962 would then be part of the regulations with necessary modifications.

**VI. KEY MODIFICATIONS TO THE PROCEDURE (UNDER THE INCOME-TAX ACT AND RULES) FOR RECOVERY OF DUES UNDER SECTION 28A**

The procedure pertaining to recovery of dues is exhaustively codified under the Second Schedule to Income-tax Act, 1961 and the Income-tax (Certificate Proceedings) Rules, 1962. The Committee has considered some of the key areas in which changes may be required in the applicable procedure as suggested herein below:

- **RULE 8 OF THE SECOND SCHEDULE TO THE INCOME-TAX ACT, 1961 – DISPOSAL OF PROCEEDS OF EXECUTION:**

**Rationale for modification:**

The Board notified the <sup>36</sup>Securities and Exchange Board of India (Appointment of Administrator and Procedure for Refunding to the Investors) Regulations, 2018 on October 03, 2018. In Regulation 11 thereof, the costs of administration incurred by the Board, if any, and the fees and charges payable to the Administrator and other persons appointed by the administrator which performing its functions under the said regulations, is given priority over other claims. This is so because the administration costs are incurred to ensure that monies are realized to repay the investors or recover the disgorgement amount. It is suggested that along the said lines, the costs and expenses incurred in the course of execution of the certificate drawn up by the Recovery Officer may be given precedence over the other claims. There may be cases where the costs and expenses related to the execution and realization of the amount specified in the certificate could be higher than the amount that may be actually recovered through such process. SEBI may thus need to consider this aspect and decide the course of action to be taken in such cases accordingly.

**Suggested amendment:**

<b>Provision in Second Schedule of the Income-tax Act, 1961</b>	<b>Suggested amendment</b>
<b>Disposal of proceeds of execution.</b> 8. (1) Whenever assets are realised by sale or otherwise in execution of a	<b>Disposal of proceeds of execution.</b> (1) Whenever monies are realized by sale of the properties of the defaulter or

<sup>36</sup> Regulations for appointing an administrator for selling the properties of the defaulter for repaying to investors and recover disgorgement amount.

<p>certificate, the proceeds shall be disposed of in the following manner, namely :—</p> <p>(a) they shall first be adjusted towards the amount due under the certificate in execution of which the assets were realised and the costs incurred in the course of such execution;</p> <p>(b) if there remains a balance after the adjustment referred to in clause (a), the same shall be utilised for satisfaction of any other amount recoverable from the assessee under this Act which may be due on the date on which the assets were realised; and</p> <p>(c) the balance, if any, remaining after the adjustments under clauses (a) and (b) shall be paid to the defaulter.</p> <p>(2) If the defaulter disputes any adjustment under clause (b) of sub-rule (1), the Tax Recovery Officer shall determine the dispute.</p>	<p>otherwise, in the execution of a certificate, the proceeds shall be disposed of in the following order, namely:-</p> <p>(a) costs and expenses incurred in the course of execution of the certificate;</p> <p>(b) the principal amount due under the certificate;</p> <p>(c) interest or returns as may be recoverable under the certificate; and</p> <p>(d) where there is more than one certificate drawn up against a defaulter, the Recovery Officer shall appropriate the amount recovered including interest, costs, charges etc. towards the dues arising first in time and then proceed to appropriate the balance amount recovered in respect of the remaining certificates.</p> <p>(2) Any amount remaining after the adjustments referred to in sub-regulation (1), shall be utilized for satisfaction of any other amount recoverable from the defaulter under the Act, the Securities Contracts (Regulations) Act, 1956 or the</p>
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	<p>Depositories Act, 1996 which may be due on the date on which the assets were realized.</p> <p>(3) Any balance amount, remaining after the adjustments under sub-regulations (1) and (2), shall be returned to the defaulter.</p> <p>(4) If the defaulter disputes any adjustment under the aforesaid clauses, the Recovery Officer shall determine the dispute.</p>
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- **RULE 9 – GENERAL BAR TO JURISDICTION OF CIVIL COURTS, SAVE WHERE FRAUD ALLEGED.**

Rule 9 prescribes that a suit may be filed in a civil court in respect of a question relating to the execution, discharge or satisfaction of a certificate, or relating to the confirmation or setting aside by an order of a sale held in execution of such certificate only on the ground of ‘fraud’.

**Rationale for modification:**

Since the Securities Appellate Tribunal is the appellate body in respect of orders passed by the Board and also since the suit/appeal referred to in the relevant provisions of Income-Tax Act and rules being followed by SEBI is an appeal to the Securities Appellate Tribunal, it is felt that the proviso to this provision allowing filing of a suit on the ground of fraud may be omitted. Any challenge to the recovery process/order could be challenged before the Securities Appellate Tribunal in terms of Explanation 3 to section 28A(1).

**Suggested amendment:**

<b>Provision in Second Schedule of the Income-tax Act, 1961</b>	<b>Suggested amendment</b>
<p><b>General bar to jurisdiction of civil courts, save where fraud alleged.</b></p> <p>9. Except as otherwise expressly provided in this Act, every question arising between the Tax Recovery Officer and the defaulter or their representatives, relating to the execution, discharge or satisfaction of a certificate, or relating to the confirmation or setting aside by an order under this Act of a sale held in execution of such certificate, shall be determined, not by suit, but by order of the Tax Recovery Officer before whom such question arises :</p> <p><b>Provided</b> that a suit may be brought in a civil court in respect of any such question upon the ground of fraud.</p>	<p><b>General bar to jurisdiction of civil courts.</b></p> <p>Except as otherwise expressly provided in these regulations, every question arising between the Recovery Officer and the defaulter or their representatives, relating to the execution, discharge or satisfaction of a certificate, or relating to the confirmation or setting aside by an order under these regulations of a sale held in execution of such certificate, shall be determined, not by suit, but by order of the Recovery Officer before whom such question arises:</p> <p>Provided that before passing any order, the Recovery Officer shall afford an opportunity to the defaulter to make his representation along with supporting evidence.</p>

- **RULE 39 – PROCLAMATION HOW MADE, RULE 50 – PROCLAMATION OF ATTACHMENT AND RULE 54 – MODE OF MAKING PROCLAMATION**

- i. Rule 39(1) requires the proclamation to be made by beat of drums or other customary mode.

- ii. Rule 50 requires that the order of attachment shall be proclaimed at some place on or adjacent to the property attached by **beat of drum or other customary mode**, and a copy of the order shall be affixed on a conspicuous part of the property and on the notice board of the Tax Recovery Officer.
- iii. Rule 54(1) inter alia requires every proclamation for the sale of immovable property to be made at some place on or near such property by beat of drum or other customary mode.

**Rationale for amendment:**

The “beat of drums” has become an outdated practice and impractical to enforce.

**Suggested amendment:**

Reference to the words “*beat of drum or other customary mode*” may be omitted in the said provisions and proclamation may be made by publication through newspapers and electronic modes.

- **RULE 57 – DEPOSIT BY PURCHASER AND RESALE IN DEFAULT.**

The rules mandate the purchaser of immovable property to immediately (i.e. after he is declared as the purchaser) deposit 25% of the purchase money and the full purchase money to be paid by the purchaser on or before the 15<sup>th</sup> day from the sale of property. The provision to rule 57 is reproduced below:

**Rationale for modification:**

In order to provide extension of time to pay the entire purchase consideration, SEBI may consider extending the period of 15 days to three months subject to the purchaser undertaking to pay interest on the balance amount with interest of 15% p.a.

**Suggested amendment:**

<b>Provision in Second Schedule of the Income-tax Act, 1961</b>	<b>Suggested amendment</b>
<p><b>Deposit by purchaser and resale in default.</b></p> <p>57. (1) On every sale of immovable property, the person declared to be the purchaser shall pay, immediately after such declaration, a deposit of twenty-five per cent on the amount of his purchase money, to the officer conducting the sale; and, in default of such deposit, the property shall forthwith be resold.</p> <p>(2) The full amount of purchase money payable shall be paid by the purchaser to the Tax Recovery Officer on or before the fifteenth day from the date of the sale of the property.</p>	<p><b>Deposit by the purchaser and resale in default.</b></p> <p>(1) On every sale of immovable property, the person declared to be the purchaser shall immediately after such declaration deposit twenty-five per cent of the amount of purchase money, including the earnest money, with the officer conducting the sale; and, upon default of such deposit, the property shall be resold forthwith.</p> <p>(2) The full amount of purchase money due shall be paid by the purchaser to the Recovery Officer on or before the fifteenth day from the date of the sale of the property.</p> <p>(3) The period of fifteen days under sub-regulation (2) may be extended by a maximum period of three months, subject to the purchaser making a request for such extension along with an undertaking to pay the remaining sale price together with interest thereon at the rate of fifteen per cent per annum for the period so extended.</p>

	<p>(4) The application for extension of time for payment shall be accompanied by an unconditional bank guarantee for the remaining outstanding sale price and interest thereon at the rate mentioned hereinabove for a period of three months.</p> <p>(5) The advertisement regarding the auction for sale of properties shall appropriately mention that extension may be granted to pay the consideration subject to compliance with sub-regulations (3) and (4).</p>
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- **RULE 58 – PROCEDURE IN DEFAULT OF PAYMENT.**

As per this provision, the deposit amount paid by the defaulting purchaser would be forfeited to the Government and the property shall be resold.

**Rationale for modification:**

Considering that expenses would be incurred while reselling the property, SEBI may consider offering the property to the next highest bidder at a price equal to the bid made by the highest bidder (i.e. defaulting purchaser).

**Suggested amendment:**

<b>Provision in Second Schedule of the Income-tax Act, 1961</b>	<b>Suggested amendment</b>
<b>Procedure in default of payment.</b>	<b>Procedure in default of payment.</b>



<p><b>58.</b> In default of payment within the period mentioned in the preceding rule, the deposit may, if the Tax Recovery Officer thinks fit, after defraying the expenses of the sale, be forfeited to the Government, and the property shall be resold, and the defaulting purchaser shall forfeit all claims to the property or to any part of the sum for which it may subsequently be sold.</p>	<p>(1) Upon default of payment within the period mentioned in the preceding regulation, the deposit may, if the Recovery Officer thinks fit, after defraying the expenses of the sale, be forfeited, and the property shall be resold, and the defaulting purchaser shall forfeit all claims to the property or any part of the sum for which it may subsequently be sold.</p> <p>(2) Without prejudice to sub-regulation (1), if the highest bidder fails to pay the purchase price in accordance with the terms of sale, the property may be offered to the next highest bidder at a price equal to the bid made by the highest bidder.</p>
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- **RULE 68B – TIME LIMIT FOR SALE OF ATTACHED IMMOVABLE PROPERTY.**

As per this rule, no sale of immovable property shall be made after the expiry of three years from the end of the financial year in which the order, giving rise to a demand of any tax, interest, fine, penalty or any other sum, for the recovery of which the immovable property has been attached, has become conclusive under the provisions of section 245-I or, as the case may be, final in terms of the provisions of Chapter XX:

Where the immovable property is required to be re-sold due to the amount of highest bid being less than the reserve price or under the circumstances mentioned in rule 57 or rule 58 or where the sale is set aside under rule 61, the aforesaid period of limitation for the sale of the immovable property shall stand extended by one year.

**Rationale for modification:**

In the context of SEBI recovery, the time limits may not be made applicable, especially where monies are due for disgorgement or refundable to investors as such monies are not the assets of the defaulter.

**Suggested amendment:**

SEBI may consider omission of Rule 68B in the context of recovery in the securities markets.

## VII. ENHANCEMENTS IN RECOVERY PROCESS

The Committee is of the view that for better efficiency in the recovery process, certain enhancements in the recovery process may be required. Such enhancements to the recovery process by way of regulations would further the purposes of the Act as specified in Section 30 of the SEBI Act (and analogous provisions in the SCRA and Depositories Act), the same would be perfectly valid.

### A. DEFINE THE TERM “PROPERTY:

Since properties of the defaulter are sought to be attached for the purposes of recovering the dues under the certificate drawn up under section 28A of the SEBI Act, it would be necessary to define the term “property”. This definition may be the same as used by SEBI in its Securities and Exchange Board of India (Appointment of Administrator and Procedure for Refunding to the Investors) Regulations, 2018:

*“**property**” means and includes assets of any kind, whether movable or immovable, tangible or intangible, corporeal or incorporeal and includes securities, bank accounts, deposits, any right or interest or legal documents or instruments evidencing title to or interest in the property and where the property is capable of conversion into some other form, then the property in the converted form and also includes the proceeds from the property;”*

Since the term “property” includes “securities”, there may be no need to continue with the definition of the expression “share in a corporation” used in rule 1(g) in the Second Schedule of the Income-tax Act, 1961. Accordingly, it is suggested to substitute the expression “share in a corporation” wherever appearing in the proposed regulations with the word “securities”.

## **B. SALE BY ELECTRONIC AUCTION FACILITY**

It is understood that SEBI utilizes the services of e-auction agencies for the purposes of auctioning and selling the attached properties. Further, e-auction is being conducted as a standard process in respect of sale of assets under the SARFAESI Act, DRT etc. This allows for wider participation and transparency in the procedure. It would therefore be appropriate to define the terms “e-auction” and “e-auction agency”.

Suggested text is as follows,-

- *“**electronic auction**” shall mean a public auction conducted electronically;*
- *“**electronic auction agency**” shall mean any company providing an electronic auction platform which is engaged by the Recovery Officer for the purposes of auctioning and selling the attached properties in pursuance of these regulations;*
- *“**Sale to be by auction.**  
The sale shall be by public auction, which may be conducted through electronic auction, to the highest bidder and shall be subject to confirmation by the Recovery Officer:  
Provided that no sale under this regulation shall be made if the amount bid by the highest bidder is less than the reserve price, if any, specified.”*

## **C. REGISTERED VALUER**

The role of a registered valuer is very vital to the recovery process as the said professional evaluates the attached property. This value is considered for fixing the ‘reserve price’. His

report should be treated as ‘confidential’. For clarity, it would be appropriate to define the term “registered valuer”, thereby restricting the categories of person who may be allowed to act as a ‘valuer’ under the proposed regulations. The expression “registered valuer” is also defined under certain Regulations framed by SEBI.

Suggested text is as follows,-

- **“registered valuer”** shall have the meaning assigned to it under the Companies (Registered Valuers and Valuation) Rules, 2017 or any other statutory modification or re-enactment thereof;
- **“Reserve price”**
  - (1) It shall be competent for the Recovery Officer to fix a reserve price in respect of any property, other than agricultural produce, below which such property shall not be sold.
  - (2) Where a valuation is required to be made in respect of any property, the Recovery Officer may appoint a registered valuer for valuation of such property.
  - (3) The valuation report submitted by a registered valuer shall be confidential.

#### **D. SERVICE OF NOTICES AND ORDERS**

It would be necessary to have clarity on the manner of service of notices and orders in the recovery process. The relevant provisions of the SEBI (Procedure for Holding Inquiry and Imposing Penalties) Rules, 1995 may be considered.

## E. POUNDAGE FEE

The poundage fee is levied in respect of any sale made in execution of a certificate and paid by the purchaser of the defaulter's property. SEBI may consider appropriating such fees as 'costs' of sale of properties in the recovery proceedings to reduce the amount of costs that is appropriated from the proceeds of sale of property.

Further, the word "poundage" may be dropped as it refers to payment of a particular amount per pound sterling of the sum involved in a transaction which terminology is not relevant in the Indian context and is a residue of the British era. Accordingly, the word "fees" may be retained.

Suggested amendment is as follows,-

***"Levy and scale of ~~poundage~~ fees.***

*(1) In respect of any sale made in the execution of a certificate, there shall be levied a fee ~~by way of poundage~~ on the gross amount realised by the sale.....*

*.....*

*(6) The ~~poundage~~ fee collected under this regulation shall be appropriated towards the cost of sale of the properties in execution of the certificate."*

## F. DEPOSIT OF EARNEST MONEY

Under the Income-Tax Rules, bids for purchase of any properties should be accompanied with payment of earnest money calculated at 10% of the reserve price, where the reserve price is up to Rs. 10 crore, subject to a minimum of Rs.50,000/- or Rs.10 lakh plus 5% on the remaining amount of reserve price, where the reserve price is above Rs.10 crore. The deposit of earnest money is stipulated in order to bring in seriousness on the persons who bid. Based on its experience, if SEBI considers that the prescribed percentage is in excess, SEBI may consider lowering the same.

Such earnest money may be returned to unsuccessful bidders within a period of 60 days from the date of confirmation of sale without interest. The earnest money should be forfeited if the bidder does not participate in the auction or when he (after declared as successful bidder) fails to pay the 25% purchase money or on default of payment of the remaining sum of money. However, it is suggested that the earnest money should not be forfeited if the bidder is allowed extension of time to make the payment of bid price.

Suggested text is as follows,-

***“Refund of earnest money.***

*Earnest money deposited by unsuccessful bidders shall be refunded without interest within sixty days from the date of confirmation of sale.*

***Forfeiture of earnest money or other payments.***

*Earnest money or any other part of the purchase price paid by a bidder shall be forfeited on the following circumstances:*

- (a) the bidder not participating in the auction after successfully submitting the bid, or*
- (b) on default in payment of twenty-five per cent of the purchase price, including the earnest money paid, immediately after the auction, or*
- (c) on default in payment of remaining seventy-five per cent within fifteen days of the sale:*

*Provided that the earnest money shall not be forfeited if time for making payment is extended in accordance with sub-regulation (3) of regulation 85.”*

**G. POWER TO SEEK INFORMATION:**

Section 28(4A) of the Recovery of Debts and Bankruptcy Act, 1993, provides that the Recovery Officer may, by order, at any stage of the execution of the certificate of recovery require any person and in case of a company; any of its officers against whom or which the certificate of recovery is issued, to declare on affidavit the particulars of his or its

assets. Such a power to seek information relating to assets and information that may aid in the recovery proceedings and execution of the certificate would be very useful for the Board. Accordingly, a provision to this effect is suggested.

Suggested text is as follows, -

***“Power to seek information.***

*(1) The Recovery Officer may at any stage of the execution of the certificate of recovery, seek from any person, any information which may be relevant to execution of the certificate of recovery or to any investigation or inquiry by the Recovery Officer.*

*(2) Without limiting generality of the foregoing provision, the Recovery Officer may at any stage of the execution of the certificate of recovery, require any person against whom the certificate of recovery is issued, and if such person is a body corporate from any of its officers, to declare on affidavit the particulars of his or its assets.”*

**H. PROVISION IN RESPECT OF PURCHASE BY GOVERNMENT.**

It is possible that a property may not have buyers even if such property is put up for sale thrice through public auction. In such a case, an option should be made available that the Board may offer such property to the Central Government or the State Government of a State where such property is situated, to purchase the property at price which is equivalent to the reserve price or higher than such reserve price. This would enable the Government to purchase the property, if it desires and use it for public good or for its infrastructure needs.



Section 58 of the Bengal Land-Revenue Sales Act, 1859<sup>37</sup>, which provides that ‘*When an estate is put up for sale under this Act for the recovery of arrears of revenue due thereon, if there be no bid, the Collector or other officer as aforesaid may purchase the estate on account of the State Government for one rupee, or if the highest bid be insufficient to cover the said arrears and those subsequently accruing up to the date of sale, the Collector or other officer as aforesaid may take or purchase the estate on account of the State Government at the highest amount of bid; in both which cases the State Government shall acquire the property subject to the provisions of the Act*’. In *Ramrao Jankiram Kadam v State of Bombay*<sup>38</sup> the Hon’ble Supreme Court *inter alia* held that only if a provision existed in the Bombay Land Revenue Code along the lines of Section 58 of the Bengal Land-Revenue Sales Act, 1859 could such sales be called a public auction. Hence, the Committee is of the view that a provision may be made to enable purchase on behalf of the Central Government and State Governments so as to enable the Board to conclude its Recovery proceedings in respect of properties which remain unsold after repeated auctions.

Suggested text is as follows,-

***“Purchase by Government.***

*When an immovable property is put up for sale for recovery of amounts due and if the property remains unsold, the Board may, after giving opportunity to the defaulter to furnish the amounts due under the certificate, offer the same to the Central Government or any State Government, who may submit a bid not lower than the reserve price and purchase the said property:*

*Provided that, -*

- i. offer to the Central or State Government under this regulation shall be made only in case two earlier auctions in respect of the said immoveable property have been unsuccessful;*

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<sup>37</sup> An Act to improve the law relating to sales of land for arrears of revenue in Bengal Presidency.

<sup>38</sup> AIR 1963 SC 827, 1963 SCR Supp. (1) 322.

- ii. *the Board may afford such time as may be deemed fit to such Central or State Government to convey its willingness to purchase and to make payment of the consideration; and*
- iii. *where the property is put up for sale for recovery of any penalty due or other amount payable to the Central Government and the reserve price does not exceed the amount due, the Central Government may acquire the property by extinguishing the liability of the defaulter equal to the reserve price.*

**I. RESIDUARY CLAUSE FOR DEVISING PROCEDURE FOR SITUATIONS NOT COVERED  
BY REGULATIONS**

It may also be necessary to provide for an enabling provision so that the Board can deal with unforeseen difficulties. An enabling provision would aid SEBI to devise a suitable procedure in such circumstances.

Suggested text is as follows,-

***“Power to determine procedure in certain circumstances.***

*In a situation not provided for in these regulations, the Recovery Officer, with the approval of the Board, may determine the procedure for specific matters, as may be required.”*

Further, as generally seen in various SEBI Regulations, the proposed regulations may also provide for a regulation to enable the Board to issue clarifications in case any difficulty arises in the interpretation or applicability of the regulations.

**J. COMPREHENSIVE REGULATIONS TO AMALGAMATE PROVISIONS OF THE  
NOTIFIED ADMINISTRATOR REGULATIONS WITH THE PROPOSED RECOVERY  
REGULATIONS**

SEBI had notified the SEBI (Appointment of Administrator and Procedure for making Refunds to Investors) Regulations, 2018 (“Administrator Regulations”). The said regulations apply in respect of all or any of the following matters -

- (a) appointment of Administrator pursuant to failure to comply with disgorgement or refund orders passed by the Board;
- (b) sale of properties attached by the Recovery Officer of the Board under the Act;
- (c) collection of claim documents and verification of claims of investors for the purpose of effecting refunds;
- (d) refund of monies to the investors pursuant to disgorgement or refund orders passed by the Board;
- (e) recovery of disgorgement amounts directed by the Board;
- (f) any act incidental or connected thereto.

Since the Securities and Exchange Board of India (Appointment of Administrator and Procedure for Refunding to the Investors) Regulations, 2018 is intrinsically connected with ‘recovery’, SEBI may consider incorporating the provisions of such regulations into the proposed regulations for recovery.

Accordingly, the draft regulations appended herein below have suitably incorporated the provisions of the Administrator Regulations also. When such comprehensive regulations dealing with recovery and administration are notified, then SEBI would be appropriately empowered to repeal the Administrator Regulations.

## VIII. DRAFT REGULATIONS

The Committee recommends that the following regulations may be issued by the Board,-

**THE GAZETTE OF INDIA**  
**EXTRA-ORDINARY**  
**PART –III – SECTION 4**  
**PUBLISHED BY AUTHORITY**  
**SECURITIES AND EXCHANGE BOARD OF INDIA**  
**NOTIFICATION**  
**Mumbai, the ..... day of ....., 2020**  
**SECURITIES AND EXCHANGE BOARD OF INDIA (RECOVERY)**  
**REGULATIONS, 2020**

In exercise of the powers conferred by section 30 read with sub-section (1) of section 11 and section 28A of the Securities and Exchange Board of India Act, 1992 (15 of 1992), section 23JB of the Securities Contracts (Regulations) Act, 1956 and section 19-IB of the Depositories Act, 1996, the Board hereby makes the following regulations to specify the procedure for recovering the amounts due under the said Acts and for matters incidental or connected thereto, namely,-

### **CHAPTER I**

#### **PRELIMINARY**

#### **Short title and commencement.**

1. (1) These regulations may be called the Securities and Exchange Board of India (Recovery) Regulations, 2020.

(2) They shall come into force on the date of their notification in the Official Gazette.

**Definitions.**

2. (1) In these regulations, unless the context otherwise requires,-

- (a) “Act” means the Securities and Exchange Board of India Act, 1992 [15 of 1992];
- (b) “Administrator” means a person registered with the Insolvency and Bankruptcy Board of India as an Insolvency Resolution Professional and who has been engaged by the Recovery Officer for the purposes of these regulations.
- (c) “advertisement” includes, -
  - (i) notices, brochures, pamphlets, circulars, showcards, catalogues, hoardings, placards, posters, insertions in newspapers, pictures, films and cover pages of offer documents;
  - (ii) any publicity through print medium, radio, television programmes or electronic media;
- (d) “auditor” means a person qualified to audit the accounts of companies under the Companies Act, 2013;
- (e) “public auction” includes,-
  - (i) an electronic auction; and
  - (ii) a purchase by the government under regulation 98.
- (f) “Board” means the Securities and Exchange Board of India established under section 3 of the Act;
- (g) "certificate" means the statement drawn up by the Recovery Officer under section 28A of the Act or section 23JB of the Securities Contracts (Regulations) Act, 1956 or section 19-IB of the Depositories Act, 1996, in respect of any defaulter referred to in those sections, and shall not include a sale certificate;
- (h) “collective investment scheme” shall have the same meaning as assigned to it under section 11AA of the Act and the regulations framed thereunder;
- (i) "defaulter" means the person mentioned as the defaulter in the certificate;
- (j) “electronic auction” shall mean a public auction conducted electronically;

- (k) "electronic auction agency" shall mean any company providing an electronic auction platform, which is engaged by the Recovery Officer for the purposes of auctioning and selling the attached properties in pursuance of these regulations;
- (l) "execution" in relation to a certificate, means the recovery of dues in pursuance of the certificate;
- (m) "investor" means the person, whether identified or not, in whose favour the refund of monies had been directed by the Board;
- (n) "property" means and includes assets of any kind, whether movable or immovable, tangible or intangible, corporeal or incorporeal and includes securities, bank accounts, deposits, any right or interest or legal documents or instruments evidencing title to or interest in the property and where the property is capable of conversion into some other form, then the property in the converted form and also includes the proceeds from the property;
- (o) "officer" means a person authorised to make an attachment or sale under these regulations;
- (p) "Recovery Officer" means an officer of the Board, who is authorised by a general or special order in writing, to exercise the powers of a recovery officer under section 28A of the Act or section 23JB of the Securities Contracts (Regulations) Act, 1956 or section 19IB of the Depositories Act, 1996;
- (q) "refund order" means a direction of the Board, issued under the Act or the Securities Contracts (Regulation) Act, 1956 or the Depositories Act, 1996, to refund monies to the investors;
- (r) "recovery proceedings" means the proceedings, initiated by a Recovery Officer, for recovery of amounts under section 28A of the Act or section 23JB of the Securities Contracts (Regulations) Act, 1956 or section 19IB of the Depositories Act, 1996;
- (s) "registered valuer" shall have the meaning assigned to it under the Companies (Registered Valuers and Valuation) Rules, 2017 or any other statutory modification or re-enactment thereof;

(2) Words and expressions used and not defined in these regulations but defined in the Act, the Securities Contracts (Regulation) Act, 1956 and the Depositories Act, 1996 or rules and regulations framed thereunder, shall have the meanings respectively assigned to them in such Acts or rules and regulations.

## **CHAPTER II**

### **GENERAL PROVISIONS**

#### **Amounts when payable.**

3. (1) Any penalty or refund of monies or disgorgement of amounts or fees due to the Board, under the Act or the Securities Contracts (Regulation) Act, 1956 or the Depositories Act, 1996, shall be paid within thirty days of service of notice or in terms of the regulations issued or an order passed by the Board:

Provided that where the Recovery Officer has reason to believe that it will be detrimental if the full period of thirty days as aforesaid is allowed, he may, with the previous approval of the Board, direct that the sum specified in the notice of demand shall be paid within such period being a period less than the period of thirty days, as may be specified by him in the notice of demand.

Explanation. – The order imposing penalty, directing refund or directing disgorgement shall be deemed to be a notice of demand.

(2) Where any notice of demand has been served upon any person and any appeal or other proceeding, as the case may be, is filed or initiated in respect of the amount specified in the said notice of demand, either by the person or the Board, then such demand shall be deemed to be valid till the disposal of the proceedings, as the case may be, and any such notice of demand shall have the following effect:

- (a) where the dues are enhanced in such appeal or proceedings or interest accrues on such monies due to passage of time, another notice of demand only in respect of the amount by which such dues are enhanced, without the service of any fresh

notice of demand, be continued from the stage at which such proceedings stood immediately before such disposal;

(b) where the dues are reduced in such appeal or proceedings, an intimation of the fact of such reduction to the person shall be issued;

(c) no proceedings in relation to such dues (including the imposition of penalty or charging of interest) shall be invalid by reason only that no fresh notice of demand was served upon the person after the disposal of such appeal or proceeding or that such dues have been enhanced or reduced in such appeal or proceeding:

Provided that where any dues are reduced in such appeal or proceeding and the person is entitled to any refund thereof, such refund shall be made in accordance with the provisions of these regulations.

(3) For removal of doubts, it is hereby declared that no fresh notice of demand shall be necessary in any case where the amount of dues is not varied as a result of any order passed in any appeal or other proceeding.

(4) The person who is liable to pay the dues as specified in sub- regulation (1), shall be liable to pay simple interest at the rate of 18% per annum on amounts in default from the date such amounts became due or from the date of passing of the original order by the Board or the Adjudicating Officer till the date of actual payment or realization of such dues, whichever is earlier:

Provided that where the amount of dues has been enhanced or reduced by virtue of any order passed in appeal or proceedings, the interest thereon shall be enhanced or reduced accordingly.

(5) Where the Recovery Officer draws up any notice of demand or a certificate, the Recovery Officer shall include therein the interest as specified above.

(6) Without prejudice to the provisions contained in this regulation, on an application made by the person before the expiry of the due date under sub- regulation (1), the Board or the Recovery Officer on approval of the Board, for reasons to be recorded in writing, may extend the time for payment or allow payment by instalments, subject to such conditions as may be imposed considering the facts and circumstances of the case:



Provided that extension of time or payment by instalments shall not be granted beyond a period of twenty-four months from the date of expiry of the period specified in sub-regulation (1).

(7) If the amount is not paid within the time specified in sub-regulation (1) or extended under sub-regulation (6), as the case may be, the person shall be deemed to be in default.

(8) Where payment by instalments is allowed under sub-regulation (6), the person who commits a default in paying any one of the instalments within the time fixed under that sub-regulation, shall be deemed to be in default as to the whole of the amount then outstanding, and the other instalment or instalments shall be deemed to have been due on the same date as the instalment which is actually in default.

(9) Where the person has presented an appeal before the Securities Appellate Tribunal, the Board or the Recovery Officer may in his discretion and subject to such conditions as he may think fit to impose in the circumstances of the case, and for reasons to be recorded in writing, treat the person as not being in default in respect of the amount due, even though the time for payment has expired, as long as such appeal remains undisposed of.

**Liability for other action.**

4. A person in default or deemed to be in default in making payment of dues, in addition to the amount which is due and the amount of interest payable on such dues, may be liable for other action under the Act or the Securities Contracts (Regulation) Act, 1956 or the Depositories Act, 1996, as may be applicable.

**Certificate.**

5. (1) When a person is in default or is deemed to be in default in making a payment of dues, namely, -
  - (e) a penalty imposed by the adjudicating officer under the Act, the Securities Contracts (Regulations) Act, 1956 or the Depositories Act, 1996; or

(f) any amount payable on failure of any person to refund any monies as directed by the Board; or

(g) any amount payable on failure of any person to disgorge monies as directed by the Board; or

(h) any fees due to the Board,

the Recovery Officer shall draw up under his signature, a written statement in the form mentioning the amount due from such person (such statement being hereafter referred to as "certificate") and shall proceed to recover from such person the amount specified in the certificate by one or more of the modes specified in these regulations and in accordance with these regulations.

(2) The Recovery Officer may take action under sub-regulation (1), notwithstanding that proceedings for recovery of the arrears by any other mode have been taken.

**Issue of notice.**

6. (1) When a certificate has been drawn up by the Recovery Officer for recovery of amounts from the defaulter, a notice shall be caused to be served by the Recovery Officer upon the defaulter requiring such defaulter to pay the amounts specified in the certificate within a period of fifteen days from the date of service of the notice.

(2) The notice mentioned in sub-regulation (1) shall put the defaulter on notice that in case of default in complying with the notice, steps would be taken under the provisions of the Act, the Securities Contracts (Regulation) Act, 1956 or the Depositories Act, 1996, as the case may be, and these regulations to realize the amount as specified in the certificate.

**Mode of recovery.**

7. If the amount mentioned in the notice is not paid within the time specified therein or within such further time as the Recovery Officer may grant in his

discretion, the Recovery Officer shall proceed to realise the amount by one or more of the following modes:—

- (a) by attachment and sale of the defaulter's movable property;
- (b) by attachment of the defaulter's bank accounts;
- (c) by attachment and sale of the defaulter's immovable property;
- (d) by arrest of the defaulter and his detention in prison;
- (e) by appointing a receiver for the management of the defaulter's movable and immovable properties.

**Recovery Officer by whom recovery is to be effected.**

8. (1) The Recovery Officer competent to take action shall be—

- (a) the Recovery Officer within whose jurisdiction the person carries on his business or profession or within whose jurisdiction the principal place of his business or profession is situate, or
- (b) the Recovery Officer within whose jurisdiction the person resides or any movable or immovable property of the person is situate, or

the jurisdiction for this purpose being the jurisdiction assigned to the Recovery Officers under the orders or directions issued by the Board.

(2) Where a person has property within the jurisdiction of more than one Recovery Officer and the Recovery Officer by whom the certificate is drawn up—

- (a) is not able to recover the entire amount by sale of the property, movable or immovable, within his jurisdiction, or
- (b) is of the opinion that, for the purpose of expediting or securing the recovery of the whole or any part of the amount, it is necessary so to do,

he may send the certificate or, where only a part of the amount is to be recovered, a copy of the certificate certified in the specified manner and specifying the amount to be recovered to a Recovery Officer within whose jurisdiction the person resides or has property and, thereupon, that Recovery Officer shall also proceed to recover the amount under these regulations as if the certificate or a copy thereof had been drawn up by him.

**Validity of certificate and cancellation or amendment thereof.**

9. No person shall be allowed to dispute the correctness of any certificate drawn up by the Recovery Officer on any ground whatsoever, but it shall be lawful for the Recovery Officer to cancel the certificate if, for any reason, he thinks it necessary so to do, or to correct any clerical or mathematical error therein.

**Stay of proceedings in pursuance of certificate and amendment or cancellation thereof.**

10. (1) It shall be lawful for the Recovery Officer to grant time for the payment of any dues and when he does so, he shall stay the proceedings for the recovery of such dues until the expiry of the time so granted.
- (2) Where the order giving rise to a demand of dues for which a certificate has been drawn up is modified in appeal or other proceeding under the Act or the Securities Contracts (Regulation) Act, 1956 or the Depositories Act, 1996, and, as a consequence thereof, the demand is reduced but the order is the subject-matter of further proceedings under the said laws, the Recovery Officer shall stay the recovery of such part of the amount specified in the certificate as pertains to the said reduction for the period for which the appeal or other proceeding remains pending.
- (3) Where a certificate has been drawn up and subsequently the amount of the outstanding demand is reduced as a result of an appeal or other proceeding under the Acts mentioned in sub-regulation (2), the Recovery Officer shall, when the order which was the subject-matter of such appeal or other proceeding has become final and conclusive, amend the certificate, or cancel it, as the case may be.

**Other modes of recovery.**

11. (1) Where a certificate has been drawn up, the Recovery Officer may, without prejudice to the modes of recovery specified in regulation 7, recover the dues by any one or more of the other modes provided in these regulations.

(2) If any person is in receipt of any income in the nature of salary, the Recovery Officer may require any person paying the same to deduct from any payment subsequent to the date of such requisition any dues from such person, and such person shall comply with any such requisition and shall pay the sum so deducted to the credit of the Board or as directed by the Recovery Officer:

Provided that any part of the salary exempt from attachment in execution of a decree of a civil court under section 60 of the Code of Civil Procedure, 1908 (5 of 1908), shall be exempt from any requisition made under this sub-regulation.

(3) (i) The Recovery Officer may, at any time or from time to time, by notice in writing require any person from whom money is due or may become due to the defaulter or any person who holds or may subsequently hold money for or on account of the defaulter to pay to the Recovery Officer either forthwith upon the money becoming due or being held or at or within the time specified in the notice (not being before the money becomes due or is held) so much of the money as is sufficient to pay the amount due by the defaulter in respect of dues or the whole of the money when it is equal to or less than that amount.

Provided that wherever the defaulter has a right to demand payment of any amount before such amount becomes payable under any contract, certificate or instrument, it shall be lawful for the Recovery Officer to demand payment of the amount forthwith.

(ii) A notice under this sub-regulation may be issued to any person who holds or may subsequently hold any money for or on account of the defaulter jointly with any other person and for the purposes of this sub-regulation the shares of the joint holders in such account shall be presumed, until the contrary is proved, to be equal.

(iii) A copy of the notice shall be forwarded to the defaulter at his last address known to the Recovery Officer, and in the case of a joint account to all the joint holders at their last addresses known to the Recovery Officer.

(iv) Save as otherwise provided in this sub-regulation, every person to whom a notice is issued under this sub-regulation shall be bound to comply with such

notice, and, in particular, where any such notice is issued to a post office, banking company or an insurer, it shall not be necessary for any pass book, deposit receipt, policy or any other document to be produced for the purpose of any entry, endorsement or the like being made before payment is made, notwithstanding any rule, practice or requirement to the contrary.

(v) Any claim in respect of any property in relation to which a notice under these regulations has been issued arising after the date of the notice shall be void as against any demand contained in the notice.

(vi) Where a person to whom a notice under this sub-regulation is sent objects to it by a statement on oath that the sum demanded or any part thereof is not due to the defaulter or that he does not hold any money for or on account of the defaulter, then nothing contained in this sub-regulation shall be deemed to require such person to pay any such sum or part thereof, as the case may be, but if it is discovered that such statement was false in any material particular, such person shall be personally liable to the Recovery Officer to the extent of his own liability to the defaulter on the date of the notice, or to the extent of the defaulter's liability for any sum due under these regulations, whichever is less.

(vii) The Recovery Officer may, at any time or from time to time, amend or revoke any notice issued under this sub-regulation or extend the time for making any payment in pursuance of such notice.

(viii) The Recovery Officer shall grant a receipt for any amount paid in compliance with a notice issued under this sub-regulation, and the person so paying shall be fully discharged from his liability to the defaulter to the extent of the amount so paid.

(ix) Any person discharging any liability to the defaulter after receipt of a notice under this sub-regulation shall be personally liable to the Recovery Officer to the extent of his own liability to the defaulter so discharged or to the extent of the defaulter's liability for any sum due under these regulations, whichever is less.

(x) If the person to whom a notice under this sub-regulation is sent fails to make payment in pursuance thereof to the Recovery Officer, he shall be deemed to be

a person in default in respect of the amount specified in the notice and further proceedings may be taken against him for the realisation of the amount as if it were due from him, and the notice shall have the same effect as an attachment of a debt by the Recovery Officer in exercise of his powers under these regulations.

(4) The Recovery Officer may apply to the court or tribunal in whose custody there is money belonging to the defaulter for payment to him of the entire amount of such money, or, if it is more than the dues, an amount sufficient to discharge the dues.

(5) The Recovery Officer may, if so authorised by the Board by general or special order, recover any dues from a defaulter by distraint and sale of his movable property in the manner laid down in these regulations.

#### **Service of notices and orders.**

12. A notice or an order issued in execution of a certificate shall be served upon a person in the following manner:

(a) by delivering or tendering it to that person or his duly authorised agent; or

(b) by sending it to the person by fax or electronic mail or courier or speed post with acknowledgement due or registered post with acknowledgement due to the address of his place of residence or his last known place of residence or the place where he carried on, or last carried on, business or personally works, or last worked, for gain: Provided that a notice sent by fax shall bear a note that the same is being sent by facsimile and in case the document contains annexure(s), the number of pages being sent shall also be mentioned:

Provided further that a notice sent through electronic mail shall be digitally signed by the Recovery Officer and bouncing of the electronic mail shall not constitute valid service.

(c) if the notice cannot be served under clause (a) or clause (b), by affixing it on the outer door or some other conspicuous part of the premises in which that person resides or is known to have last resided, or carries on business or personally works

or last worked for gain and a written report of such affixture should be witnessed by two persons;

(d) if the notice cannot be affixed as per clause (c), by publishing the notice in at least two newspapers, one in an English daily newspaper having nationwide circulation and another in a newspaper having wide circulation published in the language of the region where that person was last known to have resided or carried on business or personally worked for gain.

**When certificate may be executed.**

13. No step in execution of a certificate shall be taken until the period of fifteen days has elapsed since the date of the service of the notice required under regulation 6:

Provided that if the Recovery Officer is satisfied that the defaulter is likely to conceal, remove, transfer or dispose of the whole or any part of such of his property as would be liable to attachment and that the realization of the amount of the certificate would in consequence be delayed or obstructed, he may at any time direct, for reasons to be recorded in writing, an attachment of the whole or any part of such property:

Provided further that if the defaulter whose property has been so attached furnishes security to the satisfaction of the Recovery Officer, such attachment shall be cancelled from the date on which such security is accepted by the Recovery Officer.

**Interest, costs and charges recoverable.**

14. In addition to the amount payable under the order giving rise to the certificate, there shall be recoverable, in the proceedings in execution of every certificate,—

- (a) such interest on the amount to which the certificate relates as is payable in accordance with securities laws; and
- (b) all charges incurred in respect of—
  - (i) the service of notice upon the defaulter to pay the arrears, and of warrants and other processes, and
  - (ii) all other proceedings taken for realising the arrears.



**Purchaser's title.**

15. (1) Where property is sold in execution of a certificate, there shall vest in the purchaser merely the right, title and interest of the defaulter at the time of the sale, even though the property itself be specified.

(2) Where immovable property is sold in execution of a certificate, and such sale has become absolute, the purchaser's right, title and interest shall be deemed to have vested in him from the time when the property is sold, and not from the time when the sale becomes absolute.

**Suit against purchaser not maintainable on ground of purchase being made on behalf of plaintiff.**

16. (1) No suit shall be maintained against any person claiming title under a purchase certified by the Recovery Officer in the manner laid down in these regulations, on the ground that the purchase was made on behalf of the plaintiff or on behalf of someone through whom the plaintiff claims.

(2) Nothing in this regulation shall bar a suit to obtain a declaration that the name of any purchaser certified as aforesaid was inserted in the certificate fraudulently or without the consent of the real purchaser, or interfere with the right of a third person to proceed against that property, though ostensibly sold to the certified purchaser, on the ground that it is liable to satisfy a claim of such third person against the real owner.

**Disposal of proceeds of execution.**

17. (1) Whenever monies are realized by sale of the properties of the defaulter or otherwise, in execution of a certificate, the proceeds shall be disposed of in the following order, namely:-

- (a) costs and expenses incurred in the course of execution of the certificate;
- (b) the principal amount due under the certificate;
- (c) interest or returns as may be recoverable under the certificate; and

(d) where there is more than one certificate drawn up against a defaulter, the Recovery Officer shall appropriate the amount recovered including interest, costs, charges etc. towards the dues arising first in time and then proceed to appropriate the balance amount recovered in respect of the remaining certificates.

(2) Any amount remaining after the adjustments referred to in sub-regulation (1), shall be utilized for satisfaction of any other amount recoverable from the defaulter under the Act, the Securities Contracts (Regulations) Act, 1956 or the Depositories Act, 1996 which may be due on the date on which the assets were realized.

(3) Any balance amount, remaining after the adjustments under the preceding sub-regulations, shall be returned to the defaulter.

(4) If the defaulter disputes any adjustment under the aforesaid clauses, the Recovery Officer shall determine the dispute.

#### **General bar to jurisdiction of civil courts.**

18. Except as otherwise expressly provided in these regulations, every question arising between the Recovery Officer and the defaulter or their representatives, relating to the execution, discharge or satisfaction of a certificate, or relating to the confirmation or setting aside by an order under these regulations of a sale held in execution of such certificate, shall be determined by an order of the Recovery Officer before whom such question arises:

Provided that before passing any order, the Recovery Officer shall afford an opportunity to the defaulter to make his representation along with supporting evidence.

#### **Property exempt from attachment.**

19. (1) All such property as is by the Code of Civil Procedure, 1908 (5 of 1908), exempted from attachment and sale in execution of a decree of a civil court shall be exempt from attachment and sale under these regulations.

(2) The decision of the Recovery Officer as to what property is so entitled to exemption shall be conclusive.

**Investigation by Recovery Officer.**

20.(1) Where any claim is preferred to, or any objection is made to the attachment or sale of, any property in execution of a certificate, on the ground that such property is not liable to such attachment or sale, the Recovery Officer shall proceed to investigate the claim or objection:

Provided that no such investigation shall be made where the Recovery Officer considers that the claim or objection was designedly or unnecessarily delayed.

(2) Where the property to which the claim or objection applies has been advertised for sale, the Recovery Officer ordering the sale may postpone it pending the investigation of the claim or objection, upon such terms as to security or otherwise as the Recovery Officer shall deem fit.

(3) The claimant or objector must adduce evidence to show that—

(a) in the case of immovable property; at the date of the service of the notice issued under these regulations to pay the arrears, or

(b) in the case of movable property; at the date of the attachment, he had some interest in, or was possessed of the property in question.

(4) Whereupon the said investigation, the Recovery Officer is satisfied that, for the reason stated in the claim or objection, such property was not, at the said date, in the possession of the defaulter or of some person in trust for him or in the occupancy of a tenant or other person paying rent to him, or that, being in the possession of the defaulter at the said date, it was so in his possession, not on his own account or as his own property, but on account of or in trust for some other person, or partly on his own account and partly on account of some other person, the Recovery Officer shall make an order releasing the property, wholly or to such extent as he thinks fit, from attachment or sale.

(5) Where the Recovery Officer is satisfied that the property was, at the said date, in the possession of the defaulter as his own property and not on account of any other person, or was in the possession of some other person in trust for him, or in the occupancy of a tenant or other person paying rent to him, the Recovery Officer shall disallow the claim.

Provided that before disallowing the claim, an opportunity of hearing may be granted to the person objecting to the attachment.

(7) Where, in the course of investigation, the Recovery Officer is satisfied that the property is subject to a mortgage or charge (other than a mortgage or charge referred to in rule 16 of the Second Schedule to the Income-tax Act) in favour of a person not in possession, and thinks fit to continue the attachment, he may do so, subject to such mortgage or charge.

**Removal of attachment on satisfaction or cancellation of certificate.**

21. Where —

(a) the amount due, with costs and all charges and expenses resulting from the attachment of any property or incurred in order to hold a sale, are paid to the Recovery Officer, or

(b) the certificate is cancelled,

the attachment shall be deemed to be withdrawn and, in the case of immovable property, the withdrawal shall, if the defaulter so desires, be proclaimed at his expense, and a copy of the proclamation shall be affixed in the manner provided by these regulations for a proclamation of sale of immovable property.

**Entrustment of functions by Recovery Officer.**

22.(1) The attachment and sale of property may be made by such persons as the Recovery Officer may from time to time direct.

(2) The Recovery Officer may, as may be approved by the Board, entrust any of his functions as a Recovery Officer to any other officer lower than him in rank and such officer shall, in relation to the functions so entrusted to him, be deemed to be a Recovery Officer.

**Reserve price.**

23. (1) It shall be competent for the Recovery Officer to fix a reserve price in respect of any property, other than agricultural produce, below which such property shall not be sold.

(2) Where valuation is required to be made in respect of any property for the purposes of these regulations, the Recovery Officer may appoint a registered valuer for valuation of such property.

(3) The valuation report submitted by a registered valuer shall be confidential.

**Proclamation of sale.**

24. For the purpose of ascertaining the matters to be specified in a proclamation of sale, the Recovery Officer may summon any person whom he thinks necessary to summon and may examine him in respect of any matters relevant to the proclamation and require him to produce any document in his possession or power relating thereto.

**Auction of properties.**

25. (1) Notwithstanding anything in these regulations, public auction of properties in execution of recovery certificate may be conducted through an auction made through an electronic platform.

(2) The electronic auction specified at sub-regulation (1) may be conducted through an electronic auction platform, if any, of the Board or by engaging an electronic auction agency.

**Levy and scale of fees.**

26. (1) In respect of any sale made in the execution of a certificate, there shall be levied a fee on the gross amount realised by the sale, calculated at the rate of two per cent. on such gross amount up to rupees one thousand and at the rate of one per cent on the excess of such gross amount over rupees one thousand.

(2) The fee leviable under sub-regulation (1) shall be calculated on multiples of rupees twenty-five, that is to say, a fee of fifty paise shall be levied for every rupee twenty-five, or part of rupees twenty-five, realised by the sale up to rupees one thousand and in the case of the proceeds of the sale exceeding rupees one thousand, an additional fee of twenty-five paise for every rupee twenty-five or part thereof on the excess of such amount over rupees one thousand, shall be levied.

(3) Where the sale is in more than one lot, the fee shall be calculated with reference to the sale proceeds of each lot separately.

(4) The fee under sub-regulation (1) shall be paid by the purchaser of the property along with payment of remaining purchase price to be paid under these regulations.

(5) When a sale of immovable property is set aside under sub-regulation (2) of regulation 89, the Recovery Officer may make an order for payment, by the defaulter or by the person at whose instance the sale is set aside, of the fees paid by the purchaser of the property.

(6) The fee collected under this regulation shall be appropriated towards the cost of sale of the properties in execution of the certificate.

**Defaulting purchaser answerable for loss on resale.**

27. Any deficiency of price which may happen on a resale by reason of the purchaser's default, and all expenses attending such resale, shall be recoverable from the defaulting purchaser under the procedure provided by these regulations:

Provided that no such application shall be entertained unless filed within fifteen days from the date of resale.

**Adjournment or stoppage of sale.**

28. (1) The Recovery Officer may, in his discretion, adjourn any sale hereunder to a specified day and hour; and the officer conducting any such sale may, in his discretion, adjourn the sale, recording his reasons for such adjournment.

(2) Where a sale of immovable property is adjourned under sub-regulation (1) for a longer period than one calendar month, a fresh proclamation of sale shall be made unless the defaulter consents to waive it.

(3) Every sale shall be stopped if, before the lot is knocked down, the arrears and costs (including the costs of the sale) are tendered to the officer conducting the sale, or proof is given to his satisfaction that the amount of such arrears and costs has been paid to the Recovery Officer who ordered the sale.

**Private alienation to be void in certain cases.**

29.(1) Where a notice has been served on a defaulter under regulation 6, the defaulter or his representative in interest shall not be competent to mortgage, charge, lease or otherwise deal with any property belonging to him except with the permission of the Recovery Officer, nor shall any civil court issue any process against such property in execution of a decree for the payment of money.

(2) Where an attachment has been made under these regulations, any private transfer or delivery of the property attached or of any interest therein and any payment to the defaulter of any debt, dividend or other moneys contrary to such attachment, shall be void as against all claims enforceable under the attachment.

(3) The sub-regulations (1) and (2) shall apply *mutatis mutandis* in case of any attachment under securities laws which has been ordered prior to initiation of recovery proceedings under these regulations.

**Prohibition against bidding or purchase by officer.**

30.No person having any duty to perform in connection with any sale under these regulations shall, either directly or indirectly, bid for, acquire or attempt to acquire any interest in the property sold.

**Prohibition against sale on holidays.**

31. No sale under this regulation shall take place on a Sunday or other general holidays recognised by the Central Government or the concerned State

Government or on any day which has been notified by the concerned State Government to be a local holiday for the area in which the sale is to take place.

**Assistance by police.**

32. Any Officer authorised to attach or sell any property or to arrest the defaulter or charged with any duty to be performed under these regulations, may apply to the officer-in-charge of the nearest Police Station for such assistance as may be necessary in the discharge of his duties, and the authority to whom such application is made shall depute sufficient number of Police Officers for providing such assistance.

**CHAPTER III**

**ATTACHMENT AND SALE OF MOVABLE PROPERTY**

**PART I – ATTACHMENT**

**Warrant.**

33. Except as otherwise provided in these regulations, when any movable property is to be attached, the Officer shall be furnished by the Recovery Officer (or other officer empowered by him in that behalf) a warrant in writing and signed with his name specifying the name of the defaulter and the amount to be realized.

**Service of copy of warrant.**

34. The Officer shall cause a copy of the warrant to be served on the defaulter.

**Attachment.**

35. If, after service of the copy of the warrant, the amount is not paid forthwith, the Officer shall proceed to attach the movable property of the defaulter.

**Property in defaulter's possession.**



36. Where the property to be attached is movable property (other than agricultural produce) in the possession of the defaulter, the attachment shall be made by the actual seizure and the Officer shall keep the property in his own custody or the custody of one of his subordinates and shall be responsible for due custody thereof:

Provided that when the property seized is subject to speedy and natural decay or when the expense of keeping it in custody is likely to exceed its value, the Officer may sell it at once, in such manner as deemed fit and necessary.

**Agricultural produce.**

37. (1) Where the property to be attached is agricultural produce, the attachment shall be made by affixing a copy of the warrant of attachment—

(a) where such produce is growing crop—on the land on which such crop has grown, or

(b) where such produce has been cut or gathered,—on the threshing floor or place for treading out grain or the like, or fodder-stack, or in such other place such produce is kept or deposited,

and another copy on the outer door or on some other conspicuous part of the house in which the defaulter ordinarily resides, or with the leave of the Recovery Officer, on the outer door or on some other conspicuous part of the house in which he carries on business or personally works for gain, or in which he is known to have last resided or carried on business or personally worked for gain.

(2) The produce shall, thereupon, be deemed to have passed into the possession of the Recovery Officer.

**Provisions as to agricultural produce under attachment.**

38. (1) Where agricultural produce is attached, the Recovery Officer shall make such arrangements for the custody, watching, tending, cutting and gathering thereof

as he may deem sufficient; and he shall have power to defray the cost of such arrangements.

(2) Subject to such conditions as may be imposed by the Recovery Officer in this behalf, either in the order of attachment or in any subsequent order, the defaulter may tend, cut, gather and store the produce and do any other act necessary for maturing or preserving it; and, if the defaulter fails to do all or any of such acts, any person appointed by the Recovery Officer in this behalf may, subject to like conditions, do all or any of such acts, and the costs incurred by such person shall be recoverable from the defaulter as if they were included in the certificate.

(3) Agricultural produce attached as a growing crop shall not be deemed to have ceased to be under attachment or to require reattachment merely because it has been severed from the soil.

(4) Where an order for the attachment of a growing crop has been made at a considerable time before the crop is likely to be fit to be cut or gathered, the Recovery Officer may suspend the execution of the order for such time as he thinks fit, and may, in his discretion, make a further order prohibiting the removal of the crop pending the execution of the order of attachment.

(5) A growing crop which from its nature does not admit of being stored shall not be attached under this regulation at any time less than twenty days before the time at which it is likely to be fit to be cut or gathered.

**Debts, shares, etc.**

39. (1) In the case of—

(a) a debt not secured by a negotiable instrument,

(b) securities, or

(c) other movable property not in the possession of the defaulter except property deposited in, or in the custody of, any court,

the attachment shall be made by a written order prohibiting,—

(i) in the case of the debt—the creditor from recovering the debt and the debtor from making payment thereof until the further order of the Recovery Officer;

(ii) in the case of securities, the person in whose name such security may be standing, from transferring the same or receiving any dividend or benefit or interest thereon;

(iii) in the case of the other movable property (except as aforesaid)—the person in possession of the same from giving it over to the defaulter.

(2) A copy of such order shall be affixed on some conspicuous part of the office of the Recovery Officer, and another copy shall be sent, in the case of the debt, to the debtor, in the case of the securities, to the proper officer of the corporation or other body corporate, and in the case of the other movable property (except as aforesaid), to the person in possession of the same.

(3) A debtor prohibited under clause (i) of sub-regulation (1) may pay the amount of his debt to the Recovery Officer, and such payment shall discharge him as effectually as payment to the party entitled to receive the same.

#### **Recovery of monies due to the defaulter**

40. Notwithstanding anything contained in this Chapter, the Recovery Officer may recover the amount due to the defaulter by mode of recovery specified in sub-regulation 3 of regulation 11.

#### **Attachment of decree.**

41. (1) The attachment of a decree of a civil court for the payment of money or for sale in enforcement of a mortgage or charge shall be made to the civil court by a notice requesting the civil court to stay the execution of the decree unless and until—

(i) the Recovery Officer cancels the notice, or

(ii) the Recovery Officer or the defaulter applies to the court receiving such notice to execute the decree.

(2) Where a civil court receives an application under clause (ii) of sub-regulation (1), it shall, on the application of the Recovery Officer or the defaulter and subject to the

provisions of the Code of Civil Procedure, 1908 (5 of 1908), proceed to execute the attached decree and apply the net proceeds in satisfaction of the certificate.

(3) The Recovery Officer shall be deemed to be the representative of the holder of the attached decree, and to be entitled to execute such attached decree in any manner lawful for the holder thereof.

**Share in movable property.**

42. Where the property to be attached consists of the share or interest of the defaulter in a movable property belonging to him and another as co-owners, the attachment shall be made by a notice to the defaulter prohibiting him from transferring the share or interest or charging it in any way.

**Salary of government servants.**

43. Attachment of the salary or allowances of servants of the Government or a local authority may be made in the manner provided by rule 48 of Order 21 of the First Schedule to the Code of Civil Procedure, 1908 (5 of 1908), and the provisions of the said rule shall, for the purposes of this regulation, apply subject to such modifications as may be necessary.

**Attachment of negotiable instrument.**

44. Where the property is a negotiable instrument not deposited in a court or in the custody of a public officer, the attachment shall be made by actual seizure, and the instrument shall be brought before the Recovery Officer and held subject to his orders.

**Attachment of property in custody of court or public officer.**

45. Where the property to be attached is in the custody of any court or a public officer, the attachment shall be made by a notice to such court or officer, requesting that such property, and any interest or dividend becoming payable

thereon, may be held subject to the further orders of the Recovery Officer by whom the notice is issued:

Provided that where such property is in the custody of a court, any question of title or priority arising between the Recovery Officer and any other person, not being the defaulter, claiming to be interested in such property by virtue of any assignment, attachment or otherwise, shall be determined by such court.

**Attachment of partnership property.**

46.(1) Where the property to be attached consists of an interest of the defaulter, being a partner, in the partnership property, the Recovery Officer may make an order charging the share of such partner in the partnership property and profits with payment of the amount due under the certificate, and may, by the same or subsequent order, appoint a receiver of the share of such partner in the profits, whether already declared or accruing and of any other money which may become due to him in respect of the partnership, and direct accounts and inquiries and make an order for the sale of such interest or such other order as the circumstances of the case may require.

(2) The other persons shall be at liberty at any time to redeem the interest charged or, in the case of a sale being directed, to purchase the same.

**Inventory.**

47. In the case of attachment of movable property by actual seizure, the officer shall, after attachment of the property, prepare an inventory of all the property attached, specifying in it the place where it is lodged or kept, and shall forward the same to the Recovery Officer and a copy of the inventory shall be delivered by the Officer to the defaulter.

**Attachment not to be excessive.**

48. The attachment by seizure shall not be excessive and the property so attached shall be as nearly as possible proportionate to the amount specified in the warrant.

**Power to break open doors, etc.**

49. The Officer may break open any inner or outer door or window of any building and enter any building in order to seize any movable property, if the officer has reasonable grounds to believe that such building contains movable property liable to seizure under the warrant and the Officer has notified his authority and intention of breaking open if admission is not given:

Provided the Officer shall give all reasonable opportunity to women to withdraw.

**Custody at place of attachment.**

50.(1) Where the property attached is of such a nature that its removal from the place of attachment is impracticable or its removal involves expenditure out of proportion to the value of the property, the Officer attaching such property (hereinafter referred to as "attaching officer") shall, subject to any directions which the Recovery Officer may issue in this behalf, arrange for the proper maintenance and custody of the property at the place of attachment.

(2) The attaching officer shall forthwith send a report of having done so to the Recovery Officer.

(3) On receipt of a report from the attaching officer under sub-regulation (1), the Recovery Officer may either order the removal of the property to a place which he shall specify or sanction its maintenance and custody at the place of attachment under such conditions as he may think fit.

**Removal and custody of property in other cases.**

51. Where the attached property is not kept at the place of attachment, it shall be kept in the custody of an officer (hereinafter referred to as the "custody officer") subordinate to the Recovery Officer and authorised by the Recovery Officer for

this purpose. The custody officer may remove the property to the office of the Recovery Officer for custody under his own supervision or, with the approval of the Recovery Officer, may make such arrangements as may be convenient and economical for its safe custody with any other fit person under his own supervision and the Recovery Officer may fix the remuneration to be allowed to such person.

**Property may be handed over to the defaulter.**

52. Notwithstanding anything contained in regulation 50 or regulation 51, the attaching officer or the custody officer may, with the previous approval of the Recovery Officer, entrust, subject to his right of supervision, the attached property to the defaulter on his executing a bond, which may be so varied as the circumstances of each case may require.

Explanation.—Where the Recovery Officer proceeds to recover any dues from the defaulter by attachment and sale of, or by appointing a receiver for the management of, any movable or immovable property which is held by or stands in the name of, any of the persons referred to in the Explanation to sub-section (1) of section 28A of the Act or section 23 JB of the Securities Contracts (Regulation) Act, 1956 or section 19-IB of the Depositories Act, 1996 and which is included in the defaulter's movable or immovable property by virtue of that Explanation, the reference to "defaulter" in these regulations, as may be applicable, shall, in relation to such movable or immovable property, be construed as a reference to the person referred to in the said Explanation.

**Custody of attached cash, securities, etc.**

53. (1) If the property attached consists of cash, it shall be deposited in the bank account of the Board.

(2) If the property attached consists of government or other securities, bullion, jewellery or other valuables, the attaching officer shall seize such property and entrust the properties to the Recovery Officer along with an inventory thereof.

**Claim of any person other than the defaulter to the property under attachment.**

54. When the property remains at the place where it is attached in the custody of the attaching officer, and any person other than the defaulter claims the same, or any part thereof, the officer shall nevertheless remain in possession and shall direct the claimant to prefer his claim before the Recovery Officer.

**Return of property on cancellation or withdrawal of attachment.**

55. (1) If in consequence of withdrawal or cancellation of the attachment, the defaulter becomes entitled to receive back the movable property attached, the possession thereof shall be given to him on payment of costs, charges and expenses due, if any, in respect of the execution of the certificate against such property.

(2) For the purpose of giving possession under sub-regulation (1), the attaching officer shall inform the defaulter that the property is at his disposal.

(3) In the absence of any person to take charge of the property the officer may, if the property has been moved from the premises in which it was seized, replace it where it was found at the time of seizure.

**Property may be sold if costs, etc. not paid.**

56. In default of the payment of costs, charges and expenses, the movable property or such portion thereof as may be necessary shall be sold by auction and after defraying the expenses of such sale and the costs, charges and expenses aforesaid, the balance, if any, of the movables so party as has not been sold shall be handed over to the defaulter.

**Feeding and tending of livestock under attachment.**

57. Whenever livestock is kept at the place where it has been attached, the defaulter shall be at liberty to undertake the due feeding and tending of it, under the supervision of the attaching officer.



**Removal of livestock.**

58. In the event of the defaulter failing to feed attached livestock, the livestock may be placed in the custody of the custody officer or may be placed in a pound maintained by the Government or a local authority.

**Custody of livestock in pound.**

59. If there be any such pound near the office of the Recovery Officer, the attaching officer or the custody officer may place in it such attached livestock as can properly be kept therein in which case the pound-keeper shall be responsible for the livestock and shall receive the same rates for accommodation and maintenance thereof as are payable in respect of impounded cattle of the same description.

**Custody with a person other than custody officer.**

60. Notwithstanding anything contained in regulation 58, the custody officer may, with the approval of the Recovery Officer, entrust the attached livestock to any other person under his own supervision and the Recovery Officer may fix the remuneration to be allowed to such person after taking into account the local circumstances and the charges which such person may have to incur for the maintenance and custody of such livestock.

**Expenses of custody, maintenance, etc.**

61. The expenses of maintenance and custody of movable property including the remuneration payable to the person concerned under this Chapter shall be deemed to be costs of attachment or sale.

## **PART II - SALE**

### **Sale.**

62. The Recovery Officer may direct that any movable property attached under this regulation or such portion thereof as may seem necessary to satisfy the certificate shall be sold.

### **Issue of proclamation.**

63. When any sale of movable property is ordered by the Recovery Officer, the Recovery Officer shall issue a proclamation, in the language of the district, of the intended sale, specifying the time and place of sale and whether the sale is subject to confirmation or not.

### **Proclamation how made.**

64. (1) Such proclamation shall be made by publication in newspapers circulating in the locality, notice in the Office of the Registering Authority, publication through digital/electronic modes like publication on the website of the Board, Registering Authority, etc.—

(a) in the case of property attached by actual seizure—

(i) in the locality where the property was seized; and

(ii) at such other places as the Recovery Officer may direct;

(b) in the case of property attached otherwise than by actual seizure, in such places, if any, as the Recovery Officer may direct.

(2) A copy of the proclamation shall also be affixed in a conspicuous part of the office of the Recovery Officer.

### **Sale after fifteen days.**

65. Except where the property is subject to speedy and natural decay or when the expense of keeping it in custody is likely to exceed its value, no sale of movable property under these regulations shall, without the consent in writing of the

defaulter, take place until after the expiry of at least fifteen days calculated from the date on which a copy of the sale proclamation was affixed in the office of the Recovery Officer.

**Sale of agricultural produce.**

66. (1) Where the property to be sold is agricultural produce, the sale shall be held,—

- (a) if such produce is a growing crop—on or near the land on which such crop has grown, or
- (b) if such produce has been cut or gathered—at or near the threshing floor or place for treading out grain or the like, or fodder-stack, on or in which it is deposited:

Provided that the Recovery Officer may direct the sale to be held at the nearest place of public resort, if he is of opinion that the produce is thereby likely to sell to greater advantage.

(2) Where, on the produce being put up for sale,—

- (a) a fair price, in the estimation of the person holding the sale, is not offered for it, and
- (b) the owner of the produce, or a person authorised to act on his behalf, applies to have the sale postponed till the next day or, if a market is held at the place of sale, the next market day,

the sale shall be postponed accordingly, and shall be then completed, whatever price may be offered for the produce.

**Special provisions relating to growing crops.**

67. (1) Where the property to be sold is a growing crop and the crop from its nature admits of being stored but has not yet been stored, the day of the sale shall be so fixed as to admit of the crop being made ready for storing before the arrival of such day, and the sale shall not be held until the crop has been cut or gathered and is ready for storing.

(2) Where the crop from its nature does not admit of being stored or can be sold to a greater advantage in an unripe stage, it may be sold before it is cut and gathered, and

the purchaser shall be entitled to enter on the land, and to do all that is necessary for the purpose of tending or cutting or gathering the crop.

**Sale to be by auction.**

68. The property shall be sold by public auction in one or more lots as the officer may consider appropriate, and if the amount to be realised by sale is satisfied by the sale of a portion of the property, the sale shall be immediately stopped with respect to the remainder of the lots.

**Sale by public auction.**

69.(1) Where movable property is sold by public auction, the price of each lot shall be paid at the time of sale or as soon after as the officer holding the sale directs and in default of payment, the property shall forthwith be resold.

(2) On payment of the purchase-money, the officer holding the sale shall grant a certificate specifying the property purchased, the price paid and the name of the purchaser, and the sale shall become absolute.

(3) Where the movable property to be sold is a share in goods belonging to the defaulter and a co-owner, and two or more persons, of whom one is such co-owner, respectively bid the same sum for such property or for any lot, the bidding shall be deemed to be the bidding of the co-owner.

**Irregularity not to vitiate sale.**

70. No irregularity in publishing or conducting the sale of movable property shall vitiate the sale.

**Negotiable instruments and securities.**

71. Notwithstanding anything contained in these regulations, where the property to be sold is a negotiable instrument or a security, the Recovery Officer may, instead of directing the sale to be made by public auction, authorise the sale of such instrument or security through a stock broker or other intermediary.

**Delivery of movable property, debts and shares.**

72. (1) Where the property sold is movable property of which actual seizure has been made, it shall be delivered to the purchaser.

(2) Where the property sold is movable property in the possession of some person other than the defaulter, the delivery thereof to the purchaser shall be made by giving notice to the person in possession prohibiting him from delivering possession of the property to any person except the purchaser and requiring him to deliver possession of the property to the purchaser within the time stipulated by the Recovery Officer.

(3) Where such person in possession of the property fails without reasonable cause to deliver possession of the property to the purchaser within the time stipulated by the Recovery Officer, or within such further time as may be allowed by him, the Recovery Officer shall cause the property to be seized and delivered to the purchaser and the provisions of these regulations shall, as far as may be, apply to such seizure.

(4) Where the property sold is a debt not secured by a negotiable instrument, the delivery thereof to the purchaser shall be made by a written order of the Recovery Officer prohibiting the creditor from receiving the debt or any interest thereon and the debtor from making payment thereof to any person except the purchaser and requiring the debtor to make payment thereof to the purchaser within the time stipulated by the Recovery Officer.

(5) Where the debtor fails to make such payment to the purchaser within the time stipulated by the Recovery Officer, or within such further time as may be allowed by him, the Recovery Officer may take further proceedings to recover the amount due from the debtor as if the debtor were a defaulter in respect of whom the Recovery Officer had drawn up a certificate for the recovery of the payment.

(6) Where the property sold is a security, the delivery thereof to the purchaser may be made by a written order of the Recovery Officer prohibiting the person in whose name the securities may be standing, from making any transfer of the share to any person except the purchaser, or receiving payment of any dividend or interest thereon and requiring him to deliver the security certificate or other document of title along with

the instrument of transfer duly completed by him to the Recovery Officer within the time stipulated by the Recovery Officer and prohibiting the manager, secretary, or other proper officer of the corporation from permitting any such transfer or making any such payment to any person except the purchaser:

Provided that if the securities are held in a depository, delivery of securities shall be effected through transfer from such dematerialised account, in accordance with the provisions of the Depositories Act, 1996 and the rules, regulations or bye-laws made thereunder, to the credit of the purchaser.

(7) Where the person in whose name the security may be standing, fails to deliver the share certificate or other document of title to the Recovery Officer within the time stipulated by him, or within such further time as may be allowed by him, the Recovery Officer may take steps to obtain a duplicate of the share certificate or other document of title as if the share certificate or other document of title had been lost or destroyed:

Provided that if securities are held in a depository, the Recovery Officer shall issue appropriate directions to such depository for effecting transfer to the purchaser.

### **Transfer of negotiable instruments and shares.**

73. (1) Where the execution of a document or the endorsement of the party in whose name a negotiable instrument or a security is standing is required to transfer such negotiable instrument or security to a person who has purchased it under a sale under these regulation, the Recovery Officer may execute such document or make such endorsement as may be necessary and such execution or endorsement shall have the same effect as an execution or endorsement by the party.

(2) The Recovery Officer may cause the document to be executed on proper stamp paper and to be registered if its registration is required by any law for the time being in force and the expenses of such execution and registration shall be borne by the purchaser.

(3) Until the transfer of such negotiable instrument or share, the Recovery Officer may, by order, appoint some person to receive any interest or dividend due thereon and to

sign a receipt for the same; and any receipt so signed shall be as valid and effectual for all purposes as if the same had been signed by the party himself.

(4) Notwithstanding anything contained hereinabove, in case of shares or other securities held in an electronic form, the Recovery Officer may, by an order, direct any depository or custodian or any other person in whose custody the shares or securities are held, to transfer such shares or securities to the purchaser.

**Vesting order in case of other property.**

74. In the case of any movable property not hereinbefore provided for, the Recovery Officer may make an order vesting such property in the purchaser or as the purchaser may direct; and such property shall vest accordingly.

**CHAPTER IV**

**ATTACHMENT AND SALE OF IMMOVABLE PROPERTY**

**PART I – ATTACHMENT**

**Attachment.**

75. Attachment of the immovable property of the defaulter shall be made by an order prohibiting the defaulter from transferring or charging the property in any way and prohibiting all persons from taking any benefit under such transfer or charge.

**Service of notice of attachment.**

76. A copy of the order of attachment shall be served on the defaulter.

**Proclamation of attachment.**

77. The order of attachment shall be proclaimed by publication in newspapers circulating in the locality, publication on website of the Board etc., and a copy of the order shall be affixed on a conspicuous part of the property or such other place as may be specified by the Recovery Officer and on the notice board of the office of the Recovery Officer.

**Attachment to relate back from the date of service of notice.**

78. Where any immovable property is attached under this regulation, the attachment shall relate back to, and take effect from, the date on which the notice to pay the dues, was issued under these regulations and served upon the defaulter.

**PART II – SALE**

**Sale and proclamation of sale.**

79. (1) The Recovery Officer may direct that any immovable property which has been attached, or such portion thereof as may seem necessary to satisfy the certificate, shall be sold.

(2) Where any immovable property is ordered to be sold, the Recovery Officer shall cause a proclamation of the intended sale to be made in the language of the district.

**Contents of proclamation.**

80. A proclamation of sale of immovable property shall be drawn up after notice to the defaulter, and shall state the time and place of sale, and shall specify, as fairly and accurately as possible,—

- (a) the property to be sold;
- (b) the revenue, if any, assessed upon the property or any part thereof;
- (c) the amount for the recovery of which the sale is ordered;
- (d) the reserve price, if any, below which the property may not be sold; and



(e) any other thing which the Recovery Officer considers it material for a purchaser to know, in order to judge the nature and value of the property.

**Mode of making proclamation.**

81. (1) Every proclamation for the sale of immovable property shall be made by publication in newspapers circulating in the locality, publication on website of the Board etc. and a copy of the proclamation shall be affixed on a conspicuous part of the property or such other place as may be specified by the Recovery Officer and also upon a conspicuous part of the office of the Recovery Officer.

(2) Where the Recovery Officer so directs, such proclamation shall also be published in the Official Gazette and the cost of such publication shall be deemed to be costs of the sale.

(3) Where the property is divided into lots for the purpose of being sold separately, it shall not be necessary to make a separate proclamation for each lot, unless proper notice of the sale cannot, in the opinion of the Recovery Officer, otherwise be given.

**Time of sale.**

82. No sale of immovable property under this regulation shall, without the consent in writing of the defaulter, take place until after the expiry of at least thirty days calculated from the date on which a copy of the proclamation of sale has been affixed on the property or in the office of the Recovery Officer, whichever is later.

**Sale to be by auction.**

83. The sale shall be by public auction, which may be conducted through electronic auction, to the highest bidder and shall be subject to confirmation by the Recovery Officer:

Provided that no sale under this regulation shall be made if the amount bid by the highest bidder is less than the reserve price, if any, specified.

**Deposit of earnest money.**

84.(1) The bids for purchase of any property shall be accompanied with payment of earnest money calculated at:

(a) ten per cent of the reserve price, where the reserve price is up to rupees ten crore, subject to a minimum of rupees fifty thousand; or

(b) rupees ten lakhs plus five per cent on the remaining amount of reserve price, where the reserve price is above rupees ten crore.

(2) The earnest money so calculated shall be rounded to the nearest rupees thousand.

**Deposit by purchaser and resale in default.**

85.(1) On every sale of immovable property, the person declared to be the purchaser shall pay, immediately after such declaration, a deposit of twenty-five per cent on the amount of purchase money, including the earnest money, to the officer conducting the sale; and, in default of such deposit, the property shall forthwith be resold.

(2) The full amount of purchase money payable shall be paid by the purchaser to the Recovery Officer on or before the fifteenth day from the date of the sale of the property.

(3) The period of fifteen days under sub-regulation (2) may be extended by a maximum period of three months, subject to the purchaser making a request for such extension along with an undertaking to pay the remaining sale price together with interest thereon at the rate of fifteen per cent per annum for the period so extended.

(4) The application for extension of time for payment shall be accompanied by an unconditional bank guarantee for the remaining outstanding sale price and interest thereon at the rate mentioned hereinabove for a period of three months.

(5) The advertisement regarding the auction for sale of properties shall appropriately mention that extension to pay the consideration may be allowed subject to compliance with sub-regulations (3) and (4).

**Procedure in default of payment.**

86.(1) Upon default of payment within the period mentioned in the preceding regulation, the deposit may, if the Recovery Officer thinks fit, after defraying the expenses of the sale, be forfeited, and the property shall be resold, and the defaulting purchaser shall forfeit all claims to the property or to any part of the sum for which it may subsequently be sold.

(2) Without prejudice to sub-regulation (1), if the highest bidder fails to pay the purchase price in accordance with the terms of sale, the property may be offered to the next highest bidder at a price equal to the bid made by the highest bidder.

**Refund of earnest money.**

87. Earnest money deposited by unsuccessful bidders shall be refunded without interest within sixty days from the date of confirmation of sale.

**Forfeiture of earnest money or other payments.**

88. Earnest money or any other part of the purchase price paid by a bidder shall be forfeited on the following circumstances:

- (a) the bidder not participating in the auction after successfully submitting the bid, or
- (b) on default in payment of twenty-five per cent of the purchase price, including the earnest money paid, immediately after the auction, or
- (c) on default in payment of remaining seventy-five per cent within fifteen days of the sale:

Provided that the earnest money shall not be forfeited if time for making payment is extended in accordance with sub-regulation (3) of regulation 85.

**Application to set aside sale of immovable property on deposit.**

89.(1) Where immovable property has been sold in execution of a certificate, the defaulter, or any person whose interests are affected by the sale, may, at any time

within thirty days from the date of the sale, apply to the Recovery Officer to set aside the sale, on his depositing —

- (a) the amount specified in the proclamation of sale as that for the recovery of which the sale was ordered, with interest thereon at the rate of one and one-fourth per cent for every month or part of a month, calculated from the date of the proclamation of sale to the date when the deposit is made; and
- (b) for payment to the purchaser, as penalty, a sum equal to five per cent of the purchase money.

(2) Where a person makes an application under regulation 90 for setting aside the sale of his immovable property, he shall not, unless he withdraws that application, be entitled to make or prosecute an application under this regulation.

**Application to set aside sale of immovable property on ground of non-service of notice or irregularity.**

90. Where immovable property has been sold in execution of a certificate, the defaulter, or any person whose interests are affected by the sale, may, at any time within thirty days from the date of the sale, apply to the Recovery Officer to set aside the sale of the immovable property on the ground that notice was not served on the defaulter to pay the arrears as required by this regulation or on the ground of a material irregularity in publishing or conducting the sale:

Provided that—

- (a) no sale shall be set aside on any such ground unless the Recovery Officer is satisfied that the applicant has sustained substantial injury by reason of the non-service or irregularity; and
- (b) an application made by a defaulter under this regulation shall be disallowed unless the applicant deposits the amount recoverable from him in the execution of the certificate.

**Setting aside sale where defaulter has no saleable interest.**

91. At any time within thirty days of the sale, the purchaser may apply to the Recovery Officer to set aside the sale on the ground that the defaulter had no saleable interest in the property sold.

**Confirmation of sale.**

92.(1) Where no application is made for setting aside the sale under these regulations or where such an application is made and disallowed by the Recovery Officer, the Recovery Officer shall (if the full amount of the purchase money has been paid) make an order confirming the sale, and, thereupon, the sale shall become absolute.

(2) Where such application is made and allowed, and where, in the case of an application made to set aside the sale on deposit of the amount and penalty and charges, the deposit is made within thirty days from the date of the sale, the Recovery Officer shall make an order setting aside the sale:

Provided that no order shall be made unless notice of the application has been given to the persons affected thereby.

**Return of purchase money in certain cases.**

93. Where a sale of immovable property is set aside, any money paid or deposited by the purchaser on account of the purchase, together with the penalty, if any, deposited for payment to the purchaser, and such interest as the Recovery Officer may allow, shall be paid to the purchaser.

**Sale certificate.**

94.(1) Where a sale of immovable property has become absolute, the Recovery Officer shall grant a certificate of sale specifying the property sold, and the name of the person who at the time of sale is declared to be the purchaser.

(2) Such sale certificate shall state the date on which the sale became absolute.

**Registration of sale.**

- 95.(1) Every Recovery Officer granting a certificate of sale to the purchaser of immovable property sold under these regulations shall send a copy of such certificate to the registering officer concerned under the Indian Registration Act, 1908 (16 of 1908), within the local limits of whose jurisdiction the whole or any part of the immovable property comprised in the certificate is situated.
- (2) The Recovery Officer or any officer acting under the direction of the Recovery Officer shall be exempted from personal appearance at the registration office.

**Postponement of sale to enable defaulter to raise amount due under certificate.**

- 96.(1) Where an order for the sale of immovable property has been made, if the defaulter can satisfy the Recovery Officer that there is reason to believe that the amount of the certificate may be raised by the mortgage or lease or private sale of such property, or some part thereof, or of any other immovable property of the defaulter, the Recovery Officer may, on his application, postpone the sale of the property comprised in the order for sale, on such terms, and for such period as he thinks proper, to enable the defaulter to raise the amount.
- (2) In such case, the Recovery Officer shall grant a certificate to the defaulter, authorizing him, within a period to be mentioned therein, and notwithstanding anything contained in this regulation, to make the proposed mortgage, lease or sale:

Provided that all moneys payable under such mortgage, lease or sale shall be paid, not to the defaulter, but to the Recovery Officer:

Provided further that no mortgage, lease or sale under this regulation shall become absolute until it has been confirmed by the Recovery Officer.

**Fresh proclamation before re-sale.**

97. Every resale of immovable property, in default of payment of the purchase money within the period allowed for such payment, shall be made after the issue

of a fresh proclamation in the manner and for the period hereinbefore provided for the sale.

**Purchase by Government.**

98. When an immovable property is put up for sale for recovery of amounts due and if the property remains unsold, the Board may, after giving opportunity to the defaulter to furnish the amounts due under the certificate, offer the same to the Central Government or any State Government, who may submit a bid not lower than the reserve price and purchase the said property:

Provided that, -

- i. offer to the Central or State Government under this regulation shall be made only in case where two earlier auctions in respect of the said immovable property have been unsuccessful;
- ii. the Board may afford such time as may be deemed fit to such Central or State Government to convey its willingness to purchase and to make payment of the consideration; and
- iii. where the property is put up for sale for recovery of any penalty due or other amount payable to the Central Government and the reserve price does not exceed the amount due, the Central Government may acquire the property by extinguishing the liability of the defaulter equal to the reserve price.

**Bid of co-sharer to have preference.**

99. Where the property sold is a share of undivided immovable property, and two or more persons, of whom one is a co-sharer, respectively bid the same sum for such property or for any lot, the bid shall be deemed to be the bid of the co-sharer.

**Delivery of immovable property in occupancy of defaulter.**

100. (1) Where the immovable property sold is in the occupancy of the defaulter or of some person on his behalf or of some person claiming under a

title created by the defaulter subsequently to the attachment of such property and a certificate of sale in respect thereof has been granted under regulation 94, the Recovery Officer shall, on the application of the purchaser, order delivery to be made by putting such purchaser or any person whom the purchaser may appoint to receive delivery on his behalf in possession of the property, and if need be, by removing any person who refuses to vacate the same.

(2) For the purposes of sub-regulation (1), if the person in possession does not afford free access, the Recovery Officer may, after giving reasonable warning and facility to any woman not appearing in public according to the customs of the country to withdraw, remove or open any lock or bolt or break open any door or do any other act necessary for putting the purchaser, or any person whom the purchaser may appoint to receive delivery on his behalf, in possession.

**Delivery of immovable property in occupancy of tenant.**

101. Where the immovable property sold is in the occupancy of a tenant or other person entitled to occupy the same and a certificate of sale in respect thereof has been granted under regulation 94, the Recovery Officer shall, on the application of the purchaser, order delivery to be made by affixing a copy of the certificate of sale in some conspicuous place on the property or such other place as may be deemed appropriate by the Recovery Officer, and proclaiming to the occupant by any customary mode, at some convenient place that the interest of the defaulter has been transferred to the purchaser.

**Resistance or obstruction to possession of immovable property.**

102. (1) Where the purchaser of immovable property sold in execution of a certificate is resisted or obstructed by any person in obtaining possession of the property, he may make an application to the Recovery Officer complaining of such resistance or obstruction within thirty days of the date of such resistance or obstruction.



(2) The Recovery Officer shall fix a day for investigating the matter and shall summon the party against whom the application is made to appear and answer the same.

**Resistance or obstruction by defaulter.**

103. Where the Recovery Officer is satisfied that the resistance or obstruction was occasioned without any just cause by the defaulter or by some other person at his instigation, he shall direct that the applicant be put into possession of the property, and where the applicant is still resisted or obstructed in obtaining possession, the Recovery Officer may also, at the instance of the applicant, take steps to put the applicant into possession of the property by removing the defaulter or any person acting at his instigation.

**Resistance or obstruction by bona fide claimant.**

104. Where the Recovery Officer is satisfied that the resistance or obstruction was occasioned by any person (other than the defaulter) claiming in good faith to be in possession of the property on his own account or on account of some person other than the defaulter, the Recovery Officer shall make an order dismissing the application.

**Dispossession by purchaser.**

105. (1) Where any person other than the defaulter is dispossessed of immovable property sold in execution of a certificate by the purchaser thereof, he may make an application to the Recovery Officer complaining of such dispossession within thirty days of such dispossession.

(2) The Recovery Officer shall fix a day for investigating the matter and shall summon the party against whom the application is made to appear and answer the same.

**Bona fide claimant to be restored to possession.**

106. Where the Recovery Officer is satisfied that the applicant was in possession of the property on his own account or on account of some person

other than the defaulter, he shall direct that the applicant be put into possession of the property.

**Regulations not applicable to transferee pendente lite.**

107. Nothing in the foregoing regulations shall apply to resistance or obstruction by a person to whom the defaulter has transferred the property after the service of a notice under regulation 6 or to the dispossession of any such person.

**CHAPTER V**

**APPOINTMENT OF A RECEIVER**

**Appointment of receiver for business.**

108. (1) Where the property of a defaulter consists of a business, the Recovery Officer may attach the business and appoint a person as receiver to manage the business.

(2) Attachment of a business under this regulation shall be made by an order prohibiting the defaulter from transferring or charging the business in any way and prohibiting all persons from taking any benefit under such transfer or charge, and intimating that the business has been attached under this regulation.

(3) A copy of the order of attachment shall be served on the defaulter, and another copy shall be affixed on a conspicuous part of the premises in which the business is carried on and on the notice board of the office of the Recovery Officer.

**Appointment of receiver for immovable property.**

109. Where immovable property is attached, the Recovery Officer may, instead of directing a sale of the property, appoint a person as receiver to manage such property.

**Powers of receiver.**

110. (1) Where any business or other property is attached and taken under management under the foregoing regulations, the receiver shall, subject to the control of the Recovery Officer, have such powers as may be necessary for the proper management of the property.
- (2) A receiver appointed under these regulations shall have all such powers, as to bringing in and defending suits and for the realization, management, protection and preservation of the property, the collection of the rents and profits thereof, the application and disposal of such rents and profits, and the execution of documents as the owner himself has, or such of those powers as the Recovery Officer thinks fit.
- (3) The profits, or rents and profits, of such business or other property, shall, after defraying the expenses of management, be adjusted towards discharge of the arrears, and the balance, if any, shall be paid to the defaulter.

**Remuneration of a receiver.**

111. The Recover Officer may, by general or special order, fix the amount to be paid as remuneration for the services of the receiver.

**Duties of a receiver.**

112. (1) Every receiver so appointed shall—
- (a) furnish such security (if any) as the Recovery Officer thinks fit, duly to account for what he shall receive in respect of the property;
  - (b) submit his accounts at such periods and in such form as the Recovery Officer directs;
  - (c) pay the amount due from him as the Recovery Officer directs; and
  - (d) be responsible for any loss occasioned to the property by his wilful default or gross negligence.

(2) The receiver shall maintain true and regular accounts of the receivership and shall in particular maintain a cash book in which shall be entered from day to day all receipts and payments and also a ledger.

(3) The receiver shall also maintain a counterfoil receipt book with the leaves numbered serially in print, from which shall be given, as far as possible, all receipts for payments made to the receiver.

(4) Unless the Recovery Officer otherwise directs, the receiver shall, as soon as may be, after his appointment, open an account in the name of the receivership in such bank as the Recovery Officer may direct and shall deposit therein all moneys received in the course of the receivership immediately on receipt thereof save any minimum sums that may be required for meeting day to day current expenses. All payments by the receiver shall, as far as possible, be made by cheques drawn on the bank account.

(5) Unless otherwise ordered, a receiver shall submit his accounts once in every three months:

Provided the first of such accounts commencing from the date of his appointment and ending with the expiry of three months therefrom shall be submitted within fifteen days of the expiry of the said period of three months and the subsequent accounts brought down to the end of each succeeding period of three months within fifteen days of the expiry of each such period of three months.

**Enforcement of receiver's duties.**

113. (1) Where a receiver fails to submit his accounts at such periods and in such form as the Recovery Officer directs, the Recovery Officer may direct his property to be attached until such time as such accounts are submitted to him.

(2) The Recovery Officer may at any time make an enquiry as to the amount, if any, due from the receiver, as shown by his accounts or otherwise, or an inquiry as to any loss to the property occasioned by his wilful default or gross negligence and may order the amount found due, if not already paid by the receiver, or the amount of the loss so occasioned, to be paid by the receiver within a period to be fixed by the Recovery Officer.

(3) Where the receiver fails to pay any amount which he has been ordered to pay under sub-regulation (2) within the period specified, the Recovery Officer may direct such amount to be recovered from the security (if any) furnished by the receiver or by attachment and sale of his property or, if his property has been attached under sub-regulation (1), by the sale of such property and may direct the sale proceeds to be applied in making good any amount found due from the receiver or any such loss occasioned by him and the balance (if any) of the sale proceeds shall be paid to the receiver.

(4) If a receiver fails to submit his accounts at such periods and in such form as directed by the Recovery Officer without reasonable cause or improperly retains any cash in his hands, the Recovery Officer may disallow the whole or any portion of the remuneration due to him for the period of the accounts with reference to which the default is committed and may also charge interest at a rate not exceeding twelve per cent per annum on the moneys improperly retained by him for the period of such retention without prejudice to any other proceedings which might be taken against the receiver.

**Withdrawal of management.**

114. The attachment and management under the foregoing regulation may be withdrawn at any time at the discretion of the Recovery Officer, or if the arrears are discharged by receipt of such profits and rents or are otherwise paid.

**CHAPTER VI**

**ARREST AND DETENTION OF THE DEFAULTER**

**Notice to show cause.**

115. (1) No order for the arrest and detention in civil prison of a defaulter shall be made unless the Recovery Officer has issued and served a notice upon the

defaulter calling upon him to appear before him on the date specified in the notice and to show cause why he should not be committed to civil prison, and unless the Recovery Officer, for reasons recorded in writing, is satisfied—

- (a) that the defaulter, with the object or effect of obstructing the execution of the certificate, has dishonestly transferred, concealed, or removed any part of his property, or
- (b) that the defaulter has, or has had since the drawing up of the certificate by the Recovery Officer, the means to pay the arrears or some substantial part thereof and refuses or neglects or has refused or neglected to pay the same.

(2) Notwithstanding anything contained in sub-regulation (1), a warrant for the arrest of the defaulter may be issued by the Recovery Officer if the Recovery Officer is satisfied, by affidavit or otherwise, that with the object or effect of delaying the execution of the certificate, the defaulter is likely to abscond or leave the local limits of the jurisdiction of the Recovery Officer.

(3) Where appearance is not made in obedience to a notice issued and served under sub-regulation (1), the Recovery Officer may issue a warrant for the arrest of the defaulter.

(4) A warrant of arrest issued by a Recovery Officer under sub-regulation (2) or sub-regulation (3) may also be executed by any other Recovery Officer within whose jurisdiction the defaulter may for the time being be found.

(5) Every person arrested in pursuance of a warrant of arrest under this regulation shall be brought before the Recovery Officer issuing the warrant as soon as practicable and in any event within twenty-four hours of his arrest (exclusive of the time required for the journey):

Provided that, if the defaulter pays the amount entered in the warrant of arrest as due and the costs of the arrest to the officer arresting him, such officer shall at once release him.

Explanation.—For the purposes of this regulation,

- (i) where the defaulter is a company, the directors and other officers who are in default shall be deemed to be the defaulters;

(ii) where the defaulter is a partnership firm, all partners of the firm shall be deemed to be the defaulters; and

(iii) where the defaulter is a Hindu undivided family, the Karta thereof shall be deemed to be the defaulter.

### **Hearing.**

116. When a defaulter appears before the Recovery Officer in obedience to a notice to show cause or is brought before the Recovery Officer under regulation 115, the Recovery Officer shall give the defaulter an opportunity of showing cause as to why he should not be committed to civil prison.

### **Custody pending hearing.**

117. Pending the conclusion of the inquiry, the Recovery Officer may, in his discretion, order the defaulter to be detained in the custody of such officer as the Recovery Officer may think fit or release him on his furnishing security to the satisfaction of the Recovery Officer for his appearance whenever required.

### **Order of detention.**

118. (1) Upon the conclusion of the inquiry, the Recovery Officer may make an order for the detention of the defaulter in the civil prison and shall in that event cause him to be arrested if he is not already under arrest:

Provided that in order to give the defaulter an opportunity of satisfying the dues under the certificate along with any other dues under these regulations, the Recovery Officer may, before making the order of detention, leave the defaulter in the custody of the officer arresting him or of any other officer for a specified period not exceeding fifteen days, or release him on his furnishing security to the satisfaction of the Recovery Officer for his appearance at the expiration of the specified period if the arrears are not so satisfied.

(2) When the Recovery Officer does not make an order of detention under sub-regulation (1) he shall, if the defaulter is under arrest, direct his release.

**Prison in which defaulter may be detained.**

119. A person against whom an order of detention has been passed may be detained in the civil prison of the district in which the office of the Recovery Officer ordering the detention is situated, or, where such civil prison does not afford suitable accommodation, in any other place which the State Government may appoint for the detention of persons ordered by the civil courts of such district to be detained.

**Detention in and release from prison.**

120. (1) Every person detained in the civil prison in execution of a certificate may be so detained,—

- (a) where the certificate is for a demand of an amount exceeding two hundred and fifty rupees—for a period of six months, and
- (b) in any other case—for a period of six weeks:

Provided that he shall be released from such detention—

- (i) on the amount mentioned in the warrant for his detention being paid to the officer-in-charge of the civil prison, or
- (ii) on the request of the Recovery Officer on any ground other than the grounds mentioned in regulations 117 and 118.

(2) A defaulter released from detention under this regulation shall not, merely by reason of his release, be discharged from his liability for the arrears; but he shall not be liable to be rearrested under the certificate in execution of which he was detained in the civil prison.



**Subsistence allowance.**

121. (1) When a defaulter is arrested or detained in the civil prison, the sum payable for the subsistence of the defaulter from the time of arrest until he is released shall be borne by the Recovery Officer.
- (2) Such sum shall be calculated on the scale fixed by the State Government for the subsistence of judgment-debtors arrested in execution of a decree of a civil court.
- (3) Sums payable under this regulation shall be deemed to be costs in the proceeding: Provided that the defaulter shall not be detained in the civil prison or arrested on account of any sum so payable.
- (4) The subsistence allowance shall be supplied by the Recovery Officer by monthly instalments in advance before the first day of each month.
- (5) The first payment shall be made to the Recovery Officer for such portion of the current month as remains unexpired before the defaulter is committed to the civil prison, and the subsequent payment (if any) shall be made to the officer in charge of the civil prison.

**Release.**

122. (1) The Recovery Officer may order the release of a defaulter who has been arrested in execution of a certificate upon being satisfied that he has disclosed the whole of his property and has placed it at the disposal of the Recovery Officer and that he has not committed any act of bad faith.
- (2) If the Recovery Officer has ground for believing the disclosure made by a defaulter under sub-regulation (1) to have been untrue, he may order the re-arrest of the defaulter in execution of the certificate, but the period of his detention in the civil prison shall not in the aggregate exceed that authorised by regulation 120.

**Release on ground of illness.**

123. (1) At any time after a warrant for the arrest of a defaulter has been issued, the Recovery Officer may cancel it on the ground of his serious illness.

(2) Where a defaulter has been arrested, the Recovery Officer may release him if, in the opinion of the Recovery Officer, he is not in a fit state of health to be detained in the civil prison.

(3) Where a defaulter has been committed to the civil prison, he may be released therefrom by the Recovery Officer on the ground of the existence of any infectious or contagious disease, or on the ground of his suffering from any serious illness.

(4) A defaulter released under this regulation may be rearrested, but the period of his detention in the civil prison shall not in the aggregate exceed that authorised by regulation 120.

### **Entry into dwelling house.**

124. For the purpose of making an arrest under this regulation —

- (a) no dwelling house shall be entered after sunset and before sunrise;
- (b) no outer door of a dwelling house shall be broken open unless such dwelling house or a portion thereof is in the occupancy of the defaulter and he or other occupant of the house refuses or in any way prevents access thereto; but, when the person executing any such warrant has duly gained access to any dwelling house, he may break open the door of any room or apartment if he has reason to believe that the defaulter is likely to be found there;
- (c) no room, which is in the actual occupancy of a woman who, according to the customs of the country, does not appear in public, shall be entered into unless the officer authorised to make the arrest has given notice to her that she is at liberty to withdraw and has given her reasonable time and facility for withdrawing;
- (c) no room, which is in the actual occupancy of a woman, shall be entered into unless the officer authorised to make the arrest has given reasonable notice to her and such officer is a woman or is accompanied by a woman officer.

### **Prohibition against arrest of women or minors, etc.**

125. The Recovery Officer shall not order the arrest and detention in the civil prison of,-

- (a) a woman, or
- (b) any person who, in his opinion, is a minor or of unsound mind.

## **CHAPTER VII**

### **APPOINTMENT OF ADMINISTRATOR AND PROCEDURE FOR REFUNDING TO THE INVESTORS**

#### **PART I – PRELIMINARY**

#### **Applicability.**

126. (1) Without prejudice to the other provisions of these regulations, this provisions under this Chapter shall be applicable for all or any of the following:
- a. appointment of Administrator pursuant to failure to comply with disgorgement or refund orders passed by the Board;
  - b. sale of properties attached by the Recovery Officer of the Board under the Act;
  - c. collection of claim documents and verification of claims of investors for the purpose of effecting refunds;
  - d. refund of monies to the investors pursuant to disgorgement or refund orders passed by the Board;
  - e. recovery of disgorgement amounts directed by the Board;
  - f. any act incidental or connected thereto.
- (2) Unless otherwise specifically ordered, these regulations shall not be applicable to cases where the Securities Appellate Tribunal or a Court has appointed an administrator or any other person for the purposes of recovery and/or repayment to investors.
- (3) The provisions of these regulations shall apply *mutatis mutandis* in respect of the proceedings under the Securities Contracts (Regulation) Act, 1956 or the Depositories Act, 1996.

**Appointment of an Administrator.**

127. (1) For the purposes of this Chapter, the Board shall, after attachment of the properties of the defaulter by the Recovery Officer, appoint an Administrator in the manner specified:

(2) Notwithstanding the generality of sub-regulation (1), the Board may decide not to appoint an Administrator—

- (i) in case where the cost of administration would be higher than the amount that can be recovered from the defaulter through the means specified under the Act and these regulations; or
- (ii) in such other circumstances that may be specified by the Board.

**Eligibility norms for appointment as an Administrator.**

128. (1) The Administrator shall be a person registered with the Insolvency and Bankruptcy Board of India as an Insolvency Resolution Professional and empanelled by the Board from time to time.

(2) No person shall be appointed as an Administrator where such an appointment may be objected to on the grounds that give rise to justifiable doubts as to the independence or impartiality of such a person:

Provided that any question involving issues of conflict of interest in the appointment of an Administrator shall be decided by the Recovery Officer.

(3) The Administrator shall provide an undertaking to the Board of absence of any conflict of interest with the defaulter, its directors, promoters, key managerial personnel and its group entities.

(4) The Administrator shall also forthwith disclose to the Board any conflict of interest which may come to his knowledge during his tenure:

(5) For the purposes of these regulations, the Administrator shall be deemed to be a public servant within the meaning of section 21 of the Indian Penal Code (45 of 1860) and sections 22 and 23 of the Act shall accordingly apply to him.

**Terms of appointment.**

129. The terms and conditions of appointment including remuneration shall be specified by the Board, on a case to case basis, after taking into consideration the quantum of work, the number of investors and the quantum of money involved.

**PART II - FUNCTIONS OF THE ADMINISTRATOR****Functions.**

130. (1) An Administrator shall perform the following functions –
- (a) As may be directed by the Recovery Officer, obtain from the defaulter or any other person, any information or document including documents relating to ownership and possession of properties, details of amount raised from investors, claims of investors, amount claimed to have been refunded to investors;
  - (b) Make a record of the properties that have been attached by the Recovery Officer including the additional properties that have been entrusted by the Recovery Officer from time to time and those properties which are not part of the attachment order;
  - (c) Make a record of the bank accounts and dematerialised accounts of the defaulter and value of the monies and securities held thereunder;
  - (d) Arrange for a proclamation for the sale of the property and arrange affixation of the copy of such proclamation;
  - (e) Open an interest bearing bank account, under the control of the Recovery Officer, with a scheduled public sector bank for depositing the proceeds of the money recovered from the sale of the assets and for making repayment to the investors;
  - (f) Sell the attached properties in accordance with these regulations or as may be directed by the Recovery Officer;

(g) Call for claims, in the manner specified in these regulations or as may be directed by the Recovery Officer, for the purposes of repayment to investors, pursuant to an order of the Board for refunds;

(h) Verify the claims of investors and also that of the defaulter in respect of repayment of monies, either partly paid or wholly paid, claimed to have been made to investors on the basis of documentary evidence:

Explanation – Verification may involve forensic auditing.

(i) Carry out any other necessary incidental and supplementary act, with the prior approval of the Recovery Officer that may be required for the purpose of carrying out its obligations under these regulations.

(2) While discharging the functions under these regulations, the Administrator -

(a) may engage the services of a peer reviewed chartered accountant for verifying the claims of investors on the basis of documentary evidence and for submission of a certified report to the Administrator;

(b) shall engage the services of a registered valuer to evaluate the properties of defaulter that are attached by the Recovery Officer and for submission of a certified valuation report in accordance with the guidelines issued by the Board;

(c) may engage the services of a registrar and share transfer agent registered with the Board or such other agency as may be approved by the Recovery Officer, for managing the entire repayment process.

Provided that the fees paid for such services shall be fixed by the Administrator taking into account the relevant factors including –

(a) the number of investors and the claims that are made;

(b) quantum of work involved;

(c) the number of assets to be evaluated;

(d) the geographical location of the property and its proximity with the valuer's place of business;

and such fees shall be within the overall remuneration fixed by the Board for the Administrator:

Provided further that the intermediary or such other person engaged by the Administrator, shall not have any conflict of interest which would impede their independence or impartiality.

(3) The Administrator shall submit a monthly report or a report as and when called for by the Recovery Officer on the progress of work entrusted including the monies realised pursuant to the sale of the properties and the repayments made to the investors.

### **PART III – SALE OF ASSETS**

#### **Sale of assets.**

131. (1) The Administrator shall undertake the process of sale of properties after conducting an independent valuation of such properties by a registered valuer.

(2) After considering the valuation report, the Recovery Officer may decide on the reserve price below which the property may not be sold.

(3) The Administrator may undertake the sale of properties through electronic auction process and for this purpose engage an electronic auction agency and shall in consultation with the Recovery Officer repeat the auction process till the time such properties are disposed of or otherwise directed.

(4) The process of disposing off the properties shall be under the supervision of the Recovery Officer.

(5) On completion of the sale and receipt of the sale consideration, the Recovery Officer shall issue an order confirming such sale.

(6) The amount realized in respect of sale of properties of the defaulter shall be deposited in a separate bank account with a scheduled public sector bank in terms of clause (e) of sub-regulation (1) of regulation 130 and such account shall be under the control of the Recovery Officer.

## **PART IV – DISGORGEMENT OR REFUND OF MONIES**

### **Disgorgement or Refund to investors.**

132. (1) For the purposes of inviting claims from the investors, the Administrator shall -

(a) issue advertisements in an English and a Hindi newspaper having nationwide circulation and if so directed by the Recovery Officer, issue such advertisement in vernacular newspaper(s) having circulation in the area(s) where the investors are concentrated;

(b) direct the defaulter to issue advertisement in its website, if available.

(2) The advertisement referred to sub-regulation (1) may also be hosted on the website of the Board.

(3) The advertisements referred to in sub-regulation (1) shall contain instructions on the manner of making claims by investors and the documents and information that are to be submitted for verifying and processing their claim applications.

(4) The filing of claims from the investors shall be through electronic mode or be received in the office of the Administrator as directed:

Provided that the investors' claims received, if any, by the Board and forwarded to the Administrator shall also be included in the relevant records maintained by the Administrator.

(5) The Administrator or the chartered accountant engaged by the Administrator, shall consider the total eligible claims as against the monies available for distribution to investors in order to determine whether the whole amount or a proportionate amount may be repaid to the investors as may be directed by the Recovery Officer.

(6) Upon ascertaining the eligibility, the Administrator in consultation with the Recovery Officer, shall repay the money to the eligible investors only through pay orders, demand drafts and electronic transfer through NEFT or RTGS.

(7) The refund process shall be kept open for an appropriate period as may be decided in consultation with the Recovery Officer.



(8) The monies remaining in the interest bearing escrow bank account after satisfying all the permissible claims of investors and other charges, shall be retained therein for a period of three years in order to meet the claims that may be received from any unpaid investor.

(9) Upon completion of the period specified under sub-regulation (8), the unpaid monies due to investors, if any, shall be transferred to the Investor Protection and Education Fund of the Board:

Provided that monies transferable under the Companies Act, 2013 [18 of 2013] to the Investor Education and Protection Fund shall be transferred to such fund.

(10) In case any claim is received from an unpaid investor in respect of monies transferred to the Investor Protection and Education Fund after the refund process has been closed, the same may be made from the Investor Protection and Education Fund after necessary verification by the Administrator in consultation with the Recovery Officer:

Provided that the claim shall be made within a period of three years from the date of transfer of monies to the Investor Protection and Education Fund in terms of sub-regulation (9).

(11) The defaulter, and its officers who are in default as defined under section 2 of the Companies Act, 2013, as applicable, shall furnish an undertaking that they shall be liable for payment if any complaint is received in future by the Board from any investor.

**Costs incurred in administration and repayment process.**

133. (1) The entire costs incurred in relation to the sale of properties, verification of investors' claims, remuneration of Administrator including the fees paid, if any, to the chartered accountant or valuer or such other person engaged by the Administrator and registrar and share transfer agent and all other expenses incurred in connection with the recovery and/or the repayment process shall be borne by the defaulter(s), failing which, the monies recovered by the Board shall be appropriated in priority to the other liabilities.

(2) The cost and expenses referred to in sub-regulation (1) shall be reasonable and directly related to and necessary for the act and purposes referred to in these regulations.

(3) Where the Administrator is appointed on the request of a person against whom an order for disgorgement or refund had been issued by the Board, the remuneration of the Administrator and the other costs incurred in respect of recovery and/or refund to the investors shall be borne by such person.

**Priority in distribution of sale proceeds.**

134. The proceeds from the sale of properties of the defaulter shall be distributed in the following order of priority, namely, -

- i. the costs of administration incurred by the Board, if any, and the fees and charges payable to the Administrator and other persons appointed by the administrator in performing its functions under these regulations;
- ii. disgorgement and/or monies payable to investors;
- iii. any other penalty or fees due from the defaulter to the Board under the provisions of the Act, the Securities Contracts (Regulation) Act, 1956 or the Depositories Act, 1996.

**Refund in tranches.**

135. (1) Where recovery has not been completed but the Board is satisfied that refund to investors should be initiated based on the monies realized at the relevant time, the Board may direct the Administrator to initiate the process of refund to investors.

(2) Unless otherwise decided by the Administrator, the investors in the same class shall receive proportionately.

(3) The Administrator may refund claims in tranches by value.

**Return of monies exceeding the liability.**

136. In case the proceeds realised by way of sale of properties of the defaulter is in excess of the monies due from him under the certificate and the applicable interest and other charges, the excess money shall be paid to the defaulter after completion of three years from the date of completion of the refund process.

**Filing of the repayment report.**

137. Upon completion of the repayments to all investors or recovery of the disgorgement amount from the defaulter, the Administrator shall file a detailed repayment/recovery report to the Recovery Officer or Board, as the case may be, within the period as may be specified.

**PART V – DISGORGEMENT OF AMOUNTS****Application of this Chapter to disgorgement.**

138. The provisions of these Chapter shall be applied in so far as it is applicable and the disgorgement amount so recovered shall be credited to the Investor Protection and Education Fund of the Board unless distributed to eligible investors.

Provided that no investor shall be eligible for receiving disgorgement monies unless,-

- i. The investor has been identified by an order issued by the Board;
- ii. The investor's claim is in the nature of restitution for monies *had and received* by the defaulter(s) and not compensatory in nature.

Explanation 1. –A claim for restitution means a claim where the wrongful loss to the claimant directly resulted in, and amounted to the wrongful gain of the defaulter(s) which has been disgorged and now claimed.

Explanation 2. – A claim for compensation means a claim where the wrongful loss to the claimant did not directly result in, and amount to the wrongful gain of the defaulter(s) against whom disgorgement has been done but in the gain of someone else.

## PART VI - GENERAL OBLIGATIONS AND RESPONSIBILITIES

### Obligations and Responsibilities

139. An Administrator -

- a) shall maintain high standards of integrity, promptitude and fairness in the conduct of all his business;
- b) shall act with due skill, care and diligence in the conduct of all his business;
- c) shall not misrepresent any facts or situations and shall refrain from being involved in any action that would bring disrepute to the profession;
- d) shall act with objectivity during the course of his professional dealings by ensuring that all decisions are made without any bias, conflict of interest, coercion, or undue influence of any party, whether directly or indirectly connected to sale of properties, verification of claims and refund of monies;
- e) shall not acquire, directly or indirectly, any of the assets of the defaulter;
- f) shall maintain complete independence in all professional relationships and conduct the verification and refund process, as the case may be, independent of external influences;
- g) shall not conceal any material information or knowingly make a misleading statement to the Recovery Officer or the Board;
- h) shall not act with *mala fide* or be negligent while performing the functions and duties under the regulations;
- i) shall provide all information and records as may be required by the Recovery Officer within the time specified by him;
- j) shall ensure that confidentiality of the information relating to the sale of properties, verification and refund process, is maintained at all times;  
Provided that the Administrator may disclose any information after obtaining written authorization of the Recovery Officer or the Board;
- k) shall disclose all costs towards the verification and refund process and endeavour to ensure that such costs are not unreasonable; and
- l) shall comply with the terms and conditions of its appointment.

## **PART VII - ACTION IN CASE OF DEFAULT**

### **By an Administrator.**

140. (1) The Recovery Officer may, for reasons to be recorded in writing, recommend for replacement of the Administrator, in case the Administrator has

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- a) failed to comply with the terms and conditions of appointment;
- b) engaged valuers or chartered accountants or such other persons who are ineligible to act so;
- c) failed to comply with any of the obligations and responsibilities specified under these regulations;
- d) acted against the instructions of the Recovery Officer or the Board; or
- e) acted in such manner that is prejudicial to the interest of the investors.

(2) Without prejudice to the actions detailed under sub-regulation (1), the Recovery Officer may recommend for initiation of any appropriate action under securities laws.

(3) On receipt of such recommendation or suo moto, the Board may take appropriate action against the Administrator or such intermediary or such other person engaged by the Administrator, including the following:

- (a) remove such Administrator from the Panel;
- (b) forward the matter to the Insolvency and Bankruptcy Board of India for appropriate action against the Administrator who is an Insolvency Resolution Professional; and
- (c) issue suitable directions restraining such person from engaging in activities in the securities market in his professional capacity.

### **Loss of registration.**

141. If the registration of an Administrator with the Insolvency and Bankruptcy Board of India is cancelled or suspended at any time, such

Administrator shall be deemed to have been removed from the Panel till such cancellation or suspension is in effect and be forthwith relieved of any duties under these regulations.

## **CHAPTER IX**

### **MISCELLANEOUS**

#### **Power to take evidence.**

142. The Recovery Officer or other officer acting under the provisions of these regulations shall have the powers of a civil court while trying a suit for the purpose of receiving evidence, administering oaths, enforcing the attendance of witnesses and compelling the production of documents.

#### **Continuance of certificate.**

143. No certificate shall cease to be in force by reason of the death of the defaulter.

#### **Procedure on death of defaulter.**

144. If at any time after the certificate is drawn up by the Recovery Officer, the defaulter dies, the proceedings under these regulations (except arrest and detention) may be continued against the legal representative of the defaulter in terms of section 28B of the Act or section 23JC of the Securities Contracts (Regulation) Act, 1956 or section 19-IC of the Depositories Act, 1996, and the provisions of these regulation shall apply as if the legal representative is the defaulter.

#### **Recovery from surety.**

145. Where any person has become surety for the amount due by the defaulter, he may be proceeded against under these regulations as if he were the defaulter.

**Recovery by suit or under other law not affected.**

146. The several modes of recovery specified in these regulations shall not affect in any way the right of the Board to institute a suit for the recovery of the amount due from the defaulter and it shall be lawful for the Board to have recourse to any such suit, notwithstanding that the amount due is being recovered from the defaulter by any mode specified in these regulations.

**Costs and charges.**

147. (1) The following costs and expenses shall be recoverable in execution of a certificate -

- (a) costs incurred in attachment of movable properties, including expenses incurred in execution of attachment proceedings,
- (b) charges incurred in valuation of movable and immovable properties,
- (c) costs of publishing notices, orders etc. including in newspapers,
- (d) costs incurred in service of notices,
- (e) costs incurred in maintaining custody of articles attached, and
- (f) such other costs and expenses that may be incurred in realizing the amounts due under the certificate.

**Power to seek information.**

148. (1) The Recovery Officer may at any stage of the execution of the certificate of recovery, seek from any person, any information which may be relevant to execution of the certificate of recovery or to any investigation or inquiry by the Recovery Officer.

(2) Without limiting the generality of the foregoing provision, the Recovery Officer may at any stage of the execution of the certificate of recovery, require any person against whom or which the certificate of recovery is issued, and if such person is a body corporate from any of its officers, to declare on affidavit the particulars of his or its assets.

**Continuance of pending proceedings.**

149. All proceedings for the recovery of amounts initiated and pending before the coming into force of these regulations shall be continued under these regulations, and, for this purpose, every certificate issued by the Recovery Officer before coming into force of these regulations shall be deemed to be a certificate drawn up by the Recovery Officer under the corresponding provisions of these regulations.

**Officers deemed to be acting judicially.**

150. The Recovery Officer or other officers shall, in the discharge of functions under Act or the Securities Contracts (Regulation) Act, 1956 or the Depositories Act, 1995 and these regulations, be deemed to be acting judicially within the meaning of the Judicial Officers Protection Act, 1850 (18 of 1850).

**Forms.**

151. The Board or the Recovery Officer may specify by way of a circular the forms to be used for any order, notice, warrant, or certificate to be issued under these regulations.

**Power of the Board to issue clarifications.**

152. In order to remove any difficulties in the application or interpretation of these regulations, the Board may issue clarifications and guidelines, as deemed necessary.

**Power to determine procedure in certain circumstances.**

153. In a situation not provided for in these regulations, the Recovery Officer, with the approval of the Board, may determine the procedure for specific matters, as may be required.



**Repeal and Savings.**

154. (1) On the commencement of these regulations,-
- i. the Securities and Exchange Board of India (Appointment of Administrator and Procedure for Refunding to the Investors) Regulations, 2018 shall stand repealed and any action taken under those regulations shall be deemed to have been taken under these regulations and continued under these regulations; and
  - ii. any ongoing proceedings before a Recovery Officer appointed by the Board may be continued under these regulations.

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**PART-C**

**QUANTIFICATION OF 'DISPROPORTIONATE GAIN OR UNFAIR  
ADVANTAGE' AND 'LOSS CAUSED TO AN INVESTOR OR GROUP OF  
INVESTORS AS A RESULT OF THE DEFAULT' AND RELATED ISSUES**

## I. RELEVANCE OF QUANTIFICATION OF ‘PROFIT’ AND ‘LOSS’

### AN INTRODUCTION

Securities laws require the Board and the Adjudicating Officer to take into account relevant factors for the purpose of arriving at a suitable penalty to be levied on the persons who violate securities laws, viz. -

- (i) the amount of disproportionate gain or unfair advantage, wherever quantifiable, as a result of the default;
- (ii) the amount of loss caused to an investor or group of investors as a result of the default; and
- (iii) the repetitive nature of default.

The existing settlement regulations also require the Board to take into account these factors.<sup>39</sup> In the Report on the Settlement mechanism of the Board, this Committee has dealt with the factors relating to the ‘*repetitive nature of the default*’. In the Indian context, the first notable attempt to lay down the manner of quantification in relation to securities fraud was made by the Hon’ble Supreme Court of India in the matter of *Trojan & Co. Ltd v R. M. N. N. Nagappa Chettiar*<sup>40</sup>, wherein the apex court *inter alia* held as follows, -

“Ordinarily the market rate of the shares on the date when the fraud was practised would represent their real price in the absence of any other circumstance. *If, however, the market was vitiated or was in a state of flux or panic in consequence of the very fact that was fraudulently concealed, then the real value of the shares has to be determined on a consideration of a variety of circumstances disclosed by the evidence led by the parties. (emphasis supplied)* Thus though ordinarily the market rate on the earliest date when the real facts became known may be taken as the real value of the shares, nevertheless, if there is no market or there is no

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<sup>39</sup> Regulations 9 and 10 of the Settlement Regulations.

<sup>40</sup> AIR 1953 SC 235, 1953 SCR 780.

satisfactory evidence of a market rate for some time which may safely be taken as the real value, then if the representee sold the shares, although not bound to do so, and if the resale has taken place within a reasonable time and on reasonable terms and has not been unnecessarily delayed, then the price fetched at the resale may well be taken into consideration in determining retrospectively the true market value of the shares on the crucial date. *If there is no market at all or if the market rate cannot, for reasons referred to above, be taken as the real or fair value of the thing and the representee has not sold the things, then in ascertaining the real or fair value of the thing on the date when deceit was practised subsequent events may be taken into account, provided such subsequent events are not attributable to extraneous circumstances which supervened on account of the retaining of the thing. These, we apprehend, are the well settled rules for ascertaining the loss and damage suffered by a party, in such circumstances. (emphasis supplied)*

...

In order to determine the real price of these 3,000 shares sold to plaintiff by concealment of certain facts, the first question that needs decision is whether the market for these shares, the rate prevailing wherein would prima facie be a true index of their value, had been affected by the very fact concealed of which the plaintiff complains. *In this case from the proved facts it is clear that the market rate of these shares was seriously affected by reason of the impending decision of the Stock Exchange for closing it to stop the wave of speculation that had taken the frenzy of the market by reason of the merger of the two steel companies doing business in northern India. (emphasis supplied)* The market reports for the week ending March 19, show that the Indian Irons were standing at or around Rs. 55. By Saturday the 3rd April after the announcement of the terms of the merger by reason of the keen speculation the shares were being dealt at around Rs. 73. On Monday the 6th April the price was Rs. 77. On Tuesday the 6th, the day when the decision was taken to close the market for two days, these shares touched Rs. 79 but by the close of business fell back to Rs. 72 a sudden drop of Rs. 7. On Wednesday the 7th April in the Calcutta market they closed at Rs. 58, a drop of Rs. 14 in a day. These sudden rises and falls in the market during the course of these

two days are sufficient indication of the fact that the drop was due to the decision of the Stock Exchange to close the Exchange for two days. There is no evidence that any other factor was then disturbing the market rate of these shares.

...

Considering the whole of this material, *we are satisfied that the market rate prevailing on the 5th, 6th and 7th had been affected by reason of the decision of the Calcutta Stock Exchange to keep the market closed on the 8th and 9th and the market did not settle down till about the 17th or 18th and the prices then ruling can in the circumstances of this case be said to be their true market price. (emphasis supplied)* In our judgment, Rs. 46 per share was the real price of these shares when they were put in the plaintiff's pocket and he got Rs. 46 for each share in lieu of what he paid for either at Rs. 77 or at Rs. 77-4-0. *He is entitled to commission also which he would have to pay on the sale of these shares. (emphasis supplied)* The difference between these two rates is the damage that he has suffered and he is entitled to it.”

Thus, where a person is induced to purchase shares at a certain price by fraud, the measure of damages<sup>41</sup> which he is entitled to recover from the seller is the difference between the price which he paid for the shares and the real price of the shares on the date on which the shares were purchased. *Ordinarily the market rate of the shares on the date when the fraud was practised would represent their real price in the absence of any other circumstance. If, however, the market was vitiated or was in a state of flux or panic as a consequence of the very fact that was fraudulently concealed, then the real value of the shares has to be determined on a consideration of a variety of circumstances.*

However, post this decision, the Committee is at pains to find any further judicial decision laying down, in substantial detail, principles relating to quantification.

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<sup>41</sup> Fraud is also a part of the law relating to Torts and contracts for which damages may be awarded. Damages in law are of several kinds and ordinary damages are directly linked to the loss caused. Thus quantification of damages indirectly leads to quantification of loss caused and is relevant to the entire exercise.

The scope for revision is abundantly clear from the manner in which the Board has fared before appellate forums in the recent past, in particular,<sup>42</sup> the manner of quantification of profit by the Board was questioned and matter(s) remanded for SEBI to lay down the norms for determining illegal profits. Unless the manner of quantification is laid down in a transparent manner it will be difficult to justify why a particular amount should be disgorged or a particular penalty be levied, leaving abundant scope for defaulters to obtain favourable orders to the detriment of investors and the integrity of the securities market as a whole. The quantification of illegitimate profit and loss to investors is a complex exercise that involves consideration of several factors such as, - the determination of net gains and amounts that may be deducted, joint and several liability, applying the correct financial economics techniques, tax considerations, the nature of the violation, etc. The Committee has attempted to understand the various global practices and works by experts available on the subject to distil a probable methodology for quantification.

#### **NEED FOR PRESENT REVISION**

The Committee has had several deliberations with the officers of the Board as well as other experts. It has also had the advantage of studying the settlement and enforcement mechanisms in a holistic manner. The Committee is of the view that a clear public guidance is needed in the manner of quantification for the following reasons, -

1. The existing manner of quantification of profit is very basic and can be enhanced in view of the technical and financial resources available with the Board. It is presently limited to very specific cases and several best practices can be adopted in them;

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<sup>42</sup> *B Ramalinga Raju v SEBI*, SAT order dated 12.05.2017, available at <[http://sat.gov.in/english/pdf/E2017\\_JO2014286.PDF](http://sat.gov.in/english/pdf/E2017_JO2014286.PDF)>; *SRSR Holdings Pvt Ltd v SEBI*, SAT order dated 11.08.2017, available at <[http://sat.gov.in/english/pdf/E2017\\_JO2015463.PDF](http://sat.gov.in/english/pdf/E2017_JO2015463.PDF)> Also see, *Somani Overseas Ltd & Ors v SEBI*, SAT order dated 30.06.2016, available at <[http://sat.gov.in/english/pdf/E2016\\_JO2014227.PDF](http://sat.gov.in/english/pdf/E2016_JO2014227.PDF)> *inter alia* directing SEBI to set out the norms for determining illegal gains, -

“while upholding the decision of WTM of SEBI that the appellants are liable to disgorge the illegal gains made on sale of SIL scrip during the investigation period, we set aside the illegal profits quantified at Rs. 4,69,40,232/- and direct that the quantum of illegal profits be determined afresh by setting out the norms laid down by SEBI for determining the illegal profits.” (*emphasis supplied*)

2. The manner of quantification of loss to investors, as a guidance for levy of penalties needs to be laid down;
3. In the meeting held with the members of the High Power Advisory Committee constituted under the Settlement Regulations, the need to lay down the manner of quantification was stressed upon;
4. The Securities Appellate Tribunal has required the Board to set out the principles of quantification<sup>43</sup>;
5. The Committee's Report on Settlement Mechanism had recommended settlement based on a factual consideration of all types of cases including insider trading. This was linked to quantification of profit made and loss caused to the investors;
6. Quantification in the long run, would be a major deterrent in cases relating to fraud, tipper-tippe liability, front-running, etc.; and
7. Quantification will also enable the Board to justify its orders before appellate forums, which may otherwise reduce the penalties and disgorgement amounts since there is no appropriate guidance for the appellate authorities that may justify the penalties levied and monies disgorged.

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<sup>43</sup> *Ibid.*

## GLOBAL SCENARIO

In the Committee's earlier report, the Committee had made an examination of the laws, processes and practices prevailing in the USA and UK. While the UK processes do require that various factors be taken into account while taking an action or settling the violations, there is however little jurisprudence available in the public domain in respect of quantification.

The United States of America is known for the constitutional protection afforded to its citizens and many of our constitutional and securities laws principles are borrowed from them. Their system is also known for enforcement of securities laws and decades have been spent in developing their present guidelines. Their methods of quantification reflect in their quasi-judicial orders, from which the securities laws jurisprudence of our country can be enriched and the outcome experienced in the recent cases be avoided in the future.<sup>44</sup>

In the USA, the federal courts alone are competent to impose penalties, as well as order imprisonment, based on profit and loss factors. Hence there is abundant jurisprudence available in the public domain where the federal courts have calculated the profit and loss caused to the investors. In the instance of insider trading alone, the USA judicial system now takes into account several different methods (including statistical methods to be done by economists) of calculating the gains as a result of the default. Depending on the circumstances, the courts adopt the best method, to distinguish between 'legitimate' gains and 'illegal' gains.<sup>45</sup>

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<sup>44</sup> See *Umakanth Varottil*, "SAT Order in the Satyam Case", available at <<https://indiacorplaw.in/2017/05/sat-order-in-satyam-case.html>>:

*"Courts in several jurisdictions have sought to set out principles on how to compute wrongful profits or gains in case of securities offences such as insider trading or market manipulation, but this area is riddled with controversies. In the end, it might be necessary for SEBI to establish clearer guidelines on determining sanctions so that the outcome experienced in the Satyam case can be avoided in the future."* (emphasis supplied)

<sup>45</sup> See *Lai PY*, "The Calculation of Illicit Profit in US Insider Trading Cases", (2013) *J Stock Forex Trad* 2:105. doi:10.4172/2168-9458.1000105, available at <<https://www.omicsonline.org/open-access/the-calculation-of-illicit-profit-in-us-insider-trading-cases-2168-9458-2-105.pdf>>, the article shows the approaches across jurisdictions are similar; *Alexandra A.E. Shapiro & Nathan H. Seltzer*, "Measuring "Gain" Under The Insider Trading Sentencing



## **A BIRD'S EYE VIEW OF SOME OF THE GLOBAL METHODOLOGIES FOR CALCULATING THE AMOUNT DUE FOR DISGORGEMENT IN INSIDER TRADING CASES**

### **INTRODUCTION:**

The economic activities of the capital market of a nation are one of the key segments to boost the economic growth of the country. A healthy capital market can be created if the stock exchanges are well regulated. As the business world continues to expand in global markets, trading of shares, bonds, derivatives and other instruments continues to increase. One form of trading that has received considerable regulatory and academic interest in recent years is *insider trading*. Around the world, an active enforcement of criminal laws and regulations has increased its focus on preventing and/or punishing insider trading and market abuse.

Bhattacharya & Daouk<sup>46</sup>, in a study of 103 countries that have securities markets, revealed that only 87 countries have laws dealing with insider trading and only 38 countries have successfully enforced their laws against this crime. This situation is the result of a dispute between the two main theoretical streams.<sup>47</sup> The first is convinced that a ban on insider trading reduces market efficiency and managers' compensation, while the other states that the insider trader appropriates the value of the preferential information to the detriment of other investors and consequently the repression of this crime increases the investors' trust in the market, and hence its liquidity. Further, a ban on it reduces market efficiency, the insider, by carrying out his strategy, pushes the stock price faster towards the value that better reflects the fundamentals of the company.<sup>48</sup> According to the 'misappropriation' theory, the preferential information is

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Guideline Based On Culpability For The Deception”, Federal Sentencing Reporter, Vol. 20, No. 3, February 2008, p 194, available at, <<https://www.lw.com/thoughtLeadership/measuring-gain-under-insider-trading-sentencing-guideline>>.

<sup>46</sup> Utpal Bhattacharya & Hazem Daouk, “The World Price of Insider Trading”, pp 3, available at <[https://faculty.fuqua.duke.edu/~charvey/Teaching/BA453\\_2005/BD\\_The\\_world.pdf](https://faculty.fuqua.duke.edu/~charvey/Teaching/BA453_2005/BD_The_world.pdf)> : The Journal of Finance Vol. 57, No. 1 (Feb., 2002), pp. 75-108

<sup>47</sup> Marcello Minenna, ‘*Insider Trading, Abnormal Return and Preferential Information: Supervising through a Probabilistic Model*’, available at <<https://nscpolteksby.ac.id/ebook/files/Ebook/Journal/2015/Banking%20and%20Finance/Vol.%2027/Volume%2027%20Issue%201/Page%2059-86/Insider%20trading-abnormal%20return%20and.pdf>>.

<sup>48</sup> Finnerty, J., 1976. Insiders and market efficiency. Journal of Finance 31, 1141–1148.

property of the company. Therefore, any exploitation of information carried out by a subject other than the owner, i.e., the company, could be considered to be a theft.<sup>49</sup> As a consequence, other investors do not have the same investment opportunities as the insider and this is unacceptable according to the ‘market egalitarianism’ theory.<sup>50</sup> According to this view, making this a crime increases investors’ trust in the market, and enhance its integrity.

Regulation and enforcement of insider trading laws is important because investors are likely to be more confident in the financial statements of companies that operate in countries with strong insider trading laws. In addition, investments within countries having insider trading laws may be viewed as less risky as the information is considered to be more reliable. Therefore, some quantitative procedures have to be used in order to detect the phenomenon, to compute the value of preferential information and hence, to calculate the disgorgement, which is the undue wealth gained by the insider through the exploitation of preferential information. This estimate offers, in all legal jurisdictions punishing the crime of insider trading, a benchmark to identify the sanction to be imposed against the insider and, as such, can be considered the link between the financial and legal aspects.

### **WHAT IS DISGORGEMENT?**

The paramount purpose of enforcing the prohibition against insider trading by ordering disgorgement is to make sure that wrongdoers will not profit from their wrongdoing. Disgorgement is an equitable remedy, imposed to force a defendant to give up the amount by which he was unjustly enriched (*FTC v. Bronson Partners*<sup>51</sup>). By forcing wrongdoers to give back the fruits of their illegal conduct, disgorgement also “has the effect of deterring subsequent fraud” (*SEC v. Cavanagh*<sup>52</sup>). Because disgorgement does

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<sup>49</sup> Georges, S., 1976. L’utilisation en bourse d’informations privilegiées dans le droit des Etats-Unis, *Economica*.

<sup>50</sup> Langevoort, L., 1987. *Insider trading: regulation, enforcement and prevention*. Clark Boardman Company, New York; Loss, S., 1983. *Fundamentals of securities regulation*. Clark Boardman Company, Boston.

<sup>51</sup> *Federal Trade Commission v. Bronson Partners, LLC*, 654 F.3d 359 (2d Cir. 2011), available at <<https://www.courtlistener.com/opinion/223605/ftc-v-bronson-partners-llc/>>.

<sup>52</sup> *SEC v. Cavanagh*, No. 98-Civ.-1818-DLC, 2004 WL 1594818, at 30 (S.D.N.Y. July 16, 2004), *aff’d*, 445 F.3d 105 (2d Cir.2006).

not serve a punitive function, the disgorgement amount may not exceed the amount obtained through the wrongdoing.

Hence, the difficulty in identifying an objective, realistic, and effective way of computing this value can give rise to problems in assessing the damage caused by the insider to the market and, consequently, to the enforcement action.<sup>53</sup>

### **THE CALCULATION OF ILLICIT PROFIT/ DISGORGEMENT IN INSIDER TRADING CASES**

There are currently divergent approaches for calculating illicit profit in insider trading cases. What constitutes 'profit' differs from case to case as different court decisions confront each other, however a closer look will reveal that each method is relevant to the facts in which it was applied and there is no real conflict to resolve. The major approaches which have been adopted worldwide are the (1) net profit approach, (2) the notional profit approach (also known as market absorption approach), (3) the event studies approach and (4) the potential probabilistic disgorgement approach.

**NET PROFIT APPROACH:** The net profit approach is the approach which considers the total increase in value realized through trading in securities. Gain is the total profit actually made from a defendant's illegal securities transactions. Applying this can sometimes include legal gains also, hence its universal application is inappropriate.

**NOTIONAL PROFIT: THE MARKET ABSORPTION APPROACH:** The notional approach is the approach which treats the relevant profit as those gains made by the insider dealer when the information was made public and the market had a reasonable opportunity to digest the information. The gain is to be measured by reference to the market value of the shares at that date. At that date, the amount of the insider dealer's profit, whether realized or not, was fixed once and for all. Subsequent changes in market prices are

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<sup>53</sup> Marcello Minenna, '*Insider Trading, Abnormal Return and Preferential Information: Supervising through a Probabilistic Model*', available at <https://nscpolteksby.ac.id/ebook/files/Ebook/Journal/2015/Banking%20and%20Finance/Vol.%2027/Volume%2027%20Issue%201/Page%2059-86/Insider%20trading-abnormal%20return%20and.pdf>.

irrelevant. This method requires proper choice of the 'relevant' period when the market can be said to have absorbed the information and reflect it into the price.

**THE EVENT STUDIES APPROACH: STANDARD APPROACH:** The event-study analysis, which estimates the effect on stock returns of occurrences, such as mergers, acquisitions, takeovers, announcements, variation of the regulation in the reference micro-economical system, etc., is widely used. Event studies is an econometric approach as it seeks to isolate the impact of inside information from other market factors because a genuine event studies approach would require regression analysis using logical reasoning and statistical methods.

The constraints of the event study approach are as follows,-

- a. The methodology requires time-series data, i.e. it is useful for scrips that have been listed for at least some time (around 2 years), therefore not useful for listing defaults.
- b. The insider-trading examination is subordinated to the determination of a statistically significant reference index, which plays the role of a market portfolio proxy. This approach would be difficult to implement in the case of a large number of thinly traded stocks. Therefore, stock selection is an important criteria, it may apply to some and not apply to some scrips.
- c. The choice of a long time horizon could include events that changed the company capital structure, such as mergers, acquisitions, regulation variation, etc. to help understand scrip specific movements.
- d. This methodology requires the testing of all the hypotheses related to a linear regression model. If those hypotheses cannot be verified, the results can be invalid or lead to inevitable methodological problems.
- e. Rumors relating to the stock could generate spikes in the returns during the stipulated period (the reference time for the estimate).
- f. The event-study methodology applied to insider trading estimates the future stock returns by a linear regression model. Therefore, it relies on the assumption

that the returns on a narrow interval are generated by the same linear model coming from a set of information belonging to a definitely wider time window.

- g. The methodology calculates only one cumulative abnormal return in relation to the preferential information. By doing so, it does not take into account differences in the trading strategies of insiders that usually represent differences in their knowledge of the preferential information

**POTENTIAL PROBABILISTIC DISGORGEMENT APPROACH:** The Potential Probabilistic Disgorgement approach is a new procedure for computing the economic value of the information exploited by the insider, based on a probabilistic approach.<sup>54</sup> This methodology overcomes the issues connected to the event-study procedure and can be applied by construction to all insider-trading schemes and not only to the simplest ones. In fact, the model parameters are defined by using the trading strategy of the single insider; thus, if insider trading takes place, the model is able to offer a disgorgement computation; hence, by hypotheses of its construction, it is able to detect the difference between insiders and followers.

The advantages of the potential probabilistic computation are as follows,-

- a. The definition of the parameters is extremely realistic and difficult to break down, since it represents the insider-trading strategy on the stock under investigation carried out in the period which includes the insider trading- days before the disclosure of the information to the market and consequently entails the set of information composed by prices and quantities which create the portfolio of the insider on the stock.
- b. It allows the determination of all the possible paths of the stock under investigation under a predictive dynamic logic.
- c. It cannot be invalidated by the fact that the company has been recently quoted, since if the insider can trade the stock, the procedure can return, by means of the

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<sup>54</sup> Marcello Minenna, 'Insider Trading, Abnormal Return and Preferential Information: Supervising through a Probabilistic Model', available at <https://nscpolteksby.ac.id/ebook/files/Ebook/Journal/2015/Banking%20and%20Finance/Vol.%2027/Volume%2027%20Issue%201/Page%2059-86/Insider%20trading-abnormal%20return%20and.pdf>.

parameters-estimation procedure, a disgorgement computation.

- d. It does not require a regressor since the stock path forecast depends only on the prices of the stock under investigation incorporated in the insider trader portfolio.
- e. It does not require the definition of time horizons longer than the insider-trading days for estimating the parameters to be employed in the analysis; therefore, it is not affected by the stock liquidity, by the discontinuity of the time series, and other typical issues of econometric procedures.
- f. It offers a customized methodology for the single subject under investigation, since the model behaves differently according to the single insider-trading strategy. Further, by assuming that the insider who is closer to the information will have the more profitable trading strategy, it gives a higher disgorgement to the subjects who are closer to the preferential information and therefore it is able to distinguish between insiders and followers (i.e., tippers and other insiders).
- g. The stochastic process employed benefits from the Markov property. This property makes the model absolutely coherent with the weak form of market efficiency.
- h. It is a more intuitive approach, since it works directly on prices and not on return and it is a faster and easier procedure, in terms of implementation, than the potential econometric disgorgement computation, since it can skip all the issues related to the statistical robustness tests.

#### **INTERNATIONAL PRACTICE**

SEC has mostly adopted the Event Study methodology for calculating illicit profit, however, the divergent approaches are considered by courts for calculating Disgorgement depends on the facts and circumstance of each case and the arguments raised by the defendants. This Report takes into account various such methods, each of which depend on the facts and circumstances under consideration.

In the case of, *United States v. Nacchio*<sup>55</sup> the event studies approach was used for the disgorgement calculation, however, in the case of *United States v. Raj Rajaratnam*<sup>56</sup> the market absorption approach was considered under the disgorgement calculation. Hong Kong<sup>57</sup> has also adopted the market absorption approach to calculate disgorgement. The Italian regulator Commissione Nazionale per le Società e la Borsa (CONSOB), has developed two methods: (i) a Modified Event Study Method that has been adjusted to the behaviour of the Italian securities markets; and (ii) a new Potential Probabilistic Method for calculating the disproportionate gains due for disgorgement.

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In this respect the Committee has examined the law prevalent in other jurisdictions and arrived at certain important conclusions after drawing upon some well-established principles, as follows, -

1. The Indian law of insider trading<sup>58</sup> is similar to that of the USA<sup>59</sup>. This makes it easier for adopting similar means and methods for quantification of gains and losses.<sup>60</sup> The Committee has already noted that there are many ways to calculate gains relating to insider trading. In so far as liability of an insider who is a tippee is concerned, the quantification of gains requires the Board to adopt certain

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<sup>55</sup> *United States v. Nacchio* (2009) (10th Cir.) 573 F.3d 1062, available at <<https://casetext.com/case/us-v-nacchio-11>>.

<sup>56</sup> *United States v. Raj Rajaratnam*, (2012) (RJH) 09 Cr. 1184, available at <<https://www.leagle.com/decision/infdco20120207b98.xml>>.

<sup>57</sup> *The Insider Dealing Tribunal v. Shek Mei Ling*, (1999) 2 HKCFAR 205, available at <<https://www.hongkongcaselaw.com/the-insider-dealing-tribunal-v-shek-mei-ling/>>; *HKSAR v. Du Jun* (2009) DCCC787/2008, available <<https://www.hongkongcaselaw.com/hksar-v-du-jun-2/>>.

<sup>58</sup> See, clauses (d) and (e) of Section 12A and Section 15G of the SEBI Act.

<sup>59</sup> See, The Insider Trading Sanctions Act, 1984 and the Insider Trading and Securities Fraud Enforcement Act, 1988 which *inter alia* amended the Securities Exchange Act, 1934, available at <<https://www.govtrack.us/congress/bills/98/hr559/text>> and <<https://www.gpo.gov/fdsys/pkg/STATUTE-102/pdf/STATUTE-102-Pg4677.pdf>> respectively; Rules 10b-5, 10b5-1 and 10b5-2 of the General Rules And Regulations, Securities Exchange Act Of 1934, Subpart A—Rules and Regulations Under the Securities Exchange Act of 1934 at 17 C.F.R. (Code of Federal Regulations) available at <[https://www.ecfr.gov/cgi-bin/text-idx?SID=6172e3128b122545ee8bec9d0e5d519d&mc=true&tpl=/ecfrbrowse/Title17/17cfr240\\_main\\_02.tpl](https://www.ecfr.gov/cgi-bin/text-idx?SID=6172e3128b122545ee8bec9d0e5d519d&mc=true&tpl=/ecfrbrowse/Title17/17cfr240_main_02.tpl)>.

<sup>60</sup> For application of US law by Indian authorities, see SAT order dated 08.10.2012 in the matter of *V K Kaul v Adjudicating Officer*, available at <<https://indiacorplaw.in/wp-content/uploads/2012/12/1349843808090.pdf>>.

innovative approaches which are already well settled in the USA insider trading law<sup>61</sup>;

2. Even the anti-fraud provisions in both the jurisdictions are similar, rather it may be appropriate to state that the wordings of Section 12A of the SEBI Act are borrowed from the provisions of Section 10b of the USA Securities Exchange Act, 1934<sup>62</sup> and Rule 10b-5 of the SEC Rules.<sup>63</sup>
3. The concept of securities market price being a reflection of the ‘information’ being assimilated has universal application across various jurisdiction. The methods for quantification used by various regulators reflect this underlying principle. This is also reflected in the approach adopted by the Indian Supreme Court in the *Trojan* case. It is also reflected in the SEBI (Prohibition of Insider Trading) Regulations, 2015 which inter alia require, *‘the compliance officer taking into account various factors including the unpublished price sensitive information in question becoming generally available and being capable of assimilation by the market,*

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<sup>61</sup> See *Salman v. U.S.*, 137 S. Ct. 420 (2016), available at <[https://www.supremecourt.gov/opinions/16pdf/15-628\\_m6ho.pdf](https://www.supremecourt.gov/opinions/16pdf/15-628_m6ho.pdf)> where the U. S. Supreme Court held that the “personal benefit” to a tipper that is required to establish liability for insider trading can consist of the “gift” of that material, non-public information to a family member or friend. As such, the Court affirmed the “personal benefit” analysis articulated in the landmark 1983 case *Dirks v. SEC*, 463 U. S. 646 (1983), available at <<https://supreme.justia.com/cases/federal/us/463/646/case.html>>. Also See *SEC v. Contorinis*, US Court of Appeals, No. 12-1723 (2d Cir. 2014) upholding tipper liable to disgorge amount equal to the profit made by the person who traded, available at <<https://www.dlapiper.com/~media/files/insights/publications/2014/02/sec-v-contorinis.pdf?la=en&hash=2AB6FF5A06DE029A72FC92CC2E4E9B8CD8F1155F>>. The Court *inter alia* held that, -

“[i]n *SEC v. Warde* we held that, in the determination of a disgorgement amount, “[a] tippee’s gains are attributable to the tipper, regardless whether benefit accrues to the tipper.” 151 F.3d 42, 49 (2d Cir. 1998). That principle has deep roots in parallel civil remedial structures. For example, in *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 165 (2d Cir. 1980), we concluded that “[t]rades by tippees are attributed to the tipper” in determining liability for damages, and in *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1308 (2d Cir. 1971), the foundational case for insider trading liability, we required a tipper to make common law civil restitution “for the profits derived by his tippees.””

<sup>62</sup> See pp 89-91, available at <<http://legcounsel.house.gov/Comps/Securities%20Exchange%20Act%20Of%201934.pdf>>.

<sup>63</sup> See the General Rules And Regulations, Securities Exchange Act Of 1934, Subpart A—Rules and Regulations Under the Securities Exchange Act of 1934 at 17 C.F.R. (Code of Federal Regulations) §240.10b-5: Employment of manipulative and deceptive devices., available at <[https://www.ecfr.gov/cgi-bin/text-idx?SID=6172e3128b122545ee8bec9d0e5d519d&mc=true&node=se17.4.240\\_110b\\_65&rgn=div8](https://www.ecfr.gov/cgi-bin/text-idx?SID=6172e3128b122545ee8bec9d0e5d519d&mc=true&node=se17.4.240_110b_65&rgn=div8)>



*which in any event shall not be earlier than forty-eight hours after the information becomes generally available.’*

4. The issue of quantification of gains made and losses caused arises only after a guilt determination. The defaulter is the only person aware of the actual gains made by him and the quasi-judicial authorities are only making a ‘best judgment’ assessment of the gains made and losses caused. As such, due to the dynamic nature of the market, only an approximation can be made, uncertainty is inherent in the act of the defaulter for which the defaulter himself must bear the risk of uncertainty.<sup>64</sup> The authorities can make an assessment only on the basis of available information and is not required to make an exact assessment of the losses caused and gains made.<sup>65</sup> Similar principles should be applied to assessments made by the Board as well;
5. The authorities conducting investigation, inquiry, audit and inspection have to look closely in order to be able to ascertain the relevant factors for the quantification of gains made and losses caused in case of negligence and director related defaults<sup>66</sup>, such as related party transactions or where they have by their acts, directly or indirectly, adversely affected the company and its investors;

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<sup>64</sup> *SEC v Drexel Burnham Lambert, Inc.*, 837 F. Supp. 587 (S.D.N.Y. 1993), *aff’d sub nom.*, *SEC v Posner*, 16 F.3d 530 (2<sup>nd</sup> Cir. 1994), cert. denied, 513 U.S. 1077 (1995) quoting *SEC v Bilzerian* 814 F. Supp. 116, 121 (S.D.N.Y. 1993), available at <<https://law.justia.com/cases/federal/district-courts/FSupp/837/587/2377774/>>:

*“Since it is difficult in many cases to separate ‘legal’ from illegal profit... it is proper to assume that all profits gained while the defendants were in violation of the law constituted ill-gotten gains.” (emphasis supplied)*

<sup>65</sup> See, *U.S. v Rutkoske*, 506 F.3d 170, 179 (2d. Cir. 2007), available at <<https://www.courtlistener.com/opinion/1292285/united-states-v-rutkoske/>> ; *U.S. v Zolp*, 479 F.3d 715, 720-21 (9<sup>th</sup> Cir. 2007), available at <<https://law.resource.org/pub/us/case/reporter/F3/479/479.F3d.715.05-50822.html>>; *U.S. v. Berger*, 587 F.3d 1038, 1045 (9th Cir. 2009), available at <<https://www.courtlistener.com/opinion/1345996/united-states-v-berger/>> ; *SEC v Calvo*, 378 F.3d 1211 (11th Cir. 2004), available at <<https://www.leagle.com/decision/20041589378f3d121111462>>; and *SEC v Svoboda*, 409 F. Supp. 2d 331 (S.D.N.Y. 2006), available at <<https://www.courtlistener.com/opinion/2404810/ussec-v-svoboda/>>.

<sup>66</sup> *SEC v Church of God Inc.*, 429 F. Supp. 2d 1045 (S.D. Ind 2005), available at <<https://www.courtlistener.com/opinion/2487525/ussec-v-church-exten-of-church-of-church-of-god-inc/>> (balancing fact that the defendants provided ‘real and valuable services’ with the fact that, but for the fraud, the business would have collapsed earlier and they would not have been employed and ordering each defendant to disgorge one-half of base-salary for one year for which the business operated.); *SEC v Drexel Burnham Lambert, Inc.*, 837 F. Supp. 587 (S.D.N.Y. 1993), *aff’d sub nom.*, *SEC v Posner*, 16 F.3d 530 (2<sup>nd</sup> Cir. 1994), cert. denied, 513 U.S. 1077 (1995) (disgorgement of all compensation paid to officers where fraud enabled defendants to gain control of company

6. There is no one universally applicable way of quantification and each method has its defects and advantages depending on the factual matrix in which it may be applied<sup>67</sup>, thus wherever possible multiple calculations should be made by the investigation, inquiry, audit and inspection authorities for consideration of alternatives during proceedings under securities laws, including settlement and the most approximate and appropriate one may be selected. E.g. the *US Sentencing Guidelines*<sup>68</sup> *inter alia* notes the possibility of alternative methods in respect of the quantification of losses due to fraud in securities markets, as follows, -

“(ix) **Fraudulent Inflation or Deflation in Value of Securities or Commodities.**—In a case involving the fraudulent inflation or deflation in the value of a publicly traded security or commodity, *the court in determining loss may use any method that is appropriate and practicable under the circumstances. One such method* the court may consider is a method under which the actual loss attributable to the change in value of the security or commodity is the amount determined by—

(I) calculating the difference between the average price of the security or commodity during the period that the fraud occurred and the average price of the security or commodity during the 90-day period after the fraud was disclosed to the market, and

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and place themselves in highly-paid positions; court rejected ‘any contention’ that the defendants’ services were of ‘real value to the company’.), available at <<https://law.justia.com/cases/federal/district-courts/FSupp/837/587/2377774/>>; *SEC v Alpha Telecomms., Inc* 187 Supp. 1250 (D. Ore. 2002), *aff’d*, 350 F. 2d 1034 (9<sup>th</sup> Cir. 2003), available at <<https://law.justia.com/cases/federal/district-courts/FSupp2/187/1250/2310241/>> (disgorgement of all wages, loans and compensation paid by the company to the defaulter who ran the collective investment scheme).

<sup>67</sup> See, J Duncan, *Recalculating “Loss” in Securities Fraud*, (2013) 3 Harvard Business Law Review 257, available at <[http://www.hblr.org/wp-content/uploads/2013/10/HLB202\\_crop.pdf](http://www.hblr.org/wp-content/uploads/2013/10/HLB202_crop.pdf)>.

<sup>68</sup> Sentencing Guidelines p 99, available at <<https://www.ussc.gov/sites/default/files/pdf/guidelines-manual/2016/GLMFull.pdf>>; See Committee’s Report on Settlement Mechanism, pp 27-28 for detailed understanding of the US Sentencing Guidelines, available at <[https://www.sebi.gov.in/reports/reports/aug-2018/report-on-settlement-mechanism-by-the-high-level-committee-to-review-the-enforcement-and-settlement-mechanism\\_39967.html](https://www.sebi.gov.in/reports/reports/aug-2018/report-on-settlement-mechanism-by-the-high-level-committee-to-review-the-enforcement-and-settlement-mechanism_39967.html)>.

(II) multiplying the difference in average price by the number of shares out-standing.<sup>69</sup>

In determining whether the amount so determined is a reasonable estimate of the actual loss attributable to the change in value of the security or commodity, the court may consider, among other factors, the extent to which the amount so determined includes significant changes in value not resulting from the offense (*e.g.*, changes caused by external market forces, such as changed economic circumstances, changed investor expectations, and new industry- specific or firm-specific facts, conditions, or events).”

The Committee notes the similarities, with understandable deviations, in the USA approach relating to quantification of loss to investors in cases of fraud and the manner of quantification adopted by the Hon’ble Supreme Court of India in the matter of *Trojan & Co. Ltd v R. M. N. N. Nagappa Chettiar*<sup>70</sup> and is hopeful that with the express recognition of class action suits under Section 245 the Companies Act, 2013 and the Commercial Courts, Commercial Division and Commercial Appellate Division of High Courts Act, 2015 which *inter alia* deal with disputes relating to shareholder agreements, agreements for sale of goods,<sup>71</sup> subscription and investment agreements pertaining to financial services and related contracts of agency, there will be substantial development within India on these aspects.<sup>72</sup>

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<sup>69</sup> Out-standing shares is a market term used for calculating earnings per share and market capitalization; see <<https://www.nasdaq.com/article/shares-outstanding-cm550633>> and <<https://www.upcounsel.com/outstanding-shares>>.

<sup>70</sup> AIR 1953 SC 235, 1953 SCR 780.

<sup>71</sup> Securities are goods, See clause (7) of section 2 of the Sale of Goods Act, 1930.

<sup>72</sup> Law Commission of India’s 188th Report on Proposals for Constitution of Hi-Tech Fast – Track Commercial Divisions In High Courts, p 146, available at <<http://lawcommissionofindia.nic.in/reports/188th%20report.pdf>>:

*“In fact, in several cases, the National Consumer Commission has refused to entertain cases for justifiable reasons such as for example, where serious issues of fraud, cheating or conspiracy are involved. Such cases can still be filed in the High Court and brought before the proposed Commercial Division.”*

## **II. KEY RECOMMENDATIONS AND RATIONALE**

The Committee has examined the existing global approaches in detail and recommends the issuance of non-mandatory public guidelines. In this Chapter, the Committee examines the key recommendations in the proposed guidelines and the rationale for them.

### **1. NEED FOR GUIDANCE**

The present situation, where there is no public guidance, has resulted in limited quantification of the factors indicated in Section 15J of the SEBI Act, Section 19I of the Depositories Act and Section 23J of the SCRA.

Securities laws impose the burden of quantifying these factors on the quasi-judicial authorities and not on the fact-finding authorities, though from a practical point of view the quasi-judicial authorities are primarily dependent on the facts unearthed by the investigating authorities. It is the quasi-judicial authority that should be independently satisfied whether these factors are indeed quantifiable or not. Since, the Committee is mindful of the challenges faced by the officers and Members of the Board in exercise of their quasi-judicial functions, in view of which appropriate guidance must be issued to the investigation, inquiry, inspection and audit authorities who recommend action to the Board so as to enable them to include various factors and indicate the methods required for quantification for levy of penalty or to order disgorgement after taking into account, factors such as profit made, loss caused and the repetitive nature of the default.

However, quantification as a process cannot exclude the noticee against whom action is proposed, doing so will only serve to give grounds of appeal and lengthen the quasi-judicial process.

In the Report on Settlement, this Committee discussed how the USA Sentencing Reform Act of 1984 (SRA) which went into effect on November 1, 1987, served as the legal

foundation for the issue of non-mandatory public guidelines for federal courts in the exercise of their functions. This brought in a huge amount of certainty for the prosecutors as well as the accused, and also served as the basis of having a successful plea bargaining system which has worked better than that in India. These guidelines which create a framework for sentencing without taking away the discretion of the Judge to deviate for reasons to be recorded were upheld by the USA Supreme Court in *Mistretta v United States*.<sup>73</sup>

Even Self-Regulatory Organizations such as the Financial Industry Regulatory Authority, (FINRA) have developed publicly available Sanction Guidelines<sup>74</sup>. FINRA published the *FINRA Sanction Guidelines* ("Guidelines") in 1993 so that the members and associated persons could become familiar with the disciplinary sanctions that could result from the typical securities industry rule violations.

The Sanction Guidelines apply to all formal FINRA disciplinary actions, whether settled or fully litigated. FINRA's adjudicatory bodies—Hearing Panels and the National Adjudicatory Council (NAC)—rely on FINRA's Sanction Guidelines to determine appropriate remedial sanctions. *The Sanction Guidelines state in clear and unequivocal language that they are intended to be guidelines and that they are not absolute*. In both-settled cases and litigated matters, depending on the facts and circumstances of each case, the sanctions imposed may fall outside the ranges recommended in the Sanction Guidelines. Fines on a “per violation” basis, were the default option under the Sanction Guidelines. Since 1998, the revised general principles applicable to all sanction determinations have stated that an aggregation of violations may be appropriate for the purpose of determining sanctions if the violative conduct was unintentional or negligent, did not result in injury to public investors, or the violations resulted from a single systemic problem or a cause that has been corrected. With these revisions, the NAC clarified FINRA's existing policy on the aggregation or "batching" of violations for the purpose of

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<sup>73</sup> 488 U.S. 361 (1989), available at <<https://www.courtlistener.com/opinion/112173/mistretta-v-united-states/>>.

<sup>74</sup> Latest FINRA Sanction Guidelines available at <[http://www.finra.org/sites/default/files/Sanctions\\_Guidelines.pdf](http://www.finra.org/sites/default/files/Sanctions_Guidelines.pdf)>.

sanctions by highlighting when it is appropriate to consider sanctions on a "per violation" basis and when aggregation is acceptable.<sup>75</sup>

In the Report on Settlement Mechanism, the Committee had adopted the device of non-mandatory statutory guidance in respect of the factor relating to 'repetitive nature of default' by recommending a new regulation<sup>76</sup> (extant regulation 32) which declares the relevance of Schedule II of the settlement regulations which maintains the discretion of the quasi-judicial authorities in deciding how a repetitive default may be treated and how the monies due may be quantified. The Committee's Report on Settlement Mechanism provides guidance in respect of the factor- 'repetitive nature of the default'; this report concerns the remaining two statutory factors.

It may be noted that the Hon'ble Supreme Court in its recent order dated 28.02.2019 in the matter of *Adjudicating Officer, SEBI v Bhavesh Pabari*<sup>77</sup> has also interpreted the factor relating to '*repetitive nature of default*' in line with the recommendations of this Committee and *inter alia* held as follows,-

"13. There is a distinction between a continuing offence and a repeat offence. The continuing offence is a one which is of a continuous nature as distinguished from one which is committed once and for all. The term "continuing offence" was explained and elucidated by giving several illustrations in *State of Bihar vs. Deokaran Nenshi & Ors*<sup>78</sup>. In case of continuing offence, the liability continues

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<sup>75</sup> For a more detailed discussion, See *May 2018 Revisions to the Sanction Guidelines – FAQ*, available at <<http://www.finra.org/industry/revisions-sanction-guidelines-faq>>.

<sup>76</sup> Regulation 32 of the proposed draft Regulations in the Report on Settlement Mechanism, p 161, available at <[https://www.sebi.gov.in/reports/reports/aug-2018/report-on-settlement-mechanism-by-the-high-level-committee-to-review-the-enforcement-and-settlement-mechanism\\_39967.html](https://www.sebi.gov.in/reports/reports/aug-2018/report-on-settlement-mechanism-by-the-high-level-committee-to-review-the-enforcement-and-settlement-mechanism_39967.html)>.

<sup>77</sup> 2019 (3) SCALE 447, available at <[https://www.supremecourtindia.nic.in/supremecourt/2013/36291/36291\\_2013\\_Judgement\\_28-Feb-2019.pdf](https://www.supremecourtindia.nic.in/supremecourt/2013/36291/36291_2013_Judgement_28-Feb-2019.pdf)>.

<sup>78</sup> AIR 1973 SC 908, 1973(3) SCR 1004: the Court examined whether failure to file annual return at the due date was a continuing offence or an offence completed by non-filing on the due date. Held, that such non-compliance was not a continuing offence. It was held that a continuing offence is one which is susceptible of continuance and is distinguishable from the one which is committed once and for all. The distinction between the two kinds of offences is between an act or omission which constitutes an offence once and for all and an act or omission which continues, and therefore, constitutes a fresh offence every time or occasion on which it continues. In the case of a continuing offence, there is thus the ingredient of continuance of the offence which is absent in the case of an offence which takes place when an act or omission is committed once and for all.

until the rule or its requirement is obeyed or complied with. On every occasion when disobedience or noncompliance occurs and reoccurs, there is an offence committed. Continuing offence constitutes a fresh offence every time or occasion it occurs. In *Union of India & Anr. Vs. Tarsem Singh*,<sup>79</sup> continuing offence or default in service law was explained as a single wrongful act which causes a continuing injury. A recurring or successive wrong, on the other hand, are those which occur periodically with each wrong giving rise to a distinct and separate cause of action. We have made reference to this legal position in view of clause (c) of Section 15J of the SEBI Act which refers to repetitive nature of default and not a continuing default. The word “repetitive” as used therein would refer to a recurring or successive default. (*emphasis supplied*) This factum has to be taken into consideration while deciding upon the quantum of penalty.”

It must be noted that there is nothing unique in having non-mandatory public guidelines through a non-statutory or statutory device for the exercise of quasi-judicial process as long as discretion is preserved. Guidelines for judicial officers exist in various jurisdictions, not just USA.<sup>80</sup> The argument that guidelines somehow restrict the discretion of authorities is unwarranted and merely an excuse used by miscreants to take advantage of the loopholes afforded by the present system. Codification of the possible methods through public non-mandatory guidelines will ensure that quasi-judicial and

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*Contra see Bhagirath Kanoria v. State of Madhya Pradesh*, AIR 1984 SC 1688, 1985 (1) SCR 626, where the Hon'ble Supreme Court held that the imposition of penalty not confined to the first default, but with reference to the continued default is obviously on the footing that non-compliance with the obligation of making return is an infraction as long as the default continued. Without sanction of law, no penalty is impossible with reference to the defaulting conduct. The position that penalty is imposable not only for the first default, but as long as the default continues and such penalty is to be calculated at a prescribed rate on monthly basis is indicative of the legislative intention in unmistakable terms that as long as the assessee does not comply with the requirements of law, he continues to be guilty of the infraction and exposes himself to the penalty provided by law.

The later Supreme Court decision in *Bhagirath Kanoria v. State of Madhya Pradesh*, has accordingly ruled that the decision in *State of Bihar v. Deokaran Nenshi*, 'must be confined' to such cases only, that is, cases where such default in submitting the return has been made penal, but the penal liability has not been continued so long as the default continues, such as withholding payment after due date.

<sup>79</sup> (2008) 8 SCC 648.

<sup>80</sup> Several jurisdictions have Sentencing Guidelines- USA, UK, Uganda (judicial), and Hong Kong (judicial). See The Law Library of Congress, Report on Sentencing Guidelines (2014) <<https://www.loc.gov/law/help/sentencing-guidelines/index.php>>. Some countries have Guideline judgments: Canada, Australia, New Zealand: <<http://www.judiciary.go.ug/files/downloads/PRINCIPALS%20OF%20SENTENCINT%20A%20GLOBAL%20REGIONAL%20%20NATIONAL%20PERSPECTIVE%20final.pdf>>.

investigating officers can utilise the same in furtherance of their public duties. In respect of quantification, the Committee recommends an indirect manner of quantification whereby the burden of applying the principles in the first instance will be placed on the fact-finding authorities and not the quasi-judicial authorities.

**RECOMMENDATION:** In respect of quantification of profit made and loss caused to the investors as a result of the default, the Committee is of the view that public non-mandatory guidelines may be issued for the benefit of all stakeholders, which can be constantly revised and updated with ease.

## **2. WHETHER QUANTIFICATION IS NECESSARY IN EVERY INSTANCE OF QUASI-JUDICIAL PROCESS?**

Though Section 15J of the SEBI Act, Section 19I of the Depositories Act and Section 23J of the SCRA are couched in mandatory terms, the following need to be considered, -

- i. It may be noted that the Hon'ble Supreme Court in its recent order dated 28.02.2019 in the matter of *Adjudicating Officer, SEBI v Bhavesh Pabari*<sup>81</sup> has not considered the failure to quantify in each and every case as fatal to the levy of penalty. The court *inter alia* held that,-

“10. The above apart, the circumstances enumerated in clauses (a), (b) and (c) of Section 15J of the SEBI Act may have no relevance and may never arise in case of contraventions contemplated by certain provisions of the SEBI Act, for instance Section 15A, 15B or 15C of the SEBI Act. Failure to furnish information, return, etc.; failure to enter into agreement with clients; and failure to redress investors' grievances cannot give rise to the circumstances set out in clauses (a), (b) and (c) of Section 15J.

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<sup>81</sup> 2019 (3) SCALE 447, available at [https://www.supremecourtfindia.nic.in/supremecourt/2013/36291/36291\\_2013\\_Judgement\\_28-Feb-2019.pdf](https://www.supremecourtfindia.nic.in/supremecourt/2013/36291/36291_2013_Judgement_28-Feb-2019.pdf) >.



12. At this stage, we must also deal with and reject the argument raised by some of the private appellants that the conditions stipulated in clauses (a) to (c) of Section 15J are mandatory conditions which must be read into Sections 15A to 15HA in the sense that unless the conditions specified in clauses (a) to (c) are satisfied, penalty cannot be imposed by the Adjudicating Officer under the substantive provisions of Sections 15A to 15HA of the SEBI Act. The argument is too farfetched to be accepted. Section 15J of the SEBI Act enumerates by way of illustration(s) the factors which the Adjudicating Officer should take into consideration for determining the quantum of penalty imposable. The imposition of penalty depends upon satisfaction of the substantive provisions as contained in Sections 15A to Section 15HA of the SEBI Act [*and not the provisions of Section 15J*](*supplied*).”

- ii. Further, the statutory language is very clear, it refers to taking note of the quantification of gains and losses caused to the investors as result of the default along with taking into account the repetitive nature of the default. The focus is on the default and not on the defaulter.<sup>82</sup> In case of loss the statute is explicit that the loss may be calculated in respect of an individual investor or a group of investors. Further, in cases involving more than one defaulter, it may not be ideal to pin point how much loss is attributable to a particular defaulter. While it is tempting to do so, it amounts to applying impossible equitable considerations between defaulters; those who come with unclean hands have no right to equity until after the full amount has been paid by all or any one of them.<sup>83</sup> In cases where more than one

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<sup>82</sup> See the Committee’s Report on Settlement Mechanism, p 27, available at <[https://www.sebi.gov.in/reports/reports/aug-2018/report-on-settlement-mechanism-by-the-high-level-committee-to-review-the-enforcement-and-settlement-mechanism\\_39967.html](https://www.sebi.gov.in/reports/reports/aug-2018/report-on-settlement-mechanism-by-the-high-level-committee-to-review-the-enforcement-and-settlement-mechanism_39967.html)>.

<sup>83</sup> See *Dharni Dhar and Ors v Chandra Shekhar & Ors*, AIR 1951 All 774, discussing contribution by joint tortfeasors and its applicability in India depending on the facts and circumstances of each case:

“The rule [of *Merrywhether v Nixon* (1799) 8 T. R. 186: 16 R. R. 810 : 101 E. R. 1337] (*supplied*) was thus modified and came to be stated in these words :

“No person who has been guilty of fraud or any other form of wilful wrong-doing, and has been made liable in damages, has any right of contribution or indemnity against any other person who was a joint wrong-doer with him....”

person abets a fraud, the default that caused a loss or resulted in a profit is a composite whole and need not be broken up for considering the profit or loss and the liability is to be considered on a joint and several basis. The Committee will discuss this aspect further later in this Report. In case of fraudulent and unfair trade practices, even the persons who abet the fraudulent and unfair trade practice are covered under the SEBI Act, 1992 and the SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003, which defines 'fraud', provides that the penalty is directly linked to the profit arising out of such practices. Especially, where the person is part of a fraudulent scheme, artifice or device, then such scheme or artifice or device may be considered as a singular composite default for the purpose of quantification of illegal gains and/or loss rather than separate defaults and the *illegal profit has to be calculated on a holistic basis rather than an individual basis, though different persons may have had different roles to play.*

- iii. There is no direct co-relation between the charging sections of securities laws for imposing monetary penalties or fines, and the loss caused to investors as a result of the default. This is due to the distinct nature of the securities markets; the loss caused to investors by a defaulter may not be commensurate to the actual profit made by him. Issuer financial frauds may create huge investor losses when the artificial high price of an issuer's stock plummets with the public dissemination of information about the issuer's actual financial condition. In fact, securities laws violations may cause investor losses that dwarf, by several orders of magnitude, any profit that the defaulters may have made. In a non-zero sum game scenario,

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66. Where a civil wrong is committed jointly by certain persons as against another, they purge themselves of the consequences of the wrong when they repair the damage caused to that person. It cannot, therefore, be said that the hands of tort-feasor who has repaired the damage are unclean. Indeed the hands of the person who has not yet contributed his share of the loss are unclean and there is no justice in denying the relief to the person who has repaired the whole of the damage caused by the action of both of them."

Further see *Kushro S. Gandhi & Ors v N.A. Gajdar & Ors*, 1970 (SC) AIR 1468, 1969 SCR (2) 959, holding that the recovery of the entire liability could be made from all or any of the persons jointly liable before they rely on accord and satisfaction without going into the correctness of *Dharni Dhar and Ors v Chandra Shekhar & Ors*, AIR 1951 All 774.

linking penalty directly to the loss caused to investors could cause the penalty to be excessive and beyond the paying capacity of any defaulter. It is for this reason that penalties under securities laws is not a multiple of loss caused to investors. Further, SEBI does not have the power of directing compensation; but loss caused to investors is not totally ignored, it is used only for the purpose of guidance, between the minimum and maximum ranges permitted by law, which may also be tied to profit. The Committee is of the view that loss co-relation is indirect and for guidance only. *When imposing penalties, it is more appropriate in cases of joint and several liabilities or in case of the main accused, rather than for each and every individual involved, unless it is a serious violation, and for considering the amount of penalty to be levied within the range provided by law.* It is well settled that SEBI has no power to order loss compensation; such jurisdiction is vested with the ordinary civil courts and company courts, as the case may be.

- iv. Quantification of the amount of disproportionate gain or unfair advantage, wherever quantifiable, as a result of the default is a different matter altogether. Except in case of fraudulent and unfair trade practices, insider trading, non-disclosure of acquisition of shares and takeovers and excess brokerage charged by a broker, there is no direct co-relation in respect of any other monetary penalties specified in the statute with the amount of disproportionate gain or unfair advantage as a result of the default. In case of criminal fines, there is no direct co-relation in respect of any kind of default even if it is one of the four categories for which penalties have a direct co-relation to profit. As in loss quantification, similar issues arise in respect of quantification of profit when quantifying for each and every individual involved.
- v. Quantification may not be required where the penalty is sufficiently large enough to negate any gains that the defaulter may have otherwise made. This can be done in cases where the default is repetitive by taking into account the relevant principles indicated in the Settlement Regulations.

- vi. Further, disgorgement is a remedy which is linked to gains made, hence loss quantification is not always relevant. Since the securities laws violations are not always a 'zero' sum game, there usually arises a difference between disgorgement of the unjust enrichment resulting from the default and compensation for the legal damages caused. An investor may be liable to receive monies in case of unjust enrichment through the remedy of disgorgement<sup>84</sup> or receive compensation in case of legal damages. Where the two remedies are not commensurate to each other, the Board's power is limited to restitution of the unjust enrichment through the remedy of disgorgement made rather than directing compensation of loss. The Committee has explained the difference between restitution and compensation in the draft Regulation 138 of the proposed Recovery Regulations.
- vii. Quantification of loss to investors may not be required where the default is a victim less default<sup>85</sup> (such as *pure vanilla*<sup>86</sup> insider trading where there is no proximate and directly harmed person who suffers legal damages) or has no direct co-relation with the default (where there is break in causation).

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<sup>84</sup> *Banque Financière de la Cité v Parc (Battersea) Ltd and Ors*; House of Lords, [1998] 1 All ER 737, [1998] 2 WLR 475, [1998] UKHL 7, [1999] AC 221; available at <<https://www.bailii.org/uk/cases/UKHL/1998/7.html>>; per Lord Steyn "*unjust enrichment ranks next to contract and tort as part of the law of obligations. It is an independent source of rights and obligations.*"

<sup>85</sup> *United States v Rajat Gupta*, 904 F.Supp.2d 349 (2012), available at <<https://www.leagle.com/decision/inadvfdco13082600031>>:

"While insider trading may work a huge unfairness on innocent investors, Congress has never treated it as a fraud on investors, the Securities Exchange Commission has explicitly opposed any such legislation, and the Supreme Court has rejected any attempt to extend coverage of the securities fraud laws on such a theory. See, e.g., *Chiarella v. United States*, 445 U.S. 222, 232-235, 100 S.Ct. 1108, 63 L.Ed.2d 348 (1980). Prosecution of insider trading therefore proceeds, as in this case, on one or more theories of defrauding the institution (or its shareholders) that owned the information. See, e.g., *Dirks v. SEC*, 463 U.S. 646, 660-64, 103 S.Ct. 3255, 77 L.Ed.2d 911 (1983); *Carpenter v. U.S.*, 484 U.S. 19, 25-27, 108 S.Ct. 316, 98 L.Ed.2d 275 (1987). In the eye of the law, Gupta's crime was to breach his fiduciary duty of confidentiality to Goldman Sachs; or to put it another way, Goldman Sachs, not the marketplace, was the victim of Gupta's crimes as charged."

<sup>86</sup> Only where insider trading is combined with other delinquent conduct investors may be able to show loss as a result of such conduct and claim restitution on the lines of disgorgement. See *United States v. Skowron*, 839 F. Supp. 2d 740, 752 (S.D.N.Y. 2012), available at <<https://casetext.com/case/united-states-v-skowron>>, consisting of an insider trading scheme and an ensuing cover-up which actively frustrated its employer's Morgan Stanley's efforts to cooperate with the SEC; *United States v. Kline*, 199 F.Supp.2d 922 (2002), available at <<https://www.leagle.com/decision/20021121199fsupp2d92211044>>, restitution was awarded to investors in a thinly-traded stock where insider trading defendant actively encouraged victims to sell shares to him based on insider trading information known only to him.

**RECOMMENDATION:** In view of the above, the Committee makes the following recommendations, -

- i. Quantification of profit wherever possible should be done on the basis of the composite default and liability should generally be imposed on a joint and several basis;
- ii. When imposing liability on an individual basis, quantification may not be required where the penalty otherwise imposed is sufficient;
- iii. When imposing penalties, quantification of loss is generally appropriate in cases of joint and several liability or in case of the main accused noticee(s) rather than for ‘victimless defaults’ or for each and every individual involved in the default since apportioning loss between multiple defaulters may be even more difficult than apportioning illegal gains. Further, there is no equity between defaulters at time of directing joint disgorgement or joint penalties. It is also relevant for considering the amount of penalty to be levied within the range provided by law;
- iv. Further, in cases where it appears that the loss to the investors and profit made out of the default are more or less same, then either profit made or loss caused may be calculated using any available methodology.

### **3. WHAT IS THE ‘STANDARD’ TO BE ADOPTED FOR QUANTIFICATION?**

Quantification of ‘profits made’ and ‘losses caused’ requires the Board to examine the behaviour of the defaulter as well as the investors who may have suffered as a consequence of the default.

**STANDARD OF THE COMPLIANT MAN:** The defaulter’s behaviour has to be compared vis-à-vis the behaviour of a person who complies with securities laws. The monetary and non-

monetary benefits received by a defaulter has to be compared with the benefits received by the compliant man. *Prima facie*, the excess represents the unlawful gains of the defaulter. However, this simple formulation can sometimes require some complex computation to quantify the gains. In cases involving sale of securities, it matters whether the securities were purchased during the course of (or immediately before) the violation or sometime before. In the former case, it is easy to identify the gains using the difference in price, since the gains are directly tied to the unlawful activity. Whereas in the latter case, pre-existing gains that are legal need to be separated from the gains tied to the period of the unlawful activity. Similar issues arise when securities which have been manipulated are susceptible to movement on account of general market movement. Such movements affect all persons equally. Such movements may inflate or depress the profit of the defaulter in the same way as they would affect any investor. In order to estimate the profit resulting from a default, it may at times be important to differentiate, wherever possible, the profit resulting from general market movements and those resulting from the default. When the monies involved are large, then it is beneficial to use complex statistical methods such as those used by securities regulators world-wide to differentiate between legal gains and unlawful gains as the legal gains may be appreciably large enough to be estimated, provided the defaulter supplies the necessary information.

**STANDARD OF THE REASONABLE INVESTOR:** Securities markets operate differently from the markets of other goods and services. India follows a disclosure based regime similar to that of many developed jurisdictions. These markets are presumed to function on the lines of an *efficient market* hypothesis where the market assimilates all available information into the price of the security. An investor who trades securities at the price set by an impersonal market does so by relying on the integrity of that price. Since most publicly available information is reflected in the market price, an investor's reliance on any public material misrepresentations may be presumed for various purposes. Securities market jurisprudence is built around the concept of 'fraud-on-the-market' i.e. in an open and developed securities market, the price of a company's securities are determined by the available material information regarding the company and its business. Misleading statements will therefore defraud the investors of securities even if the investors do not

directly rely on the misstatements. The misstatements affect the price of the security, and thus defraud investors who rely on the price which is an indication of the security's value and all relevant information relating to that security. The causal connection between the defaulter's fraud and the investors' purchase of a security in such a case is no less significant than in case of direct reliance on misrepresentations. In both cases, defaulter's fraudulent statements or omissions cause investors to purchase securities which they would not have purchased absent defaulter's misstatements and/or omissions. Thus in securities laws cases SEBI is not required to prove direct reliance by investors on defaulter's misrepresentations but can satisfy its burden of proof on the element of causation by showing that the defaulter made material misrepresentations and it will be presumed that the misrepresentations occasioned an increase in the security's value that, in turn, induced the investors to purchase a security, though it may very well be that the investors never bothered to take note of the disclosures made on the exchange or the bulky prospectuses or that they were guided by astrological considerations or were just investing at a whim. The investors are presumed to have behaved in a reasonable way. The standard of a reasonable investor was recognised by the US Supreme Court in several matters.<sup>87</sup> This has been applied in the context of Indian securities litigation as well<sup>88</sup> and relied upon by SEBI also.<sup>89</sup>

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<sup>87</sup> *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 96 S.Ct. 2126, 48 L.Ed.2d 757 (1976), available at <<https://casetext.com/case/tsc-industries-inc-v-northway-inc?q=426%20U.S.%20438%20&p=1&tab=keyword&jxs=&sort=relevance&type=case>> (An omitted fact is material if there is a substantial likelihood that a *reasonable shareholder* would consider it important in deciding how to vote. It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote, but contemplates a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the reasonable shareholder's deliberations.); *Basic Incorporated, et al. v. Max L. Levinson, et al.*, 485 U.S. 224 (1988) (108 S.Ct. 978, 99 L.Ed.2d 194), available at <<https://casetext.com/case/basic-incorporated-v-levinson?q=485%20U.S.%20224%20&p=1&tab=keyword&jxs=&sort=relevance&type=case>> (“We face here the narrow question whether information concerning the existence and status of preliminary merger discussions is significant to the *reasonable investor's* trading decision.... We therefore find no valid justification for artificially excluding from the definition of materiality information concerning merger discussions, which would otherwise be considered significant to the trading decision of a *reasonable investor*, merely because agreement-in-principle as to price and structure has not yet been reached by the parties or their representatives”).

<sup>88</sup> See *In re Pharma Pharmaceuticals Products of India Ltd.*, (2006) 131 Comp Cas 747 (Bom). (2006) 5 CompLJ 282 Bom; 2006 70 SCL 93 Bom; *Maneck-chowk and Ahmedabad Manufacturing Co. Ltd., In re*, [1970] 40 Comp Cas 819. (The petitioner must *prima facie* show that the scheme is preeminently fair and reasonable as a prudent and reasonable shareholder would approve of and not object to.) Also See *Miheer H. Mafatlal v Mafatlal Industries Ltd*, JT 1996 (8) 205 (SC).

<sup>89</sup> SEBI Discussion Paper on review of Clause 36 and related clauses of the equity listing agreement, available at <[https://www.sebi.gov.in/sebi\\_data/attachdocs/1408444809721.pdf](https://www.sebi.gov.in/sebi_data/attachdocs/1408444809721.pdf)>; Also see *Hindustan Lever Ltd. v SEBI*, 1998

While considering the above standards, a few other factors also need to be kept in mind, such as cases which revolve around an omission(s), such as failure to give an advertisement in respect of changes between the draft offer documents and the RHP, failure to give an open offer, etc. In order to impart seriousness to compliance of laws, it is important to consider the 'cost of compliance' avoided instead of imposing base penalties of a few lakhs or thousands. In such cases, the defaulter avoids 'fixed' costs such as the cost of giving the advertisement or making the open offer. These 'fixed costs' can be estimated based on the prevailing practices by comparison with similarly placed compliant market participants. To these 'fixed' benefits, there may also be 'variable' benefits. In particular, in the case of an open offer, it may be possible that the open offer, even if it had been made, it would not have evinced any interest from the investors or it may have been partly or fully subscribed; however, it is clear that the intent behind evading the open offer obligation was the probability of it being subscribed. Since the standard of proof in civil and administrative proceedings is the test of preponderance of probability<sup>90</sup>, quantification can be based on assumptions that match the intent. Quantification of gains becomes difficult in such cases but not impossible. In such cases, law permits that a presumption may be made in respect of *the 'common course of natural events, human conduct and public and private business'*<sup>91</sup>, having regard to the facts of *the particular scrip* by comparing with similar scrips and open offers, etc. made in the past a probable cost may be determined and the noticee may be given an opportunity to show why such assumptions adopted may not be correct and some other amount may be arrived at, e.g. on these very lines Table VI of the Schedule-II of the Settlement Regulations *inter alia* already provide for the Board to consider the '*probable cost of open*

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(18) SCL 311 (AA), detailing SEBI's order dated 11.03.1998. (SEBI *inter alia* held that, since information about merger would have affected the price of securities and any reasonable investor would have attached importance to such an information, non-disclosure of this information to UTI put UTI to distinct disadvantage and prevented it from taking an informed decision.)

<sup>90</sup> *Adjudicating Officer, SEBI v Bhavesh Pabari*, 2019 (3) SCALE 447, available at <[https://www.supremecourtfindia.nic.in/supremecourt/2013/36291/36291\\_2013\\_Judgement\\_28-Feb-2019.pdf](https://www.supremecourtfindia.nic.in/supremecourt/2013/36291/36291_2013_Judgement_28-Feb-2019.pdf)>.

<sup>91</sup> See Section 114 of the Indian Evidence Act, 1872, which has been held to be relevant and applicable to proceedings under securities laws and applied by the Supreme Court in *SIRECL & Ors v SEBI & Anr.*, order dated 31.08.2012 available at <<https://www.sebi.gov.in/enforcement/orders/aug-2012/order-in-the-matter-of-sahara-india-real-estate-corporation-limited-and-ors-23665.html>>.



*offer as recommended by the Corporate Finance Department.* Just as independent valuers are used for valuation of properties, costs may be called from independent merchant bankers using relevant information sought from the noticee to determine the probable cost of an open offer.

Similarly, there are omissions where the monies of clients are mixed with own funds to satisfy some margin or net-worth requirements. In these cases, the time value of the funds so taken or provided, needs to be taken into account with any other attendant profit.

There are also instances where a benefit may be drawn in respect of legal and illegal activities, such as salary, bonuses, etc. These issues have also been dealt with in the Report.

To the extent possible, the Board should attempt to quantify the fixed and variable benefits and losses, though the exact amounts may never be ascertainable with certainty, since uncertainty is a necessary feature of any dynamic securities market and investors and defaulters are subject to it alike; it is not an advantage or a disadvantage for either. Investors and defaulters are willing to subject themselves to market uncertainties while making trading decisions for making profits, they must therefore be subjected to the same uncertainties when being adjudicated for unlawful activities.

**INVESTOR'S RIGHT OF RESTITUTION v LOSS COMPENSATION:** The standards are relevant for determining *inter alia* losses by investors, which is only used as a measure for guidance for determining penalty to be levied rather than for grant of compensation. For the purpose of computation of losses to the investors while levying penalties, the investors are assumed to have acted in a reasonable manner and thus suffered in a similar manner allowing the determination to be made in an approximate manner instead of involving the regulator in a never ending inquiry involving millions of investors in every other proceeding. However, it is quite possible that investors may have suffered higher or lower losses or even the number of investors affected may be larger since the securities may change several hands during the default period. Since the uncertainty is a result of the

misconduct of the defaulter he bears the risk of uncertainty and cannot object to the approximation method for quantification of loss. Hence, the methods of loss quantification recommended in this report are used only to provide guidance in levy of penalty in India (or to determine terms of imprisonment and quantum of fines in the USA) and not for providing compensation to the investors since that power is anyways not vested with SEBI but with the civil court (or commercial courts) and the NCLT in certain instances. Investors must independently discharge their burden in the proceedings brought by them.<sup>92</sup>

#### 4. QUANTIFICATION OF LOSS TO INVESTORS

Quantification of loss to investors in respect of a closed group (a PMS, MF, AIF or an InVIT, etc.) is easier since the investors partake in a common scheme fund and the details of the investment values and subsequent values are easily available. The funds are required to calculate NAV on a regular basis and the same can be used.

The issue of multiple causation commonly arises when a defaulter's conduct has apparently caused some actual loss to the victim, but the defaulter alleges that but for the intervention of unforeseen factors, the loss would have been smaller or would not have occurred at all. Consider, for example, a victim who purchased stock based on a defaulter's fraudulent misrepresentations about its value, and then sees the stock price decrease still further because of an unforeseen downturn in the stock market after the purchase. From one point of view, the only loss directly caused by the defendant in this case is the difference between price the victim paid for the stock based on the misrepresentations by the defendant and the *intrinsic* market value of the stock at the time of purchase. On the other hand, *but for* the defaulter's blandishments, the victim would not have been holding the stock to begin with and thus would not have suffered the additional harm caused by the market decline which lowered the realisable value below the *intrinsic* market value of

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<sup>92</sup> *S.E.C. v. Tambone*, 597 F.3d 436, 461 (1st Cir. 2010), available at <<https://casetext.com/case/sec-exch-commn-v-tambone>> ([P]rivate litigants face multiple burdens in pleading securities claims. Not only must they meet the standard requirement that allegations of fraud be pleaded with particularity, but — unlike the SEC — they also must prove reliance on the alleged misrepresentations, economic loss, and loss causation).

the stock at the time of purchase.<sup>93</sup> Therefore, even in case of multiple causation except for what can be assessed and separated based on the facts available to the Board, the defaulter bears the responsibility for the default created by the uncertainty of his default as his default is the proximate cause.

**The need for asserting the importance of disclosures:** The year 1992 is important because that is the year when the Indian stock market moved towards a disclosure based regime. By a disclosure based regime, we mean a regime where the issue of capital and trading thereof are considered to be vital and the basis of an 'efficient securities markets'. However, the Committee is of the view that we have not really acknowledged the importance of true and fair disclosures. Even now the violation of disclosure requirements is considered 'technical' by the regulator as well as the Tribunal in several of their orders and pronouncements. Section 34 of the Companies Act, 2013 declares liability for fraud for misstatements in prospectus for issue of shares, but there is no such clarity in SEBI regulations which governs the issue of various kinds of securities and offer documents.

The Committee is of the view that unless the importance is given to disclosures, overall governance cannot improve. Similarly, giving importance to the quality and timing of disclosures and non-disclosures (other than those contained in offer documents) will also enable the regulator to focus on the various modes through which illegitimate profit is made by various delinquents. The Committee notes that in the USA, wherefrom the disgorgement remedy in the securities market has been adopted has been used for a plethora of violations and not just fraud, because no person can be permitted to profit for money had and received on account of any kind of violation of law, in particular,-

- i. Trading done after disclosure violations. Eg. The SEC requires that purchasers of more than 5% of the stock of a publicly traded company file a Schedule 13D within 10 business days after crossing the 5% threshold. A filer must promptly update the Schedule 13D filing to reflect any material change in the facts disclosed, including,

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<sup>93</sup> *Frank O. Bowman, Coping with "Loss": A Re-Examination of Sentencing Federal Economic Crimes under the Guidelines*, 1998 (3) Vol. 51 Vanderbilt Law Review 461, p 524, available at <<https://scholarship.law.missouri.edu/cgi/viewcontent.cgi?article=1077&context=facpubs>>.

among other things, the acquisition or disposition of 1% or more of the class of securities that are the subject of the filing. A late Schedule 13D filing results in disgorgement because it enables the purchaser to buy subsequent shares more cheaply than had he purchased them after the stock price reflected the disclosure;<sup>94</sup>

- ii. Negligence without fraudulent intent. E.g. corporate raider selling stock without disclosure after having announced an acquisition and before completion thereof.<sup>95</sup> Negligent failure to adopt and implement policies and procedures reasonably designed to prevent violations of securities laws.<sup>96</sup>
- iii. Failure to comply with business norms not amounting to fraud. E.g. Rating surveillance fees for 3 years were directed to be disgorged due to *inter alia* credit rating agency failing to disclose changes to certain surveillance assumptions as the methodology stated that the firm would do, misrepresenting its surveillance methodology for ratings of certain complex financial instruments during a three-year period, etc.<sup>97</sup>

Once greater attention is paid to disclosures requirements, any trading around the relevant period will allow the Board to compute the undue profits made and the losses caused to investors who were denied similar opportunity. Similarly, when a stock exchange purports to provide services to market participants, where market participants are lead to believe that they are all receiving similar kind of services from the exchange for similar fees when in fact they were not, the stock exchange may be asked to disgorge the monies earned in breach of law and of its fiduciary duty to the various market participants who traded on the stock exchange.

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<sup>94</sup> Mark L. Mitchell and Jeffrey M. Netter, *The Role of Financial Economics in Securities Fraud Cases: Applications at the Securities and Exchange Commission*, *The Business Lawyer*, Vol. 49, No. 2 (February 1994), 545, 554-556 & 579-582 available at <https://www.jstor.org/stable/40687469>.

<sup>95</sup> Mark L. Mitchell and Jeffrey M. Netter, *The Role of Financial Economics in Securities Fraud Cases: Applications at the Securities and Exchange Commission*, *The Business Lawyer*, Vol. 49, No. 2 (February 1994), 545, 583-584 available at <https://www.jstor.org/stable/40687469>.

<sup>96</sup> SEC Administrative Order in the matter of *TPG Capital Advisors LLC* dated 21.12.2017, available at <https://www.sec.gov/litigation/admin/2017/ia-4830.pdf>.

<sup>97</sup> SEC order against *DBRS Inc.* available at <https://www.sec.gov/litigation/admin/2015/34-76261.pdf>.

Disclosures are important from the perspective of the investors also. Merely because the disclosure that was not made indicates 'no change', especially ownership and financial information, compared to past disclosure does not mean it is technical. Infact, information disclosed on a stock exchange including that which reflects 'no growth' or 'no change' may be a key driver for timely divestment by investors to invest in some other scrip where growth is more probable. While large acquirers undertake their own additional due-diligences, the regulatory disclosures are the key drivers of price movement for investors. Investor wealth grows if the company grows, investors choose to invest, stay invested or divest based on the price outlook which depends on the disclosed information, even if it is no information. After all, the efficient market concept implies that all available, or lack of information, is reflected in the price of the listed stock.

The importance of disclosures is also crucial in financial economics (discussed later in this Report) which uses *inter alia* event study methodologies that focus on the study of the effect of disclosures on price of the securities markets. A focus on the effect of disclosures/non-disclosures and 'follow the money (or securities or assets)' are the key foundation of investigation in securities laws. These statistical techniques in conjunction with focus on disclosures will enhance the ability of the regulator to quantify profit made due to failure from disclosures and the loss caused to investors.

**RECOMMENDATION:** The Committee is of the view that,-

- i. The SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003 may be amended on the lines of Section 34 of the Companies Act, 2013 to clarify that misstatements of any kind in an offer document, placement memorandum, or any other document calling for subscription to securities amounts to fraud;
- ii. The period of investigation, inquiry, audit or examination should ideally encompass the trading around the period the disclosures were required to be made or have been made and also encompass any delinquent who may be the

recipient of the unlawful proceeds or securities/assets. An internal Circular may be issued in respect of this guideline.

**AT-LEAST BASIS:** Loss calculation is not easy and in certain cases can reflect the nature of the complexity of the scam. Especially in cases where a fraud has been perpetrated over a period of time, the amount of loss though not entirely quantifiable, still an attempt can be made on 'at least' basis. In *U.S. v Ebbbers*,<sup>98</sup> the Court of Appeals estimated a loss to the investors of at least US \$ one billion and *inter alia* held as follows:

“Determining this amount is no easy task. One version of the so-called market capitalization test would, in its simplest form, take the share price on the date of a fraudulent statement—X-day, we shall call it—subtract from it the share price on the day after the fraud is revealed—Y-day— and multiply that amount by the number of outstanding shares.

There is a problem, however, with this simplistic analysis. If the truth had been told on X-day, shareholder A would have suffered an immediate loss commensurate with the fraud loss because potential buyers at the earlier price would have immediately disappeared upon the bad news. When perpetrated, therefore, the fraud would not damage A anymore than the truth, at least immediately. However, were investor B to buy the stock after the fraudulent statement and in reliance upon the integrity of the market price, B would suffer a loss in the amount of the price paid less the intrinsic value, which, under the market capitalization test, would usually be deemed to be the price after the disclosure of the fraud on Y-day.

While shareholder A is as damaged by the truth as by the fraud on X-day, many frauds are ongoing, and, contrary to the testimony of Ebbbers' expert, shareholder A may suffer a loss over time in being misled in assessing whether to hold or sell the stock. While A can be said not to have lost anything as a

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<sup>98</sup> 458 F.3d 110 (2<sup>nd</sup> Cir. 2006), available at <<https://www.leagle.com/decision/2006568458f3d1101558>>.

result of the fraud on X-day —assuming no prior disclosure obligation on the defendant's part—if new fraudulent statements are issued on X +1, X +2, etc., and the company's true value has further diminished on each occasion, the succeeding X-day frauds would have the effect of preventing A from making an informed judgment about holding the stock.

The securities laws are intended to allow investors to buy, sell, or hold based on accurate information. An investor who buys securities before an extended fraud begins, and holds them during the period of the fraud, may therefore be little different from one who buys in mid-fraud.

For example, the ongoing fraud here involved a series of periodic, fraudulent financial reports that systematically inflated WorldCom's operating profits. If the first report had been accurate, some decrease in fundamental value would have been revealed, but the decrease would have been far less than that revealed in June 2002 after several more fraudulent reports. Investors who held their stock throughout the fraud period were therefore denied the opportunity to reassess and perhaps sell according to their own informed estimates of the declining performance.

The loss to investors who hold during the period of an ongoing fraud is not easily quantifiable because we cannot accurately assess what their conduct would have been had they known the truth. However, some estimate must be made for Guidelines' purposes, or perpetrators of fraud would get a windfall. (*emphasis supplied*) Moreover, revelation of an extended period of fraudulent financial statements may cause losses beyond that resulting from the restatement of financial circumstances because confidence in management and in even the truthful portions of a financial statement will be lost. ...

To be sure, this calculation is flawed. Ebberts' expert testified that at least some of the decline in WorldCom's stock price immediately after June 25,

2002, was attributable to factors other than accounting fraud, ... Even so, the loss amount is still well above \$1 billion, or ten times greater than the \$100 million dollar threshold for the 26-level enhancement.... Even a loss calculation of \$1 billion is therefore almost certainly too low, and there is no reasonable calculation of loss to investors that would call for a remand.”

Further, since there is no direct relation between the loss to investors and the penalty or fine to be levied or the term of imprisonment to be ordered, the strictness with which the loss needs to be calculated, is not found in Indian securities laws.

#### **A. DIFFICULTY IN RESPECT OF AN UNREGISTERED OR FRAUDULENT SCHEME FUNDS.**

In securities schemes where money has been raised without the required approvals under law e.g. certificate of registration, the person raising the funds without registration (and his creditors acquire no right to such funds<sup>99</sup>) hold the monies in trust and must refund them. The Hon’ble Supreme Court in *PGF Limited & Ors. v Union of India & Anr.*<sup>100</sup> has noted that *‘The investors virtually by signing on the dotted lines of those stereotyped blank documents would never be aware of the nature of constraints created in the document, which would virtually wipe out whatever investment made by them in course of time and ultimately having regard to the legal tangles in which such investors would have to undergo by spending further monies on litigations, ultimately prefer to ignore their investments cursing themselves of their fate. More than 90 per cent of such*

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<sup>99</sup> See *G. R. Deo, Liquidator, C.P. and Berar Government Clerks’ Mutual benefit Fund, Nagpur v F Karim and Anr*, AIR 1946 Nag 196, wherein the High Court *inter alia* held as follows:

“The question is whether these sums, however paid, and however received, and into whatever account they were paid, can be claimed by the liquidator as part of the company's assets. In our opinion, they cannot. Section 3 (l), Insurance Act of 1938, contains an express prohibition. It states that:

No insurer carrying on any class of insurance business in British India shall, after the expiry of three months from the commencement of this Act, continue to carry on such business, unless he has obtained from the Superintendent of Insurance a certificate of registration.

8. As the certificate was not obtained, the company was prevented by law from carrying on its business. Part of its business was to obtain contributions from its members. Therefore, it was prohibited from receiving these contributions. Accordingly, if it continued to receive these moneys in spite of this prohibition, it could not, in our opinion, claim the moneys as its own..”

<sup>100</sup> Civil Appeal No. 6572 of 2004, Judgment dated 12.03.2013, Para 41.



*investors would prefer to forget such investments than making any attempt to secure their money back. Thereby, the promoters put to unlawful gain who always thrive on other peoples money.'* Thus in such cases it is safe to say that, unless refunded the monies raised amount to unlawful gain.

Similarly, the loss computation arises in the context of the monies raised and the monies available for refund. Also since the person (or the liquidator thereof and his creditors) has no title to the funds, the monies in excess must go the IEPF<sup>101</sup> or the IPEF<sup>102</sup>, as the case may be.

**RECOMMENDATION:** In this respect some of the principles that may be used for quantifying the losses to investors are as follows, -

- i. In case of an investment scheme requiring registration under securities laws, loss to an investor shall not be reduced by the money or the value of the property transferred to any individual investor in the scheme in excess of that investor's principal investment (*i.e.*, the gain to an individual investor in the scheme shall not be used to offset the loss to another individual investor in the scheme);<sup>103</sup>
- ii. In a case involving a scheme in which - (I) services were fraudulently rendered to the victim by persons falsely posing as licensed/registered professionals; (II) services were falsely represented as approved by SEBI or a governmental regulatory agency; or (III) services for which regulatory approval by SEBI or a government agency was required but not obtained, or was obtained by fraud, - loss shall include the amount paid for the property or services transferred, rendered, or misrepresented, with no credit provided for the value of those items or services;<sup>104</sup> and

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<sup>101</sup> See Section 125 of the Companies Act, 2013.

<sup>102</sup> See SEBI (Investor Protection and Education Fund) Regulations, 2009.

<sup>103</sup> US Sentencing Guidelines p 98, available at <<https://www.uscc.gov/sites/default/files/pdf/guidelines-manual/2016/GLMFull.pdf>>.

<sup>104</sup> *Ibid.*

- iii. The losses equal the unreturned amounts originally invested by the investors and the earnings re-invested in such schemes (promised returns which are not re-invested are not part of the loss calculation), even though those earnings accrued as a result of such schemes. However, the most recent promised or reported earnings are excluded.<sup>105</sup>

**B. LOSS TO INVESTORS DUE TO DEFLATION OR INFLATION BY DEFAULTS SUCH AS FRAUDULENT TRADING, FALSE OR MISLEADING INFORMATION, ETC.**

Generally, there is no loss attributable to a fraud unless and until the truth (by truth we mean any *information* which breaks the veneer of falsehood and thus discloses the fraud, since the whole truth may never come to the knowledge of the market) is subsequently revealed and the price of the stock is adversely affected. Where the value of a security declines for other reasons, however, such decline, or component of the decline, is not a "loss" attributable to the fraud<sup>106</sup> and where such 'attributable' loss is mixed with 'un-attributable' loss it may be distinguished from attributable loss to the extent possible.

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<sup>105</sup> Primer Loss Calculations under §2B1.1(b)(1) of the US Sentencing Guidelines p 23, available at <[https://www.ussc.gov/sites/default/files/pdf/training/primers/2016\\_Primer\\_Loss.pdf](https://www.ussc.gov/sites/default/files/pdf/training/primers/2016_Primer_Loss.pdf)>. See *United States v Hsu*, 669 F.3d 112 (2d Cir. 2012), available at <<https://www.courtlistener.com/opinion/623036/united-states-v-hsu/>>:

"The guidelines provide that when an investor puts money into a fraudster's hands, and ultimately receives nothing of value in return, his loss is measured by the amount of principal invested, not by the principal amount plus the promised interest or return that was never received. The situation is different, however, in a case in which an investor is told not simply that his investment will grow, but that it has grown, and that the total of his original investment and the accrued interest or other gain is now available to be withdrawn or reinvested in the scheme, depending on the investor's preference. (*emphasis supplied*) ... The task in Hsu's case, however, is straightforward. Hsu's victims frequently returned post-dated checks to him for reinvestment, thereby relinquishing the opportunity to cash those checks and withdraw from the scheme. When this occurred, the reinvested checks- including the previously promised returns- became part of their principal investment, and therefore constitute the very losses that Hsu intended to inflict upon his victims. The fact that such money may never have "existed," or that the scheme may have collapsed sooner if all investors had attempted to withdraw their purported gains at once, does not affect the loss calculation. On the facts of this case, the investors were given a clear opportunity to withdraw the total amount of their principal and accrued interest, and were induced not to do so by fraudulent promises of continued gain. The reinvestments were thus appropriately counted as loss. (*emphasis supplied*) Hsu's argument that the "gains" did not exist, and that there was no money to pay the investors, reduces to the claim that the victims' losses do not count because he was unable to pay them back."

<sup>106</sup> See *United States v. Olis*, 429 F.3d 540, 546 (5th Cir. 2005), available at <<https://www.leagle.com/decision/2005969429f3d5401966>>.

**RECOMMENDATION:** In case of frauds where a large number of investors get affected the loss may be calculated on the affected shares using the methods indicated by the US Sentencing Commission and those used in securities litigations, with suitable modifications as follows, -

**“Inflation or Deflation in Value of Securities.**—In a case involving the fraudulent inflation or deflation in the value of securities, *the Board in determining loss may use any method including the following that is appropriate and practicable under the circumstances,* -

i. **MODIFIED RESCISSORY METHOD**<sup>107</sup>: the actual loss attributable to the change in value of the security is the amount determined by—

(I) calculating the difference between the average price of the security during the period that the fraud occurred and the average price of the security during the relevant<sup>108</sup> period after the fraud was disclosed to the market or after the misconduct ended, as may be applicable, and

(II) multiplying the difference in average price by the number of securities out-standing after excluding those held by the defaulters themselves (if they amount to substantial holdings) throughout the period of the default, if available.

*Explanation 1.* – Average price may be calculated by using the closing price of each trading day of the time period selected or by

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<sup>107</sup> *United States v. Bakhit*, 218 F. Supp. 2d 1232 (C.D. Cal. 2002), available at <<https://www.courtlistener.com/opinion/2360321/united-states-v-bakhit/>>; *United States v. Grabske*, 260 F.Supp.2d 866 (2002), available at <<https://www.courtlistener.com/opinion/2578802/united-states-v-grabske/>>:

“It is thus appropriate to compute the loss based on the average purchase price during the fraud and the average price during a relevant period after the fraud. Second, the rescissory method eliminates, or at least reduces, the complexity, uncertainty, and expense inherent in attempting to determine out-of-pocket losses.”

<sup>108</sup> **Suitable period:** choice of appropriate time period may be made to *inter alia* consider the time when the market could be said to have absorbed the information and reflect the same in the price of the security. There may be delay with which the market may start correcting itself or extended periods for the market to correct itself. This depends on individual stock and market conditions as seen in *Trojan & Co. Ltd v R. M. N. N. Nagappa Chettiar*, AIR 1953 SC 235: 1953SCR780, it need not begin immediately.

using any other relevant price, including weighted average price or other method. It is not necessary that the relevant period may refer to the entire period from which the default occurred and the fraud came to a stop, the 'relevant' period may refer to a sub-period during which substantial trades took place or which was immediately connected to the fraud.

*Explanation 2.* – '**relevant' period for averaging: In case of illiquid securities** [including related exchange traded derivatives and debt instruments]: the price on the day (or the next trading day, whichever is appropriate) the true and fair information/fraud has been become publicly disseminated/stopped may be selected or the average price for a period not exceeding seven trading days, to the extent possible, after the true and fair information/fraud has been become publicly disseminated/stopped may be selected, as may be deemed fit.

*Explanation 3.* – '**relevant' period for averaging: In case of liquid securities** [including related exchange traded derivatives and debt instruments]: the period may be a multiple<sup>109</sup> of fifteen trading days to be selected after the true and fair information/fraud has been become publicly disseminated/stopped provided that it shall not exceed ninety days, to the extent possible, especially in relation to securities which are part of any index [including related exchange traded derivatives and debt instruments]. Shorter periods may be selected in case extraneous factors demonstrably affect the price.

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<sup>109</sup> The deeper the market for a security the longer the period, with maximum possible period in case of a main indices such as BSE SENSEX or NIFTY 50.

In determining whether the amount so determined is a reasonable estimate of the actual loss attributable to the change in value of the security, the Board may consider, among other factors, the extent to which the amount so determined includes ‘significant changes’ in value not resulting from the default (*e.g.*, changes caused by external market forces, such as changed economic circumstances, changed investor expectations, and new industry- specific or firm-specific facts, conditions, or events that appear to impact the price movement by more than 20%) by fixing if possible, a suitable percentage of the amount determined above.

ii. **MARKET CAPITALIZATION METHOD<sup>110</sup>**: the actual loss attributable to the change in value of the security is the amount determined by—

(I) calculating the difference between the immediate price of the security during a suitable period prior to the disclosure/stoppage of the fraud (usually the closing price the day before the disclosure/stoppage) and the immediate price of the security after the fraud was disclosed to the market/stopped (usually the closing price after the disclosure/stoppage) (or next day price), and

(II) multiplying the difference by the number of shares out-standing after excluding those held by the defaulters themselves (if they amount to substantial holdings) throughout the period of the default, if available.

In determining whether the amount so determined is a reasonable estimate of the actual loss attributable to the change in value of the

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<sup>110</sup> (Suitable for instances where the stock valuation falls substantially after the fraud *e.g.* WorldCom, Enron, Satyam, etc.) *United States v. Olis*, 429 F.3d 540, 546 (5th Cir. 2005), available at <<https://www.leagle.com/decision/2005969429f3d5401966>>; *United States v. Moskowitz*, 215 F.3d 265 (2d Cir.2000), available at <<https://law.justia.com/cases/federal/appellate-courts/F3/215/265/608045/>>; and *United States v. Hedges*, 175 F.3d 1312 (11th Cir.1999), available at <<https://www.leagle.com/decision/19991487175f3d131211334>>. See also *United States v. Bakhit*, 218 F. Supp. 2d 1232 (C.D. Cal. 2002), available at <<https://www.courtlistener.com/opinion/2360321/united-states-v-bakhit/>>.

security<sup>111</sup>, the Board may consider, among other factors, the extent to which the amount so determined includes ‘significant changes’ in value not resulting from the default (*e.g.*, changes caused by external market forces, such as changed economic circumstances, changed investor expectations, and new industry-specific or firm-specific facts, conditions, or events that appear to impact the price movement by more than 20%) by fixing if possible, a suitable percentage on the amount determined above:

Provided that in case of companies which become entirely worthless after the default, i.e. If the company whose securities is sold has no activities, assets, facilities, or any other source of value, so that "company" has no underlying equity; in such cases instead of taking the difference take the entire value of stock prior to the fraud coming to light.<sup>112</sup>

*Explanation.* – The fact that the stock cannot be traded at all after the fraudulent scheme came to light or the stock has been traded only by “insiders” in the fraudulent scheme shall be relevant to decide if the stock was worthless.

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<sup>111</sup> See *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005) (S.C.), available at <<https://supreme.justia.com/cases/federal/us/544/336/>>:

“For one thing, as a matter of pure logic, at the moment the transaction takes place, the plaintiff has suffered no loss; the inflated purchase payment is offset by ownership of a share that at that instant possesses equivalent value. Moreover, the logical link between the inflated share purchase price and any later economic loss is not invariably strong. Shares are normally purchased with an eye toward a later sale. But if, say, the purchaser sells the shares quickly before the relevant truth begins to leak out, the misrepresentation will not have led to any loss. If the purchaser sells later after the truth makes its way into the marketplace, an initially inflated purchase price might mean a later loss. But that is far from inevitably so. When the purchaser subsequently resells such shares, even at a lower price, that lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price. (The same is true in respect to a claim that a share's higher price is lower than it would otherwise have been, a claim we do not consider here.) Other things being equal, the longer the time between purchase and sale, the more likely that this is so, i.e., the more likely that other factors caused the loss.”

<sup>112</sup> *U.S. v. Zolp*, 479 F.3d 715 (9th Cir. 2007), available at <<https://law.resource.org/pub/us/case/reporter/F3/479/479.F3d.715.05-50822.html>>.

- iii. **MODIFIED MARKET CAPITALIZATION METHOD<sup>113</sup>**: comparing the change in stock value of other, stock of similarly placed but unaffiliated companies after irregularities in those companies were disclosed to the market. The average depreciation may be taken as loss caused.
- iv. **SIMPLE RECESSIONARY METHOD<sup>114</sup>**: the actual loss attributable to the change in value of the security is the amount determined by calculating the difference between the price paid by the affected set of investors and the price existing after the fraud was disclosed to the market/stopped.
- v. **AVERAGE LOSS TO VICTIM<sup>115</sup>**: the number of shares held by holders who are aggrieved and average loss based on the difference between the average price during the fraud (or relevant period selected) and average price during the averaging period selected after the fraud.”

The reasons for doing so are as follows, -

- i. Since there are several ways of calculating loss to investors due to the default, therefore only the most approximate calculation in a given set of facts and circumstances may be adopted, otherwise estimation of loss will be an endless inquiry;
- ii. Calculating loss based on depressed stock price on the date trading resumed following disclosure of fraud may result in an inflated loss adjustment because initial price drop may be temporary and an

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<sup>113</sup> *U.S. v. Berger*, 587 F.3d 1038 (9th Cir. 2009), available at <https://www.courtlistener.com/opinion/1345996/united-states-v-berger/>.

<sup>114</sup> Suitable for a loss calculation for a limited set of investors. See *United States v. Grabske*, 260 F. Supp. 2d 866, 872–73 (N.D. Cal. 2002), available at <https://www.courtlistener.com/opinion/2578802/united-states-v-grabske/> (loss is based upon the price that the victim paid for the security and the price of the security as it existed after the fraud was disclosed).

<sup>115</sup> Suitable for a loss calculation for a limited set of investors where the entire period small, max is a few weeks. See *United States v. Snyder*, 291 F. 3d 1291 (11th Cir 2002), available at <https://www.courtlistener.com/opinion/75836/united-states-v-harry-w-snyder-jr/>.

anomaly which could be an extreme reaction to the announcement of the fraud, hence a bounce-back period for averaging out anomalies has to be considered;<sup>116</sup>

- iii. Though the statute requires that the loss to investors as a result of the default to be calculated, no detailed empirical study is required to be done to consider the effect of every conceivable variable, which can affect the profit or loss. Unrelated market events are material only insofar as they could be identified and assessed;<sup>117</sup>
- iv. The aforesaid methods are neutral to the exact *modus operandi* which cause the price to rise or fall, whether it be false news or circular trading or something else, the aforesaid methods can be used;
- v. Investors have a right to recover exact damages under civil laws but not under securities laws proceedings where they serve only as a guidance tool, because compensating investors are not within SEBI's remit.<sup>118</sup> Hence methods to approximate loss are sufficient;
- vi. The direct losses caused are limited to only those investors who may trade with the fraudster; whereas indirect losses are between investors, some have lost money but their losses translate into profit of another sub-set of investors with whom they traded, and not that of the fraudster. In such cases, it is an impossible task to differentiate between the investors who have lost and who have unwittingly profited. Also several persons may have traded multiple times and

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<sup>116</sup> *United States v. Bakhit*, 218 F. Supp. 2d 1232 (C.D. Cal. 2002), available at <<https://www.courtlistener.com/opinion/2360321/united-states-v-bakhit/>>.

<sup>117</sup> *United States v. Gordon*, 710 F. 3d 1124 (10<sup>th</sup> Cir. 2013), available at <<https://www.leagle.com/decision/infco20130315045>>.

<sup>118</sup> *Rakesh Agarwal v SEBI*, [2004] 49 SCL 351 (SAT) (Further, the disgorgement of alleged profits is always directed as a measure of deterrence and not compensation. Also authority for the point that Civil Court jurisdiction is preserved with regard to matters which the Board is not empowered to pass orders by or under the SEBI Act), , available at <[https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi\\_data/attachdocs/1299749902889.pdf](https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi_data/attachdocs/1299749902889.pdf)>.



some may not have traded at all but lost money merely on account of holding it during the period of fraud. Hence a general approximation is made in respect of all the outstanding shares, as if they have been affected at least once. By its very nature, it is not meant to be an exact determination of loss caused for making compensation or restitution. Restitution is tied to the concept of profits made by the fraudster(s) and not the victim's losses, under the garb of restitution directing the fraudster(s) to make good the profits not received by him/them but by another set of trading investors, - would amount to compensation;

- vii. Investors buy and sell at different prices, some at great loss and some at a profit and the trades may be concentrated during a particular period and thereafter market forces may have resulted in a higher price notwithstanding the fraud thereby creating the perception of having diminished the effect of the fraud. Averaging and focusing on particular period around the relevant default, enables the loss to be calculated even in cases where price after the disclosure of the fraud was higher than the average price during the fraud.<sup>119</sup>

**DIFFERENTIATING IMPACT FROM MARKET MOVEMENTS AND THE DEFAULT:** There are many statistical techniques to understand the impact of information on price- some simple some complex depending on the nature of information. The Board as a specialised body regulating the securities market should become adept in using these techniques. Macroeconomic events— such as changes in interest rates, government spending, monetary policy, and oil prices just to name a few—affect almost all companies and the returns on almost all stocks. These changes have nothing to do with company-specific news. Some stocks are more (or less) affected than others by such market fluctuations and the sensitivity of a stock's returns to gyrations in market returns is called a stock's beta. Stocks with a beta ( $\beta$ ) greater than 1.0 typically respond more than one-for one to changes

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<sup>119</sup> *United States v. Snyder*, 291 F. 3d 1291 (11th Cir 2002), available at <<https://www.courtlistener.com/opinion/75836/united-states-v-harry-w-snyder-jr/>>.

in the return of the overall market. Stocks with a beta ( $\beta$ ) less than 1.0 typically vary less than one-for-one with market returns. A stock with a beta ( $\beta$ ) of 2.0 would therefore fall by twice the percentage as the market, on average, absent any company-specific news because that stock is twice as sensitive as the average stock to market movements. Stock returns can be broken down into two parts: (i) the part explained by market returns and the firm's beta ( $\beta$ ); and (ii) the part affected by company-specific news. These two parts are additive. Suppose that the broader market is down by 2% and a company with a beta ( $\beta$ ) of 2.0 releases a negative earnings announcement that would result in a precipitous decline of 10% solely related to the earnings announcement. Holding everything else constant, the stock should be down by 4% because of the market decline, plus another 10% because of the company specific news, for a total decline of 14%.<sup>120</sup>

Thus using statistical methods (the *Beta* ( $\beta$ ) and *Delta* ( $\Delta$ ) of securities are statistical aspects which are used for predicting behaviour of securities by investment managers, exchanges and other financial advisors) it may<sup>121</sup> be possible to even distinguish between impact caused by a default and impact caused by market forces acting on a scrip at the same time, since the impact from the market forces can be estimated and deducted from the actual movement.

**RECOMMENDATION:** Where the information mix includes information, which affects the market (it may be the entire securities market or sector-specific) it may be possible to use the *beta* ( $\beta$ ) of a scrip and *delta* ( $\Delta$ ) in case of options, if reliable, to arrive at the difference between projected change based on market data and actual change in addition to advanced statistical methods.

**C. SPECIAL CASE: LOSS TO INVESTORS MAY ARISE WITHOUT FALL IN PRICE OF SECURITY OR IN SPITE OF RECOVERY IN PRICE.**

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<sup>120</sup> For beta cases see, J Duncan, *Recalculating "Loss" in Securities Fraud*, (2013) 3 Harvard Business Law Review 257, pp 268-269 available at <[http://www.hblr.org/wp-content/uploads/2013/10/HLB202\\_crop.pdf](http://www.hblr.org/wp-content/uploads/2013/10/HLB202_crop.pdf)>.

<sup>121</sup> Like all statistical methods, it has drawbacks such as, -a *low correlation*, another statistical aspect, may make Beta unreliable. Also, given the nature of securities markets, *past results are no guarantee for future results*, hence the predictions may not always be spot on. However, Delta which is used for options trading is more highly predictive. The difference between predicted return and actual return can give the loss caused to investors as a result of the default.

This is a special case of loss to investors where positive and negative information is mixed. Shareholders may experience an actionable loss if stock does not appreciate as it would have absent the fraudulent conduct.<sup>122</sup> A recovery in share price after the fraud was disclosed to the purchasers does not automatically defeat an inference of economic loss.<sup>123</sup> The inflation in price attributable to fraud could be reduced or eliminated even if there were a net increase in price. That could happen, for example, if the company corrected the false information and at the same time issued unrelated positive information. “*A firm that lies about some assets cannot defeat liability by showing that other parts of its business did better than expected, counter-balancing the loss.*”<sup>124</sup> Suppose a mining corporation makes a market announcement that it has found gold and the price moves up

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<sup>122</sup> See *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005) (S.C.), available at <<https://supreme.justia.com/cases/federal/us/544/336/>>.

<sup>123</sup> See *In re Columbia Sec. Litig.*, 155 F.R.D. 466, 483 (S.D.N.Y. 1994); *Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824, 832 (8<sup>th</sup> Cir. 2003), available at <<https://openjurist.org/335/f3d/824/gebhardt-v-conagra-foods-inc-c-p-w-d>>:

“ConAgra argues that since its stock's value increased in the weeks after the May announcement the plaintiffs can show no connection between the misrepresentations and any loss. However, stockholders can be damaged in ways other than seeing their stocks decline. If a stock does not appreciate, as it would have absent the fraudulent conduct, investors have suffered harm. (*emphasis supplied*) Therefore, we decline to attach dispositive significance to the stock's price movements absent sufficient facts and expert testimony, which cannot be considered at this procedural juncture, to put this information in its proper context.”

*Acticon AG v. China North East Petroleum Holdings Ltd.*, 692 F.3d 34 (2d Cir. 2012), available at <<https://www.leagle.com/decision/infco20120801053>>. Acticon alleged that NEP misled investors about its reported earnings, oil reserves, and internal controls. It further alleged that NEP revealed this information through a series of corrective disclosures and that in the trading days after each disclosure was made, NEP's stock price dropped. NEP argued that these allegations are not sufficient to allege economic loss because its share price rebounded on certain days after the final disclosure to the point that Acticon could have sold its holdings and avoided a loss. The Court disagreed with NEP and *inter alia* held that, -

“[A] share of stock that has regained its value after a period of decline is not functionally equivalent to an inflated share that has never lost value. This analysis takes two snapshots of the plaintiff's economic situation and equates them without taking into account anything that happened in between; it assumes that if there are any intervening losses, they can be offset by intervening gains. But it is improper to offset gains that the plaintiff recovers after the fraud becomes known against losses caused by the revelation of the fraud if the stock recovers value for completely unrelated reasons. Such a holding would place the plaintiff in a worse position than he would have been absent the fraud. (*emphasis supplied*) Subject to the bounce-back limitation imposed by the PSLRA, a securities fraud action attempts to make a plaintiff whole by allowing him to recover his out-of-pocket damages, that is, the difference between what he paid for a security and the uninflated price. See *Levine*, 439 F.2d at 334. In the absence of fraud, the plaintiff would have purchased the security at an uninflated price and would have also benefitted from the unrelated gain in stock price. If we credit an unrelated gain against the plaintiff's recovery for the inflated purchase price, he has not been brought to the same position as a plaintiff who was not defrauded because he does not have the opportunity to profit (or suffer losses) from ‘a second investment decision unrelated to his initial decision to purchase the stock.’”) (*emphasis supplied*)

<sup>124</sup> *Goldberg v. Household Bank, F.S.B.*, 890 F.2d 965, 966 (7<sup>th</sup> Cir. 1989), available at <<https://openjurist.org/890/f2d/965>> (in relation to earnings re-statement by a bank).

from Rs. 10 to Rs. 100/- a share, and investors purchase shares of the corporation. After a few months the corporation announces that they have found platinum but not gold. The stock price rockets to Rs. 1000, in this case the corporation may still have caused loss to investors as the price could have been higher by Rs. 90 had the company found both gold and platinum.<sup>125</sup>

**RECOMMENDATION:** In cases where price is affected by positive and negative news relating to the company examination of loss may be possible by examining their separate and cumulative effect.

##### **5. PRINCIPLES RELATING TO QUANTIFICATION OF DISPROPORTIONATE GAIN MADE IN INSIDER TRADING MATTERS**

In respect of insider trading, the Committee proposes to discuss quantification in respect of disgorgement and in respect of penalties separately, due to the unique nature of disgorgement and for ensuring a sound enforcement regime against insider trading apart from just quantification.

The prevention of insider trading is dependent on fixing a suitable deterrent on the insiders who engage in ‘tipping.’ When directors and other insiders within the company directly engage in tipping, the profits made by such insiders who themselves trade are easy to figure out and therefore easier to subject to deterrent penalties and disgorgement. However, even insiders know this and that is why this form of insider trading is rare. Instead, such company insiders ‘tip’ off outsiders including their relatives, who then trade. There are several advantages to such modus operandi, -

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<sup>125</sup> This example is adapted from the U.S. Supreme Court’s oral proceedings in *Dura Pharmaceuticals, Inc. v. Broudo*. Transcript of Oral Argument, *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 2005 WL 236546, (Jan. 12, 2005) available at <[https://www.supremecourt.gov/oral\\_arguments/argument\\_transcripts/2004/03-932.pdf](https://www.supremecourt.gov/oral_arguments/argument_transcripts/2004/03-932.pdf)>. Also See Elizabeth Chamblee Burch, *Reassessing Damages in Securities Fraud Class Actions*, available at <<https://core.ac.uk/download/pdf/76623384.pdf>>:

‘If the gold-platinum scenario sounds too hypothetical, consider a pharmaceutical company that announces higher than expected profits to create a market frenzy and later issues both a revised filing revealing its past financial woes and announces that it received regulatory approval for a new cancer-fighting drug.’

- i. It may be difficult to prove the link between such persons;
- ii. Even if the link is proven, the person who actually commits insider trading may be a person of little consequence propped up to bear the blame of insider trading. Further, the profits made may have been withdrawn from their bank accounts without leaving a trace, thus even before the crime is detected, the entire proceeds become irrecoverable from such propped up persons. Hence imposing a penalty or debarment on such a person may have no deterrent effect since he was selected because he has no real association with the securities markets and the monies would be irrecoverable; and
- iii. The inside tipper can always claim to not have 'benefitted' from the whole event even though insider trading could not have been possible without him breaching his fiduciary duties to the company and the shareholders in the first place. Though the company insider's liability is the greatest, he tries to appear as the most 'innocent' of the lot by claiming he has not benefitted- if this were true there is no reason for such defaults to happen in the first place. Unless joint liability is considered it will be difficult to justify levy of deterrent penalty and debarment on such delinquent insiders when their cases are considered individually.

The unfortunate result of the present state of law is that insider trading continues unabated, without material deterrent to company insiders who are the first line of defence against insider trading.

## A. DISGORGEMENT FOR INSIDER TRADING.

It is the view of the Committee that, the joint penal provision of the SEBI Act is clear in respect of tippers link with the profit of the tippee<sup>126</sup>, however there is little clarity in respect of disgorgement.

In this respect an analysis of the law of disgorgement is essential. SEBI initially attempted to develop an equitable tool for disgorgement similar to that found in developed jurisdictions. It however failed in its initial attempts since the remedy of disgorgement was framed as tool of compensation rather than as an anti-unjust enrichment mechanism.<sup>127</sup> Disgorgement depends on the profits made. Subsequently, in *Karvy Stock Broking Ltd. v SEBI*<sup>128</sup>, which is the foundational case of disgorgement law in India<sup>129</sup>, the Board had,<sup>130</sup> ordered disgorgement and imposed joint and several liability while doing so.

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<sup>126</sup> See 5.B below.

<sup>127</sup> *Rakesh Agarwal v SEBI*, [2004] 49 SCL 351 (SAT), available at <[https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi\\_data/attachdocs/1299749902889.pdf](https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi_data/attachdocs/1299749902889.pdf)> and *Hindustan Lever v. SEBI*, [1998] 18 SCL 311 (Appellate Authority); the remedy never had a compensatory nature to begin with even in the USA, see *Federal Trade Commission v. Bronson Partners, LLC*, 654 F.3d 359 (2d Cir. 2011), available at <<https://www.courtlistener.com/opinion/223605/ftc-v-bronson-partners-llc/>>:

“Nor, having obtained a disgorgement award, are public entities required to make any particular effort to compensate the victims that they can identify. See *Fischbach*, 133 F.3d at 176; see also *SEC v. Wang*, 944 F.2d 80, 88 (2d Cir.1991) (affirming a distribution plan that engaged in "line-drawing[,] which inevitably leaves out some potential claimants"). While agencies may, as a matter of grace, attempt to return as much of the disgorgement proceeds as possible, the remedy is not, strictly speaking, restitutionary at all, in that the award runs in favor of the Treasury, not of the victims.”

<sup>128</sup> [2008] 84 SCL 208 (SAT), available at <<https://indiacorplaw.in/wp-content/uploads/2008/05/karvystock.pdf>>.

<sup>129</sup> Though *NSDL v SEBI*, Appeal No. 147/2006, SAT Order dated 22.11.2007, available at <[https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi\\_data/attachdocs/1291962820302.pdf](https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi_data/attachdocs/1291962820302.pdf)> was decided before *Karvy Stock Broking Ltd. v SEBI*, both were related cases and the Tribunal was of the view that ‘*We are further of the view that all these issues should have been determined only after the passing of the final order holding the appellants guilty of the alleged wrong doings for which proceedings are still pending.*’ The law relating to disgorgement was explained and laid down in the subsequent case of *Karvy Stock Broking Ltd. v SEBI*.

<sup>130</sup> *Ibid*:

“The liability of all the 10 entities to disgorge the aforesaid amount was made joint and several as, according to the Board, they were a party to one large fraud where they either deliberately closed their eyes when the wrong doers perpetrated their illegality or were actively involved in the transactions. Quite interestingly, the Board observed that the exact apportionment of the liability between various parties could be decided by them inter se either by settlement or by suits of indemnity/contribution between each other and from all persons including financiers, key operators and other violators. (*emphasis supplied*) It was further observed that “It is not in the interest of the public that the regulator should spend its time in deciding private disputes between various perpetrators of the IPO fraud/cornering of shares” (*emphasis supplied*). It is against this order that the present appeal has been filed.”

On appeal the Securities Appellate Tribunal *inter alia* held as follows, -

“5. Before we deal with the contentions of the parties, it is necessary to understand what disgorgement is. It is a common term in developed markets across the world though it is new to the securities market in India. Black’s Law Dictionary defines disgorgement as “The act of giving up something (such as profits illegally obtained) on demand or by legal compulsion.” (*emphasis supplied*) In commercial terms, disgorgement is the forced giving up of profits obtained by illegal or unethical acts. It is a repayment of ill-gotten gains that is imposed on wrongdoers by the courts. Disgorgement is a monetary equitable remedy that is designed to prevent a wrongdoer from unjustly enriching himself as a result of his illegal conduct. It is not a punishment nor is it concerned with the damages sustained by the victims of the unlawful conduct. Disgorgement of ill- gotten gains may be ordered against one who has violated the securities laws/regulations but it is not every violator who could be asked to disgorge. Only such wrongdoers who have made gains as a result of their illegal act(s) could be asked to do so. (*emphasis supplied*) Since the chief purpose of ordering disgorgement is to make sure that the wrongdoers do not profit from their wrongdoing, it would follow that the disgorgement amount should not exceed the total profits realized as the result of the unlawful activity. In a disgorgement action, the burden of showing that the amount sought to be disgorged reasonably approximates the amount of unjust enrichment is on the Board.”

Thus the foundational case-law of the equitable remedy of disgorgement in India, though trying to draw an analogy from more developed jurisdictions (like the Board’s earlier attempt) was based on the dictionary meaning of the term rather than on a legal examination of case-laws of developed jurisdictions in respect of disgorgement, which were not placed before the Tribunal. Even existing Indian jurisprudence in respect of joint

and several liability was not explored by either litigant.<sup>131</sup> What is interesting to note is even US federal Courts initially floundered on a key aspect of disgorgement but subsequently corrected themselves once the inequitableness came to the fore.<sup>132</sup>

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<sup>131</sup> See *Dharni Dhar and Ors v Chandra Shekhar & Ors*, AIR 1951 All 774, discussing contribution by joint tortfeasors and its applicability in India depending on the facts and circumstances of each case:

“The rule [of *Merrywhether v Nixon* (1799) 8 T. R. 186: 16 R. R. 810 : 101 E. R. 1337] (*supplied*) was thus modified and came to be stated in these words :

“No person who has been guilty of fraud or any other form of wilful wrong-doing, and has been made liable in damages, has any right of contribution or indemnity against any other person who was a joint wrong-doer with him....”

66. Where a civil wrong is committed jointly by certain persons as against another, they purge themselves of the consequences of the wrong when they repair the damage caused to that person. It cannot, therefore, be said that the hands of tort-feasor who has repaired the damage are unclean. Indeed the hands of the person who has not yet contributed his share of the loss are unclean and there is no justice in denying the relief to the person who has repaired the whole of the damage caused by the action of both of them.”

Also see *Kushro S. Gandhi & Ors v N.A. Gajdar & Ors*, 1970 (SC) AIR 1468, 1969 SCR (2) 959, holding that the recovery of the entire liability could be made from all or any of the persons jointly liable before they rely on accord and satisfaction without going into the correctness of *Dharni Dhar and Ors v Chandra Shekhar & Ors*, AIR 1951 All 774.

<sup>132</sup> See *SEC v Lauer & Ors.*, 445 F. Supp. 2d 1362 (S.D. Fla. 2006), available at <<https://www.courtlistener.com/opinion/2499896/sec-v-lauer/>>, wherein the court inter alia observed the development of requirement of tracing in respect of disgorgement,-

“Lauer cites, among other cases, *S.E.C. v. First City Financial Corp., Ltd.*, 890 F.2d 1215, 1230 (D.C.Cir.1989) (“First City”) which states that because “disgorgement primarily serves to prevent unjust enrichment, the court may exercise its equitable power only over property causally related to the wrongdoing.” Several cases have cited First City for this proposition, most notably for our purposes, *CFTC v. Sidoti*, 178 F.3d 1132, 1138 (11th Cir.1999), and *SEC v. Gane*, 2005 WL 90154, \*19 (S.D.Fla. 2005) (Gonzales, J.). The Eleventh Circuit, relying upon First City, held that “the district court may not disgorge profits obtained without the aid of any wrongdoing.” *Sidoti*, 178 F.3d at 1138. The Sidoti Court went on to find that the district court had abused its discretion for ordering disgorgement of profits for a period during which there was no record evidence of fraud.

Subsequent to First City, the Court of Appeals for the District of Columbia reviewed the narrow interpretation Lauer proposes for the holding in First City and held to do so conflicts with longstanding precedent and would lead to a monstrous doctrine that would perpetuate rather than correct an inequity. In *SEC v. Banner Fund Int'l, et al.*, 211 F.3d 602, 617 (D.C.Cir.2000), the Court of Appeals explained: (emphasis supplied)

“Because disgorgement is an equitable obligation to return a sum equal to the amount wrongfully obtained, rather than a requirement to replevy a specific asset, we reject Blackwell's challenge and affirm the district court.

. . . As the SEC points out, the requirement of a causal relationship between a wrongful act and the property to be disgorged does not imply that a court may order a malefactor to disgorge only the actual property obtained by means of his wrongful act. Rather, the causal connection required is between the amount by which the defendant was unjustly enriched and the amount he can be required to disgorge. To hold, as Blackwell maintains, that a court may order a defendant to disgorge only the actual assets unjustly received would lead to absurd results. Under Blackwell's



Pursuant to a detailed enquiry into the foundations of the equitable nature of disgorgement the Committee is of the view that the aforesaid decision (whereby disgorgement in India is limited to only those persons who have received the proceeds of default and only to the extent of the proceeds received) is *per incuriam*.

The Committee has examined the case laws surrounding disgorgement in USA, which is the foremost securities market in the world where this remedy has been prominently applied<sup>133</sup> and several Anglo-American principles of equity and law in common with those

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approach, for example, a defendant who was careful to spend all the proceeds of his fraudulent scheme, while husbanding his other assets, would be immune from an order of disgorgement. Blackwell's would be a monstrous doctrine for it would perpetuate rather than correct an inequity. (emphasis supplied)"

Many district courts faced with this argument agree that "[t]here is no requirement that frozen assets be traceable to the fraudulent activity underlying a lawsuit." *SEC v. Dennis Crowley*, Case No. **0480354-Civ-Middlebrooks**, Slip. Op. (S.D.Fla.2004) (order by consent by Magistrate Judge Johnson) [DE 1368, Ex. I]; see also *SEC v. A.B. Financing and Inv., Inc.*, Case No. 02-23487-Civ-Ungaro-Benages, Slip. Op. at 2-3. (S.D.Fla.2003) ("a district court may freeze assets not specifically traced to illegal activity" quoting *Levi Strauss & Co. v. Sunrise Int'l Trading Inc.*, 51 F.3d 982 (11th Cir.1995)) [DE 1368, Ex. J]; *SEC v. Belmonte*, No. 88 6557, 1991 WL 214252 (S.D.Fla.1991) (Roettger, J.) (refusing to release funds from sale of home, even though home had been acquired prior to alleged fraud, because there had been no showing that ill-gotten funds had not been used to subsidize mortgage payments or improve home); *SEC v. Current Financial Svcs.*, 62 F. Supp. 2d 66, 68 (D.D.Cir.1999) (refusing to release personal funds not traceable to the fraud because defendant's liability exceeded total funds frozen); *SEC v. Grossman*, 887 F. Supp. 649, 661 (S.D.N.Y.1995) ("it is irrelevant whether the funds affected by the Asset Freeze are traceable to the illegal activity") (aff'd, 101 F.3d 109 (2d Cir. 1996)); *SEC v. Roor*, No. 99-3372, 1999 WL 553823 at \*2 (S.D.N.Y.1999) (denying motion to release so-called "untainted" funds from mortgage of property that preexisted alleged fraud); *SEC v. Glauberman*, No. 90-5205, 1992 WL 175270 at \*1 (S.D.N.Y.1992) (rejecting defendant's argument that funds subject to disgorgement must be traced "dollar for dollar" to the illegal activity). (emphasis supplied)

....The amount of assets to be frozen, prior to the finding of liability, is determined not by whether the funds themselves are traceable to the fraudulent activity underlying the lawsuit, but by showing a reasonable approximation of the amount, with interest, the defendant was unjustly enriched. *Id.*; *SEC v. Blatt* 583 F.2d 1325, 1335 (5th Cir.1978). (emphasis supplied)"

<sup>133</sup> *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (directing the district court to consider the remedy of restitution), available at <<https://law.justia.com/cases/federal/appellate-courts/F2/401/833/324140/>>; *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (district court directing restitution), available at <<https://law.justia.com/cases/federal/district-courts/FSupp/312/77/1468753/>> and *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301 (2d Cir. 1971) (upholding district court order of restitution), available at <<https://law.justia.com/cases/federal/appellate-courts/F2/446/1301/140482/>>.

and our jurisdiction. No statute governs the disgorgement of ill-gotten profits- rather, the principles of equity provide the foundation for this remedy.<sup>134</sup>

While the equity foundation of disgorgement is correct and disgorgement is generally limited to the extent of the illegal gains made by a particular defaulter, however equity provides for an important exception: joint defaulters. In case of joint defaulters, the disgorgement remedy has always been on the basis of joint and several liability. It is not limited to the amount of monies received by a particular defaulter. The latest landmark ruling in respect of joint and several liability is *SEC v. Contorinis*,<sup>135</sup> wherein the US Court of Appeals examined the entire case law relating to disgorgement and *inter alia* held as follows, -

“The primary issue presented is whether an insider trader who trades on behalf of another person or entity using funds he does not own, and thus produces illegal profits that he does not personally realize, can nevertheless be required to disgorge the full amount of illicit profit he generates from his illegal and fraudulent actions. Because our cases have established that tippers can be required to disgorge profits realized by their tippees’ illegal insider trading, and this case is distinguishable only insofar as Contorinis himself executed the fraudulent trades rather than leave that task to a tippee, we conclude that the district court was empowered to enter the disgorgement order, and did not abuse its discretion in doing so.

...

Contorinis argues that because he never personally controlled the profits that accrued to the Paragon Fund – although he could make investment decisions, he

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<sup>134</sup> See *Janigan v. Taylor*, 344 F.2d 781, 786 (1st Cir.1965), available at <<https://www.leagle.com/decision/19651125344f2d7811934>>.

<sup>135</sup> 2014 U.S. App. LEXIS 2927 (2d Cir. Feb. 18, 2014), available at <<https://cases.justia.com/federal/appellate-courts/ca2/12-1723/12-1723-2014-02-18.pdf?ts=1410919262>>. Also see, *SEC v. Great Lakes Equities Co.*, 775 F. Supp. 211, 214 (E.D. Mich. 1991), available at <<https://law.justia.com/cases/federal/district-courts/FSupp/775/211/1555222/>>, wherein the court *inter alia* held that,-

*"[t]he benefit or unjust enrichment of a defendant includes not only what it gets to keep in its pocket after the fraud, but also the value of the other benefits the wrongdoer receives through the scheme. Thus, in insider trading cases, a tipper must disgorge not only his own profits but also any profits made by his tippees, even if the tipper did not receive any tangible kickback from those tippees."*

did not control disbursement of the proceeds – ordering him to disgorge the entire amount gained through his insider trading is a misapplication of the disgorgement principle. The argument identifies an ambiguity in the concept of disgorgement.

...

Contorinis argues, in effect, that one can only “disgorge” what one has personally “swallowed”; the SEC argues that a fraudster should be compelled to return not only those profits from the fraud that he has reserved for his own use, but also those that he has bestowed on others.

...

In resolving this dispute, we do not write on a clean slate. Our prior cases indicate that an insider trader may be ordered to disgorge not only the unlawful gains that accrue to the wrongdoer directly, but also the benefit that accrues to third parties whose gains can be attributed to the wrongdoer’s conduct. We have long applied that principle in the tipper-tippee context. Thus, in *SEC v. Warde* we held that, in the determination of a disgorgement amount, “[a] tippee’s gains are attributable to the tipper, regardless whether benefit accrues to the tipper.” 151 F.3d 42, 49 (2d Cir. 1998). That principle has deep roots in parallel civil remedial structures. For example, in *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 165 (2d Cir. 1980), we concluded that “[t]rades by tippees are attributed to the tipper” in determining liability for damages, and in *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1308 (2d Cir. 1971), the foundational case for insider trading liability, we required a tipper to make common-law civil restitution “for the profits derived by his tippees. That rule makes perfect sense. A potential tipper in possession of inside information who seeks to confer a benefit on a friend or to curry favor with someone who can confer reciprocal benefits in the future can do so either by trading on this information himself and passing the *profit* on to the intended beneficiary, or by passing the *information* to the beneficiary and thus allowing the tippee to realize the profit himself. In the former case, the insider would unquestionably be liable to disgorge the profit; disgorgement is required whether the insider trader has put his profits into a bank account, dissipated them on

transient pleasures, or given them away to others. It would make little sense to allow the insider to escape disgorgement when he gives away not the proceeds of a trade predicated on his insider knowledge, but rather the knowledge itself to others who he knows will spin the information into gold by trading on it themselves. (*emphasis supplied*)

...

There is no injustice, therefore, in making him responsible for the profits he made for others, as well as for himself, through his fraudulent insider trades.

...

As we said in *Warde*, in the absence of the discretion to allocate liability to wrongdoers, “[t]he value of the rule in preventing misuse of inside information would be virtually nullified [because] those in possession of such information, although prohibited from trading for their own accounts, [would be] free to use the inside information on trades to benefit their families, friends, and business associates.” 151 F.3d at 49. See also *Tex. Gulf Sulphur*, 446 F.2d at 1308 (“[W]ithout such a remedy, insiders could easily evade their duty to refrain from trading on the basis of inside information. Either the transactions so traded could be concluded by a relative or an acquaintance of the insider, or implied understandings could arise under which reciprocal tips between insiders in different corporations could be given.”). (*emphasis supplied*)

...

We do not conclude that district courts *must* impose disgorgement liability for insider trading upon wrongdoers when the gains accrue to innocent third parties, but rather that the district courts *may* elect to do so in appropriate circumstances. (*emphasis supplied*)

...

As our consideration of the tipper context demonstrates, to so limit the power of courts to order disgorgement would permit evasion of the prohibition on insider trading by allowing the direction of benefits to acquaintances.

...

As our case law has indicated (and as our opinion here confirms), when third parties have benefitted from illegal activity, it is possible to seek disgorgement from the violator, even if that violator never controlled the funds. The logic of this, as more fully articulated *supra*, is that to fail to impose disgorgement on such violators would allow them to unjustly enrich their affiliates. Thus, ordering a violator to disgorge gain the violator never possessed does not operate to magnify penalties or offer an alternative to fines, but serves disgorgement's core remedial function of preventing unjust enrichment. (*emphasis supplied*) District courts possess the equitable discretion to determine whether disgorgement liability should fall upon third parties or violators, a responsibility concordant with the district courts' broad discretion to assay disgorgement more generally."

Also see *SEC v. Hughes Capital Corp.*,<sup>136</sup> wherein the Court *inter alia* explained the principles of the law of torts underpinning disgorgement and held as follows, -

"*Disgorgement is an equitable remedy designed to deprive a wrongdoer of his unjust enrichment and to deter others from violating securities laws.*" *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1230 (D.C. Cir. 1989). When apportioning liability among multiple tortfeasors, it is appropriate to hold all tortfeasors jointly and severally liable for the full amount of the damage unless the liability is reasonably apportioned. "*Where joint tortfeasors cause a single and indivisible harm for which there is no reasonable basis for division according to the contribution of each, each tortfeasor is subject to liability for the entire harm.*" (*emphasis supplied*) *United States v. Alcan Aluminum Corp.*, 964 F.2d 252, 268-69 (3d Cir. 1992).<sup>137</sup>

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<sup>136</sup> 124 F.3d 449, 455 (3d Cir. 1997), available at <<https://casetext.com/case/securities-and-exchange-v-hughes-capital>>.

<sup>137</sup> See *United States v. Alcan Aluminum Corp.*, 964 F.2d 252 (3d Cir. 1992), available at <<https://www.leagle.com/decision/19921216964f2d25211183>>:

"Obviously, of critical importance in this analysis is whether a harm is divisible and reasonably capable of apportionment, or indivisible, thereby subjecting the tortfeasor to potentially far-reaching liability. Under the Restatement, where a joint tortfeasor seeks to apportion the full amount of a plaintiff's damages according to that tortfeasor's own contribution to the harm, it is the tortfeasor's burden to establish that the damages are capable of such apportionment. As the comments concerning this issue explain, the burden of proving that the harm is capable of apportionment is placed on the tortfeasor to avoid."

Courts have held that joint-and-several liability is appropriate in securities cases when two or more individuals or entities collaborate or have close relationships in engaging in the illegal conduct. (*emphasis supplied*) See *First Jersey Securities*, 101 F.3d at 1475; *Hateley v. SEC*, 8 F.3d 653, 656 (9th Cir. 1993). In the instant case, the defendants all collaborated in a single scheme to defraud Hughes' investors through the bogus initial public offering and the subsequent sale of warrants. They enjoyed a "close relationship" with each other through their connection to Hughes, the other corporations used in the scheme, and the nominee accounts used to perpetuate the scheme."

Thus, the elective nature of imposing joint and several liability for fraud and insider trading by drawing upon the common law principles of tort and equity is well laid down in US law. For a long time, in USA disgorgement was a remedy available only through Federal Courts; in 1990 the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisors Act of 1940 and the Investment Company Act of 1940 were amended by the Securities Enforcement Remedies and Penny Stock Reform Act<sup>138</sup> and the SEC has been authorised to seek disgorgement in its own proceedings.

Indian jurisprudence while trying to frame a remedy of disgorgement on the lines of developed jurisdictions actually fell short of imposing joint and several liability on defaulters, as our Anglo-Indian tort jurisprudence of joint and several liability was not examined, thus allowing defaulters to arrange their affairs in a manner to defeat the enforcement of securities laws.

The Securities Laws (Amendment) Act, 2014, inserted the following Explanation in Section 11B of the SEBI Act, Section 19 of the Depositories Act and Section 12A of the SCRA, -

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**It is not the profit to be disgorged that has to be apportioned, but the harm. If the harm caused is an indivisible whole like a scheme to defraud investors, the profit may be disgorged, jointly and severally.**

<sup>138</sup> Available at <<https://www.gpo.gov/fdsys/pkg/STATUTE-104/pdf/STATUTE-104-Pg931.pdf>>.

“Explanation. —For the removal of doubts, it is hereby declared that power to issue directions under this section shall include and always be deemed to have been included the power to direct any person, who made profit or averted loss by indulging in any transaction or activity in contravention of the provisions of this Act or regulations made thereunder, to disgorge an amount equivalent to the wrongful gain made or loss averted by such contravention.”

The Explanation gives the impression that the disgorgement can be done ‘only’ from a person who has made illegal gains by indulging in a contravention of securities laws and such disgorgement shall be equal to the amount gained. As such the Explanation gives an impression by converse reasoning that disgorgement can only be done from a person who has received monies. However, a deeming provision is not to be extended to what it does not say, it is to be applied only to what it says. A legal fiction cannot be carried further than what it says.<sup>139</sup> The Explanation does not use the word ‘only’ nor does it actually prohibit the levy of joint and several liability. The Explanation was introduced only for the removal of certain doubts rather than creating new ones. Hence, it is the view of the Committee that Section 32 which permits the application of other laws is an important source by which securities laws jurisprudence can be developed and remedies shaped to deal with different kinds of situations. Hence, the Committee is of the view that notwithstanding the present Explanation, it is permissible for the Board to rely upon Section 32 of the SEBI Act and direct disgorgement on joint and several liability basis whether or not all such persons have actually received monies, since the delinquent act is *joint*, the receipt of illegal proceeds by anyone in furtherance of such an act is receipt by all.

In this respect it must be considered that the concept of fraud in securities laws is wider than the concept of common law fraud, which is too restrictive to deal with the complexities of the securities markets.<sup>140</sup> While the restrictions may not applicable vis a

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<sup>139</sup> See *K. S. Dharmadatan vs Central Government And Ors*, 1979 AIR SC 1495, 1979 SCR (3) 832; *Commissioner of Sales Tax, Uttar Pradesh v. The Modi Sugar Mills Ltd.*, 1961 AIR SC 1047, 1961 SCR (2) 189; *Braithwaite & Co. (India) Ltd. v. Employees' State Insurance Corporation*, 1968 AIR SC 413, 1968 SCR (1) 771; *Commissioner of Income Tax Bombay City v. Elphinstone Spinning and Weaving Mills Co. Ltd.*, 1960 AIR SC 1016.

<sup>140</sup> *SEBI v Kanaiyalal Baldevbhai Patel*, 2017 (15) SCC 1 : 2017 SCC Online SC 1148.

vis the Board, several of the broader concepts relating to common law fraud are equally applicable to securities laws are definitely applicable, in view of section 32 of the SEBI Act, 1992. Thus, the Supreme Court has considered the American caselaw (including cases relating to insider trading) surrounding their *pari materia* anti-fraud provision in securities laws, which also covers insider trading without specifically mentioning it, and has held that in cases of fraud, joint liability can be imposed on the delinquents (including the one who initiates) and those who aid and abet.<sup>141</sup>

**ALTERNATIVE RECOMMENDATION:** Though an amendment for the purpose of clarifying the joint and several liability is not required, however for sake of clarity it may be considered.

- i. If required, the existing explanation in respect of disgorgement in securities laws be amended for the sake of clarifying any doubts in respect of joint and several liability, as follows, -

“Explanation.—For the removal of doubts, it is hereby declared that the power to issue directions under this section shall include and always be deemed to have been included the power to direct **jointly and severally, all or any of the persons**, who ~~made profit or averted loss by indulging~~ in any transaction or activity in contravention of the provisions of this Act or regulations made thereunder, to disgorge an amount equivalent to the wrongful gain made or loss averted by such contravention.”

**SPECIAL CASE: DISGORGEMENT ACTION TAKEN BY EMPLOYERS AGAINST THEIR EMPLOYEES:** It is seen that various companies and other entities take action in the nature of disgorgement against their employees. But there is no clarity as to where the monies disgorged by such companies and entities from their employees go. Some have complied with the spirit of the securities laws and deposited the monies with the SEBI IPEF while

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<sup>141</sup> *Ibid.*



some have taken advantage of the situation and kept the monies with themselves. Further, there is no clarity in this respect as not all companies and entities report in detail the nature of action taken against delinquent employees, since no standardised reporting format has been provided.

Objectively seen, there is already a situation where insider trading is difficult to prove and even in cases where violations are found they are not adequately reported to the Board. The entire insider trading regime is open to misuse where unscrupulous employers can use 'employees' as front men to undertake trading and then use their powers to 'penalise' or 'sanction' such employees under the Code of Conduct to fill their own coffers by taking advantage of lack of clarity in law. Even the reporting of such violations by the employer to the Board was inadequate or incomplete and only recently a detailed reporting format has been specified by the Board vide Circular dated July 19, 2019. It is interesting to note that this situation has continued since 2002 when the Code of Conduct was first mandated in the 1992 Regulations relating to insider trading.

Hence a detailed examination of the power of disgorgement, if any, of the powers vested in employers under securities laws has been undertaken in this Report. The SEBI (Prohibition of Insider Trading) Regulations, 1992 *inter alia* provided as follows,-

**“Penalty for contravention of code of conduct**

- .1 Any employee/officer/director/partner who trades in securities or communicates any information for trading in securities in contravention of the code of conduct may be penalised and appropriate action may be taken by the company/organisation/firm.
- .2 Employees/officers/directors/partners of the company who violate the code of conduct shall also be subject to disciplinary action by the company, which may include wage freeze, suspension, ineligible for future participation in employee stock option plans, etc.
- .3 The action by the company/organisation/firm shall not preclude SEBI from taking any action in case of violation of SEBI (Prohibition of Insider Trading) Regulations, 1992.”

The open ended language pertaining to the ‘penalties’ that the employer may impose has given rise to this issue. In the first instance, it must be noted that ‘penalties’ imposed by an employer are not ‘penalties’ imposed by the Board under securities laws. Sanctions and penalties by employers are essentially disciplinary in nature and form the terms of employment of every employee-employer contract, and are not ‘delegated’ by the Board. Further, the provision makes clear that the action taken by the employer is not supposed to prejudice any action by the Board. In cases where illegal trading take place and disgorgement is done by the employer who then keeps the monies with himself instead of depositing them in the IPEF, not only does such employer prejudice the disgorgement action which would otherwise have been taken by the Board and the monies deposited in the IPEF, but it is also not in line with the ‘equitable’ nature of disgorgement. Insider trading violations which result in unlawful gains do not create any ‘equities’ between the employer and employee which need to be adjusted between them, it is generally considered to be a victim-less crime. It is not in the nature of an excess remuneration or incentive that is later recovered or clawed back from the employee.

The SEBI (Prohibition of Insider Trading) Regulation, 2015 *inter alia* provides that ‘*Without prejudice to the power of the Board under the Act, the code of conduct shall stipulate the sanctions and disciplinary actions, including wage freeze, suspension, recovery, clawback, etc.*’ Though the new regulations remove the confusion in respect of employer disciplinary action being ‘penalties under securities laws’ as well as lay down that in case of contra trades the monies should be deposited in the IPEF, there is still no clarity in respect of disgorgement taken by the employer for other violations including insider trading. Hence, the aforesaid reasoning applies with equal force to other violations and the employer cannot recover or clawback or disgorge the unlawful profits from non-contra trade violations and keep them with himself, thereby ‘unjustly enriching’ himself under the guise of enforcement of the Code of Conduct. Clawback and recovery are provisions designed to take ‘back’ the amounts that the employer may have given to the employee in the first place. Unlawful profits accruing from trading are not monies that

the employee has *made from or on behalf of or given by* the employer which the employer may recover or clawback under these provisions.

**RECOMMENDATION:** The Board may consider issuing a circular to all employers who are required to frame a code of conduct under the 1992 or 2015 regulations relating to insider trading, to, in case of sanctions have been imposed by an employer in the nature of disgorgement under the 1992 or 2015 regulations relating to insider trading prior to the issue of the Circular, the monies so disgorged shall be deposited in the SEBI IPEF within 30 working days; and

**RECOMMENDATION:** The Board may consider amending the 2015 insider trading regulations to clarify that the employer cannot impose a sanction against an employee, if such sanction would amount to disgorgement of profit resulting from insider trading.

#### **B. PENALTY IN RESPECT OF INSIDER TRADING.**

Penalty for insider trading is levied under Section 15G of the SEBI Act which reads as follows, -

**“Section 15G. Penalty for insider trading.-**

If any insider who,—

- (i) either on his own behalf or on behalf of any other person, deals in securities of a body corporate listed on any stock exchange on the basis of any unpublished price-sensitive information; or
  - (ii) communicates any unpublished price-sensitive information to any person, with or without his request for such information except as required in the ordinary course of business or under any law; or
  - (iii) counsels, or procures for any other person to deal in any securities of any body corporate on the basis of unpublished price-sensitive information,
- shall be liable to a penalty which shall not be less than ten lakh rupees but which may extend to twenty-five crore rupees or three times **the amount of profits made out of insider trading**, whichever is higher.”

Section 15G covers different kinds of default and only clause (i) is actual *insider trading*.<sup>142</sup>

Clause (iii) is *linked* to insider trading, it is sufficient for an insider to only ‘counsel’ another to deal in securities, though actual trading may not happen.

Clause (ii) is *linked* to insider trading, it is the act of ‘tipping’ and does not require actual trading by the ‘tippee’ for the tipper to be punishable.

However, under 15G whenever, trading does happens as a result of clause (ii) and (iii), the persons liable under (ii) and (iii) are liable to the extent of three times the amount of profits made by the act of insider trading [clause (i)], even it is not done by them- and not from the act of communication or procurement for which they are charged with under clauses (ii) and (iii).

Section 15G is to a large extent a condensed version of Sections 20(a) & (b),<sup>143</sup> 20A and 21A of the Securities Exchange Act, 1934<sup>144</sup> which imposes penalty on a person, who passes unpublished price sensitive information, equal to the profits made by insider trading. Thus, the intent of Indian securities law is to impose a form of joint and several penal liability on the ‘tipper-tippee’ relatable to the profits made from the act of insider trading *per se*, rather than to penalize the each person only to the extent of the money that he may receive.

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<sup>142</sup> Insider trading is the act of trading while in possession of unpublished price sensitive information, See Regulation 4 of SEBI (Prevention of Insider Trading) Regulations, 2015.

<sup>143</sup> Sec *Dirks* v. *SEC*, 463 U. S. 646 (1983), available at <<https://supreme.justia.com/cases/federal/us/463/646/case.html>> (tipper liability is based on Section 20(b) of the Securities Exchange Act, 1934), inter alia holding that:

“The conclusion that recipients of inside information do not invariably acquire a duty to disclose or abstain does not mean that such tippees always are free to trade on the information. The need for a ban on some tippee trading is clear. Not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they also may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain. See 15 U.S.C. § 78t(b) (i.e. Section 20(b) of the Securities Exchange Act, 1934-supplied) (making it unlawful to do indirectly "by means of any other person" any act made unlawful by the federal securities laws).” (*emphasis supplied*)

<sup>144</sup> Available at <<http://legcounsel.house.gov/Comps/Securities%20Exchange%20Act%20Of%201934.pdf>> and codified at U. S. Code, Title 15, Chapter 2B, §78a-78qq, available at <<http://uscode.house.gov/view.xhtml?path=/prelim@title15/chapter2B&edition=prelim>>.

Disgorgement is a very important remedy in securities laws. When a defaulter makes an unlawful gain he enriches himself unjustly so the penalty imposed on him should not be allowed to be paid using such ill-gotten gains, else the penalty loses its deterrent effect. Hence, in cases where disgorgement is not made, the penalty should be higher than the ill-gotten gains. This is an important barometer to decide which multiple of profit should be selected while imposing penalty in insider trading matters (as well as under Section 15HA of the SEBI Act). It is important to expand upon the liability of insiders to ensure proper control mechanisms are put in place to avoid the possibility of insider trading.

**RECOMMENDATION:** Securities laws may be amended as follows,-

- i. A new provision should be introduced regarding ‘controlling person liability’ similar to that found in USA. Employers and intermediaries who fail to put in place reasonable systems that can control and limit the violations of securities laws must be held liable for the defaults that they allow to occur due to their recklessness. Further, the provision should also clarify the liability of joint persons, i.e. (i) persons who employ other persons to assist such persons in the violation of securities laws; and (ii) those who provide substantial assistance to such person. The following amendment to securities laws may be considered, -

“Section....

(1) Every person who, directly or indirectly, controls any person liable under any provision of this Act or of any rule or regulation made thereunder, shall also be liable jointly and severally with and to the same extent as such controlled person in any action brought under this Act or any rule or regulation made thereunder, unless the controlling person acted in good faith and did not directly or indirectly induce or enable the act or omission constituting the violation or cause of action.

*Explanation 1.* - No person shall be liable as a controlling person solely by reason of employing another person, but the liability of such employer may

be subject to sub-section (1) where he is under a duty to control but intentionally or by gross negligence fails to exercise control.

*Explanation 2.* – In this section ‘control’ includes direct and indirect positive acts or omissions that amount to control.

(2) It is hereby clarified that it shall be and always has been unlawful for any person, directly or indirectly, to do any act or thing which would be unlawful for such person to do under the provisions of this Act or any rule or regulation made thereunder, through or by means of any other person.

(3) Any person who knowingly or in absence of good faith provides substantial assistance to another person in violation of a provision of this Act, or of any rule or regulation made thereunder, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.

*Explanation.* - For the purpose of this section, nothing is said to be done in “good faith” which is done without due care and attention.

(4) The Board may proceed against all or any of the persons who may be liable jointly for the violation of securities laws and non-initiation of proceedings under securities laws against any particular person shall not by itself amount to discharge or acquittal of such person and such person shall remain liable to be proceeded against in appropriate proceedings, if the Board so deems fit.”

The recommended provision is neutral and applies to all kinds of violations, not just insider trading. Further, it does not declare that trivial abettors are not liable, but rather focuses on imposing the liability of such persons ‘on’ the person who controlled them. The Board would then be free to concentrate its enforcement action against the main persons- persons who employed others and those who provided substantial assistance i.e. the ‘smart’ enforcement through action on the

main accused and enforce securities laws in a time bound manner to protect the interest of investors rather than expend its limited resources and time on pursuing the entire chain of defaulters.

**6. GENERAL PRINCIPLES RELATING TO QUANTIFICATION OF DISPROPORTIONATE GAIN AND LOSS CAUSED TO INVESTORS AS A RESULT OF THE DEFAULT**

- I. The statutory position in USA and India is the same. The gain and loss quantification is limited only to that amount which is as a result of the default. *Indeed, simply to take the definition of “gain” without limiting it to gain “resulting from the default” would lead to absurd results. It is not all the defaulter(s) stock gains-over an entire lifetime of stock trading, but only the stock gains “resulting from the default.”*<sup>145</sup>
  
- II. Defaults by company personnel throw up some interesting issues for the purpose of quantification. Given the competitive nature of capitalistic markets wherein the corporate insiders may indulge in such activities to ensure that they can continue in their corporations and/or obtain higher compensation in the present or future. In this respect the issue of quantification of profit made by the corporate insider may not be clear, as it may be in the form of salary, bonuses and stock options. In this respect the Committee notes the global practice of disgorging such compensation or a relevant part thereof. *[The right of an employer to dismiss for cause and cancel or claw-back compensation already given or promised is different from the right of the Board to quantify relevant gain and disgorge, though both arise only after the violation has come to light. Clawback undertaken by the employer will not completely nullify disgorgement (as the possibility of overlap is limited to situations where the salary and bonuses paid by the*

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<sup>145</sup> See *United States v Mooney*, (2005) (8th Cir.) 425 F.3d 1093, available at <<https://casetext.com/case/us-v-mooney-10>>; *United States v. Nacchio* (2009) (10th Cir.) 573 F.3d 1062, available at <<https://casetext.com/case/us-v-nacchio-11>>.

*employer amounts to the illegal gain) by the Board and vice versa as neither is a voluntary or self-remedial process rather a contentious one which the defaulter is made to comply unwillingly nor are they a replacement for each other, the jurisprudence surrounding both is different]. Bonus which are dependent on earnings can be recalculated on restated financials after the fraudulent information is out and compared with the bonuses paid out on the original reported financials. However in case of multiple financial years this is calculated on a percentage basis as such fraudulent information can have cumulative effect.<sup>146</sup> In other cases where no such clear linkage exists, an approximation may be adopted.*

In cases where executive compensation includes acquisition of securities under any options or grants, if there is a corrective disclosure before the executive liquidates his position, then the grant generates a loss measured using the Black Scholes method of valuation<sup>147</sup> (to take account for possibility of early exercise) caused by the fraud that should be offset with other gains, if any, from the fraud. In case there is an increase in price due to disclosure before the position is liquidated, the gain would have to be measured by using the difference in inflation per share between grant and sale.<sup>148</sup> In case of other employee benefits such as retirement schemes, restrictive stock grants, etc. experts use analyses similar to those used for bonus and option compensation.<sup>149</sup>

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<sup>146</sup> See, Elaine Buckberg and Frederick G. Dunbar, *Disgorgement: Punitive Demands and Remedial Offers*, The Business Lawyer Vol. 63, No. 2 (February 2008), 347, 362-369, available at <<https://www.jstor.org/stable/40688470>> for example based on the SEC methodology for calculating bonuses to be disgorged.

<sup>147</sup> This is the most common method of valuation of employee stock options in India and consistent with Ind AS 102. The other methods known as the Monte Carlo method and Binomial methods are not in much use in india for valuation of securities. See, <<https://numeraconsulting.com/blog/3-methods-for-valuation-of-employee-stock-options/>>. Also see, Ministry of Corporate Affairs: Ind AS 102 including the principles for valuation of share options to employees available at <[http://mca.gov.in/Ministry/pdf/Ind\\_AS102.pdf](http://mca.gov.in/Ministry/pdf/Ind_AS102.pdf)>.

<sup>148</sup> See, Elaine Buckberg and Frederick G. Dunbar, *Disgorgement: Punitive Demands and Remedial Offers*, The Business Lawyer Vol. 63, No. 2 (February 2008), 347, 372-, available at <<https://www.jstor.org/stable/40688470>> for example based disgorgement based on employee stock options.

<sup>149</sup> Ibid.



The issue of loss caused by corporate insiders is far more complex. Where corporate insiders, including promoters misuse corporate facilities for self-profit, their liability for secret profits is well settled in law. This is not limited to just the corporate insider who makes the secret profit but a contribution claim could succeed against another corporate insider who took no steps to prevent a misapplication of the company's property by its director.<sup>150</sup> Where a concealment of interest in another organization, directly or indirectly controlled by the insider or its related parties is made, who benefits from such transactions, the liability extends to all transactions, unless proven to be independent by the corporate insider; and the corporate entity which benefits from the same is also liable to the full extent.<sup>151</sup> When the related party transaction results in a loss, the Companies Act, 2013 expressly provides under Section 188 (4) & (5) requiring the corporate

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<sup>150</sup> *Clegg v Pache (Deceased)*, [2017] EWCA Civ 256 (UK Court of Appeals); available at <<http://www.bailii.org/ew/cases/EWCA/Civ/2017/256.html>>. (Also see *N Narayanan v Adjudicating Officer of the Securities and Exchange Board of India*, AIR 2013 SC 3191, available at <[https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi\\_data/attachdocs/1413521982829.pdf](https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi_data/attachdocs/1413521982829.pdf)>; See *MSI v Raven*, [2013] EWHC 3147 (Comm), available at <<https://www.bailii.org/ew/cases/EWHC/Comm/2013/3147.html>>: "It has long been established that a trustee who knowingly permits a co-trustee to commit a breach of trust is also in breach of trust. A director who has knowledge of his fellow director's misapplication of company property and stands idly by, taking no steps to prevent it, will thus not only breach the duty of reasonable care and skill (which is not fiduciary in character): *Ultraframe v Fielding* [2005] EHC 1638 (Ch), [1300]-[1302]), but will himself be treated as party to the breach of fiduciary duty by his fellow director in respect of that misapplication by having authorised or permitted it: *Walker v Stones* [2001] QB 902, 921D-E; *Gidman v Barron and Moore* [2003] EWHC 153 (Ch) at [131]; *Neville v Krikorian* [2006] EWCA Civ 943, [49]-[51] and *Lexi Holdings v Luqman* (No. 1) [2007] EWHC 2652 (Ch) at [201]-[205]."

<sup>151</sup> *Ibid*:

"Mr Dagnall relied upon conventional, long established, legal principles for this part of his appeal. ... In relation to the burden of proof, he submitted that the present case fell well within the "*Armory v Delamirie*" principle [Armory was awarded the maximum value that a jewel of that form which was stolen could have as the original could not be examined (under the principle that a wrongdoer should not be able to derive gain from the effects of his wrongdoing due to uncertainty of damages)] (*supplied*), as applied by Longmore LJ in *Keefe v The Isle of Man Steam Packet Company Limited*[2010] EWCA Civ 683 at paragraph 19, namely that a defendant who has in breach of duty made it difficult or impossible for a claimant to adduce relevant evidence must run the risk of adverse factual findings. ...it should have been directed on the basis of a starting point that all FPL's (beneficiary company) (*supplied*) profits during the relevant period should be accountable, subject to the exclusion of such transactions or profits as the defendants could show were independently undertaken or earned, (*emphasis supplied*)... Mr Dagnall satisfied me that the case was also put in that much simpler, more general and legally principled way (as he presented it on appeal), at least in the closing written submissions to which the parties and the court had recourse on the final day of the trial, headed "Summary of the case in law against first and third defendants"

insider to indemnify the losses to the company.<sup>152</sup> In some cases, the profits made may be insignificant to the losses caused by a related party transaction, which goes sour. If any loss or depreciation results as a result of a related party transaction, no question of any foreseeability or remoteness arises and the corporate insider is automatically liable for the loss caused to the investors.<sup>153</sup>

III. In case of illegal activities, credit for the monies/assets returned to avoid detection or after detection of the illegal activity is not to be considered for levy of penalty<sup>154</sup> or if payments are made in respect of initial investments to entice additional investments and conceal the default.<sup>155</sup> However, the same may be considered while taking into account any disgorgement obligation.

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<sup>152</sup> Also see, *Mahesan v. Malaysian Govt. Officers Co-operative Housing Society Ltd* [1978] 1 MLJ 149; [1979] AC 374, [1978] 2 All ER 405 (Privy Council) (The appellant was a director and secretary of the respondent co-operative society. He brought land for the society at overvalue. The appellant knew of the land being overvalued however he failed to inform the society. The society discovered the fact only after the sale was done and discovered the appellant had received a secret commission from the vendor. As a result, the Privy Council held that the respondent could recover either bribe or the amount of the actual loss suffered by it as a consequence of entering into the contract).

<sup>153</sup> *Duckwari plc (No. 2) Re:* (1998) 2 BCLC 315; (1998) 3 WLR 913 (CA). See also, *Duckwari plc (No. 3) Re:* (1999) 1 BCLC 168; (1999) 2 WLR 1059 (CA). (The position of a director is fiduciary in nature and similar where a trustee makes an unauthorized investment).

<sup>154</sup> See *US Sentencing Guidelines* p 97, available at <<https://www.ussc.gov/sites/default/files/pdf/guidelines-manual/2016/GLMFull.pdf>>; and Primer Loss Calculations under §2B1.1(b)(1) of the US Sentencing Guidelines pp 27-32, available at <[https://www.ussc.gov/sites/default/files/pdf/training/primers/2016\\_Primer\\_Loss.pdf](https://www.ussc.gov/sites/default/files/pdf/training/primers/2016_Primer_Loss.pdf)>

<sup>155</sup> The US Sentencing Guidelines take into account 'intended' loss as well as 'actual' loss, whereas Indian securities laws explicitly refer only to actual loss to investors. However, securities laws do not exclude the application of any other relevant factor for consideration. [See *Siddharth Chaturvedi v SEBI*, (SC) (Civil Appeal No. 14730 of 2015 decided on March 14, 2016); *Adjudicating Officer, SEBI v Bhavesh Pabari*, 2019 (3) SCALE 447, available at <[https://www.supremecourtindia.nic.in/supremecourt/2013/36291/36291\\_2013\\_Judgement\\_28-Feb-2019.pdf](https://www.supremecourtindia.nic.in/supremecourt/2013/36291/36291_2013_Judgement_28-Feb-2019.pdf)> and Finance Act, 2017] This principle for not giving credit to certain repayments is based on the two grounds, namely (i) 'intended loss' (ii) the payments are essentially part of the fraudulent scheme. Both grounds hold good in respect of Indian securities laws and hence the recommendation, since intended loss is loss that is foreseen by the defaulter or hence foreseeable and relevant. See *United States v. Dobish*, 102 F.3d 760 (6th Cir. 1996), available at <<https://www.courtlistener.com/opinion/731240/united-states-v-michael-dobish/>> (An investment manager normally occupies a position of trust. Mr. Dobish constructively held such a position, based on his own representations, and he abused that position to defraud his victims. The court also found that money was returned only as a means of perpetuating the fraud, and that the scheme would have been continued indefinitely had the victims not discovered what was going on.); *United States v. Mucciante*, 21 F.3d 1228 (2d Cir. 1994), available at <<https://law.justia.com/cases/federal/appellate-courts/F3/21/1228/622994/>> (Mucciante's sentence was properly enhanced. Although he returned some of Berger's money, and repaid Yohay and Horowitz, he did so as part of a meretricious effort to maintain their confidences. He is therefore not entitled to credit for sums returned, or for sums spent for Berger's benefit. Finally, it is of course irrelevant that Mucciante took the money to impress people, rather than for a more sinister purpose).

IV. In case of costs incurred for running an illegal activity, no benefit is required to be given for such costs, including fixed costs.<sup>156</sup> However, direct trading costs (including securities transaction tax) may be deductible depending on the facts and circumstances of each case, as direct transaction-specific costs.<sup>157</sup> In disgorgement cases where illicit profits are used for payment of income taxes unrelated to such profits no such credit is required to be given, however if profits are used for payment of taxes related to such profits then it is discretionary to grant such credit for taxes paid, i.e. in cases where the restitution is possible to identified investors no such tax credit should be allowed and in case the disgorgement is due to the Board's Investor Protection and Education Fund, the defaulter may be allowed credit if such taxes can be computed easily and information is provided or else in all such cases the defaulter must approach the Income Tax authorities for relief instead of the Board.<sup>158</sup> In case of penalty calculation, profit made is only a barometer for assessing penalty rather than for the purpose of refund/restitution

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<sup>156</sup> See *Federal Trade Commission v. Bronson Partners, LLC*, 654 F.3d 359 (2d Cir. 2011), available at <<https://www.courtlistener.com/opinion/223605/ftc-v-bronson-partners-llc/>>:

“We need not dwell long on this argument, as it is well established that defendants in a disgorgement action are “not entitled to deduct costs associated with committing their illegal acts.” *SEC v. Cavanagh*, No. 98-Civ.-1818-DLC, 2004 WL 1594818, at 30 (S.D.N.Y. July 16, 2004), *aff'd*, 445 F.3d 105 (2d Cir.2006). Although we sometimes refer casually to the power of district courts to “require wrongdoers to disgorge fraudulently obtained profits,” *Official Comm. of Unsecured Creditors of WorldCom, Inc. v. SEC*, 467 F.3d 73, 81 (2d Cir.2006) (emphasis added), that is because in many securities fraud cases the wrongdoer receives no direct monetary transfer from his victims. Where that is true, the defendant's ill-gotten gains are equal to the profits of his unlawful trading. But where the profits from fraud and the defendant's ill-gotten gains diverge, the district court may award the larger sum. In *SEC v. DiBella*, for example, we rejected an argument that “disgorgement is limited to profits reaped through [the defendant's] securities law violations,” such that a defendant who was paid to assist another's violation of Section 10(b) could not be required to disgorge his fees. 587 F.3d 553, 572 (2d Cir.2009) (internal quotation marks omitted). And in *Verity*, we explained that although the defendants-appellants were not liable for consumer payments that never reached them, “the district court should determine the amount of the ... total billings that the defendants-appellants received ..., without deducting monies paid by the defendants-appellants to other parties.” 443 F.3d at 68. Likewise, at least three other circuits measure unjust gains in FTC actions by revenues instead of profits. See *FTC v. Direct Mktg. Concepts, Inc.*, 624 F.3d 1, 14-16 (1st Cir.2010); *FTC v. Kuykendall*, 371 F.3d 745, 765-67 (10th Cir. 2004) (holding that unjust gains should be calculated based on a defendant's “gross receipts”); *Febre*, 128 F.3d at 536.”

<sup>157</sup> See SEC *Administrative Decision in the matter of Curtis A Peterson*, pp 6-7, discussing several authorities in respect of discretionary deduction for transaction specific costs and denying others, available at <<https://www.sec.gov/alj/aljdec/2017/id1124jsp.pdf>>.

<sup>158</sup> See SEC *Administrative Decision in the matter of Curtis A Peterson*, pp 5-8, discussing several authorities in respect of non-deductibility of taxes, available at <<https://www.sec.gov/alj/aljdec/2017/id1124jsp.pdf>>. Also see, Elaine Buckberg and Frederick G. Dunbar, *Disgorgement: Punitive Demands and Remedial Offers*, *The Business Lawyer* Vol. 63, No. 2 (February 2008), 347, at 381, available at <<https://www.jstor.org/stable/40688470>>.

or recovery of the disproportionate profit, hence taxes and other costs incurred after the default are of no relevance and no credit is required.

- V. Where the investors' property is destroyed or lost e.g. in case of share certificates, the fair market value when the default was detected by the investor or the authority, whichever is earlier can be considered or the cost of replacement can be considered.<sup>159</sup> In this respect the Hon'ble Supreme Court of India in its recent judgment in *63 Moons Technologies Ltd. v U.O.I & Ors.*<sup>160</sup> has *inter alia* noted various methods of valuation of shares as follows,-

“71. In *Miheer H. Mafatlal v. Mafatlal Industries Ltd.*, (1997) 1 SCC 579, in the context of a voluntary amalgamation made under Sections 391 to 394 of the Companies Act, this Court went into share valuation. This Court held:

“40. .... It must at once be stated that valuation of shares is a technical and complex problem which can be appropriately left to the consideration of experts in the field of accountancy. Pennington in his Principles of Company Law mentions four factors which had to be kept in mind in the valuation of shares:

- “(1) Capital Cover,
- (2) Yield,
- (3) Earning Capacity, and
- (4) Marketability.

For arriving at the fair value of share, three well-known methods are applied:

- (1) The manageable profit-basis method (the Earning Per Share Method)
- (2) The networth method or the break value method, and
- (3) The market value method.”

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<sup>159</sup> See *US Sentencing Guidelines* p 96, available at <<https://www.ussc.gov/sites/default/files/pdf/guidelines-manual/2016/GLMFull.pdf>>.

<sup>160</sup> Judgment dated 30.04.2019 available at <[https://www.sci.gov.in/supremecourt/2018/4493/4493\\_2018\\_Judgement\\_30-Apr-2019.pdf](https://www.sci.gov.in/supremecourt/2018/4493/4493_2018_Judgement_30-Apr-2019.pdf)>.

What is clear from the various methods of valuation of shares, when it comes to such valuation qua the transferor and transferee company, is that the market value method is one method in which shares can be valued so that their equivalent can then be provided for in the amalgamated company. This would be nothing other than what those shares were worth in the market on a particular day or an average taken within a certain period. What is important to note is that the market value of shares is market value of shares reflective of their economic value, being an interest measured by a sum of money, is not something that is completely alien to determining the rights of or interest of a shareholder in the transferor or transferee company, as the case may be.”

- VI. In some cases the estimate of loss may be more or less equal to the illegal gains derived, even though such monies available for disgorgement may have dwindled or lost in value by the time the default is detected or recovery initiated. E.g. in case of unauthorized investment schemes.
- VII. In case of activities requiring registration, recognition or any other authorization by the Board are conducted without requisite approvals, the fees due to the regulator which would otherwise be payable and have not been paid shall amount to loss avoided and counted towards illegal gains.
- VIII. Technological firms nowadays seek to issue securities to the public to raise cheap capital. Such firms have trade secrets or other proprietary information in the nature of unpublished price sensitive information, which needs to be protected. Loss of such information can result in substantial loss of stock valuation. In case of misuse of such information, an estimate of illegal gains or loss caused may be based on the estimate of the fair market value of such information<sup>161</sup> failing which

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<sup>161</sup> See International Accounting Standards Board standard 38 (IAS 38) read with International Financial Reporting Standard 3 (Business Combinations) and Indian Accounting Standard (Ind AS) 38 (Intangible Assets).

the cost of developing that information may be used, if available with the victim company, and where the company suffers a loss of business, including loss of business opportunity.<sup>162</sup> The principles for calculation of loss of profit including loss of business are well understood and may be applied in such instances.<sup>163</sup> Some such methods are,-

- i. When the harm is for a finite period of time and is related to a separately identifiable cash flow, a lost profits approach is preferred due to the finite period of damages. This approach represents the difference between profits the victim would have attained, “but for” the harmful event, and profits actually attained. Profits can be defined variously depending on the venue, facts and circumstances of the underlying engagement. The calculated lost profits are then adjusted for mitigation, if any. A lost profits analysis is commonly employed in breach of contract, intellectual property and general commercial litigation cases. It may be done using,-
  - a. *The sales projection method* which compares forecasted profits before the harmful event to actual profits after the harmful event;
  - b. The *before-and-after method*, which compares profits before the harmful event to profits after the harmful event, is appropriate for many businesses;
  - c. The *accounting for profits method* is based on incremental sales or profits achieved by the defaulter as the result of the harmful event. It should be reasonably certain that the victim would have attained the same amount of sales or profits as the defaulter, “but for” the harmful event;
  - d. The *yardstick method* compares profits to a quantifiable yardstick, before and after the harmful event. This method is typically used in industries where profit margins are closely tied to a measurable yardstick such as the price of raw material;

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<sup>162</sup> See *US Sentencing Guidelines* p 97, available at <<https://www.ussc.gov/sites/default/files/pdf/guidelines-manual/2016/GLMFull.pdf>>.

<sup>163</sup> See <<https://www.alvarezandmarsal.com/ar/insights/damages-measured-lost-profits-or-lost-business-value>>

- e. The *market share method* is based on the market share the plaintiff would have attained, “but for” the harmful event. This method may be suitable for industries where reliable data regarding the overall market is readily available.
  
- ii. In circumstances where the loss of earnings is considered or assumed to be permanent and into perpetuity, or where a business is destroyed completely, a lost business value approach is generally appropriate. This approach is commonly applied in business destruction, shareholder oppression, dissenting shareholder and tax matters. A business valuation is performed before the date of harm and after the date of harm, with the resulting difference regarded as the lost business value, this may be done using the following methods,-
  - a. The *asset-based approach* involves analyzing the plaintiff’s tangible and intangible assets net of liabilities. This approach does not directly address the operating earnings of the business and, as such, is useful in estimating the value of a non-operating business where cash flows are nominal, such as a holding company or an asset-intensive business;
  - b. The *market approach* uses pricing multiples taken from guideline companies or transactions and applies these multiples to the appropriate performance measure of the company being valued;
  - c. The *income approach* calculates a business’s value by applying a discount or capitalization rate to a measure of its expected future earnings to arrive at a present value of the future benefit streams. This approach is commonly used in estimating the value of both publicly-traded and closely-held businesses.

In any event, these losses are generally relevant only when a particular company is targeted, causing indirect loss to share-holders. The losses may be calculated using the assistance of the person impacted.

- IX. Technology has changed the way transactions are done and has created newer modes of committing plain vanilla defaults. Front-running is essentially the placing of trades ahead of another trade order based on prior knowledge of such subsequent order to take advantage of the price change on account of such subsequent order vis-à-vis other traders. The US SEC views co-location services as a material aspect of the operation of the facilities of an exchange.<sup>164</sup> Co-location enables access to legalized data feed in a way that counters geographical disadvantages where the trader is allowed to access stock prices a split second before the general market by being ‘closer’ to the exchange.<sup>165</sup> However, when exchange officials, actively or passively, provide preferential access to a particular person where trade data is actually received before others in a discriminatory and unfair manner, trading on such preferential information may result in trading ahead of the market. In such cases, the advantage does not arise from the server being co-located at the exchange, rather the advantage arises from prior dissemination of the information to a particular person who has been given preferential access to the co-location server vis-à-vis others.
- X. Where securities are purchased and sold during the default period it is easy to calculate the realized profit. Quantification of profit includes notional loss.<sup>166</sup>

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<sup>164</sup> See Exchange Act Release No. 34-61358, 75 Fed. Reg. 3594, 3610 & fn. 76 (Jan. 21, 2010), available at <<https://www.sec.gov/rules/concept/2010/34-61358.pdf>>.

<sup>165</sup> *In Re: Barclays Liquidity Cross and High Frequency Trading Litigation* (Opinion and Order, SDNY, 14-md-02589, August 25, 2015), pp 8-9, available at <[http://securities.stanford.edu/filings-documents/1052/NA00\\_01/2015826\\_o01x\\_14MD02589.pdf](http://securities.stanford.edu/filings-documents/1052/NA00_01/2015826_o01x_14MD02589.pdf)>.

<sup>166</sup> *Dushyant N. Dalal & Anr v SEBI*, SAT Appeal No. 182 of 2009 decided on 12.11.2010, p 9, available at <<https://www.sebi.gov.in/satorders/dalal.pdf>>:

“The next argument of the learned senior counsel is that the Board was in error in taking into account the unrealized gains for the shares which are still being held by the appellants and the said amount should be omitted for calculating the gains. It is true that the appellants did not sell all the shares that were cornered by them through the key operators and that some of them are still lying in their demat accounts. The whole time member in the impugned order has worked out the notional gain with reference to the closing price of the shares on the first day of listing and deducted the issue price therefrom. As at present advised, we can think of no better way of calculating the notional gain made by the appellants. Even if there is a better method of calculating the notional gains, we do not think that the method adopted by the whole time member is in any way arbitrary or unfair calling for our interference. Surely the appellants cornered the shares through illegal means and they cannot be heard to say that notional profits should not be worked out merely because they continue to hold



However complexity arises in the cases of notional profit<sup>167</sup> or where the acquisition price is not available or in cases where the illegal profit may be mixed with legal profit. Further, trading need not result in net cash positive transaction. Gain in the form of undue advantage (loss avoided) will also arise in cases where the default was done to lower the possible losses than would have otherwise resulted from market conditions, e.g. if the historical cost price was much higher than the prevailing price at the beginning of the default period. In such cases a variation of the averaging period may be used to arrive at a suitable fair notional price (acquisition or sale) to arrive at the difference between cost and purchase value.

- XI. **TAX EVASION AND GAIN QUANTIFICATION:** Cases where the primary purpose of a scheme is tax evasion, rather than defrauding investors in securities markets is a particular case. In such cases the securities regulator may have to deal with concerns that are unrelated to securities markets. Such transactions if continued unabated, risks the misuse of securities markets for defrauding other authorities. In 2014 the US SEC succeeded in disgorging the profits of a fraudulent scheme [setting up foreign trust accounts to hide beneficial ownership and trade in securities] *inter alia* on the basis that federal taxes were avoided even when the US Internal Revenue Services had not sought to recover the unpaid taxes and inspite

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some of them. They cannot be allowed to unjustly enrich themselves. We, therefore, reject this argument of the appellants as well.”

<sup>167</sup> See *SEC v. Shapiro*, 494 F.2d 1301 (2d Cir. 1974), available at <<https://casetext.com/case/securities-and-exchange-commission-v-shapiro>>, the defendant continued to hold stock he had fraudulently obtained after the inside information on which he had acquired the stock became public. The district court ordered the defendant to disgorge his profits computed as of the day the inside information was publicly disclosed. The defendant argued that such a disgorgement constituted a penalty because he would be forced to give up more than the stock was actually worth when it was sold, as its value had dropped after the inside information became public. The Court of Appeals disagreed with defendant's logic, noting that:

“[Defendant's] additional losses resulted not from any penalty imposed by the court but from his unwise investment decision to keep the stock after February 18 [the date the inside information became public].

...

[A] contrary holding would create a serious anomaly that might encourage insider trading. To require disgorgement only of actual profits in cases where the price of the stock subsequently fell would create a heads-I-win-tails-you-lose opportunity for the violator: he could keep subsequent profits but not suffer subsequent losses.”

of there being no statutory basis or precedent of using unpaid taxes as a measure of disgorgement.<sup>168</sup>

In *SEC v Wyly*,<sup>169</sup> the court *inter alia* held as follows, -

“The SEC arrives at its proposed measure of disgorgement by 1) calculating the total profits earned on the sale of the Issuer securities by the IOM trusts, and 2) approximating the amount of taxes that... would have been paid on those profits had the Wylys accurately disclosed beneficial ownership of the securities. For the following reasons, I conclude that this is an appropriate measure.... On June 13, 2013, I held that the SEC was not foreclosed, as a matter of law, from seeking disgorgement in an amount equivalent to the federal income taxes the Wylys would have been required to pay if they properly disclosed beneficial ownership over the Issuer securities. "There is no explicit prohibition, either in the Tax Code or in the Exchange Act, on using tax benefits as a measure of unjust enrichment in other contexts" and no "express limitation on the SEC's authority to calculate and disgorge any "reasonable approximation of profits causally connected to the violation." (*emphasis supplied*) ....

Congress has granted exclusive authority to the Secretary of the Treasury to assess and "collect the taxes imposed by the internal revenue laws," who has, in turn, delegated that authority to the IRS. Section 7401 of the Tax Code states that "[n]o civil action for the collection or recovery of taxes, or of any fine, penalty or forfeiture, shall be commenced unless the Secretary authorizes or sanctions the proceedings and the Attorney General [of the United States] or his delegates directs that the action be commenced."

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<sup>168</sup> See <<https://www.jdsupra.com/legalnews/sdny-judge-permits-novel-theory-and-86626/>>.

<sup>169</sup> *S.E.C. v. Wyly*, 56 F.Supp.3d 394 (2014) 1:10-cv-05760-SAS, ECF 476 at 67 n.218 (S.D.N.Y. Sept. 25, 2014) available at <<https://www.leagle.com/decision/infdco20140925e94>>.

As I previously held, "this is *not* a civil action for the collection or recovery of taxes. . . . Rather, this is a civil action for securities law violations, the *remedy* for which is measured by the amount of taxes avoided" as a result of the defendants' securities violations." [A] tax is an enforced contribution to provide for the support of the government. "Disgorgement is a discretionary and equitable remedy aimed at preventing unjust enrichment. Measuring unjust enrichment by approximating avoided taxes does not transform an order of disgorgement into an assessment of tax liability.... Thus, unlawful gains may be measured in any number of different ways. For example, courts commonly order defendants to disgorge not only the proceeds of a fraud or the profits of an unlawful trade, but also salary and bonuses earned during the period of a fraud, and amounts equivalent to losses avoided as a result of the securities violations. (*emphasis supplied*) Disgorgement "is a remedy that gives courts flexibility" to determine the appropriate remedy "to fit the wrongful conduct."...

The SEC is not seeking disgorgement equivalent to the unpaid taxes for *all* profits earned by the IOM trusts. Rather, the SEC's disgorgement amount pertains specifically to the taxes avoided on profits relating to the exercise of options and sale of stock in four companies in which the Wyllys were influential insiders. The jury found that the Wyllys were beneficial owners of all of the Issuer securities—from the time the options were transferred to the trusts to the time the trusts exercised the options or otherwise acquired stock to the time they were sold. The jury also found that the Wyllys' pervasive failure to disclose beneficial ownership constituted securities fraud. There is no evidence in the record that the purpose of this fraud was to manipulate or distort the market. (*emphasis supplied*) There is ample evidence, however, that the driving purpose of the securities fraud was to conceal the Wyllys' relationship to the IOM trusts and preserve the preferential tax treatment on secret offshore profits for as long as possible. ...

This measure of disgorgement reflects the unique circumstances of this case. The Wylys engaged in securities fraud to conceal their relationship to and control of the IOM trusts in order to maintain the secrecy of the offshore system and preserve their tax benefits. The unlawful gains causally related to the securities violations found by the jury, is an amount equivalent to the taxes avoided on the profits the Wylys realized on the sale of Issuer securities. (*emphasis supplied*)”

On appeal, the aforesaid ruling of the District Court was upheld by the US Court of Appeals<sup>170</sup>, *inter alia* holding as follows, -

“In its September opinion explaining its disgorgement order, the District Court emphasized that “this is not a civil action for the collection or recovery of taxes. Rather, this is a civil action for securities law violations, the remedy for which is measured by the amount of taxes avoided as a result of the defendants' securities violations.” The Court made clear that “[m]easuring unjust enrichment by approximating avoided taxes does not transform an order of disgorgement into an assessment of tax liability.”

Since the tax avoidance sum merely served the purpose of quantifying the disgorgement remedy, rather than forming the basis for liability itself, it is irrelevant that—or whether—tax liability is non-transferable. What matters is that the gains received were ill-gotten in violation of securities laws, a determination that has already been made by the jury at trial. (*emphasis supplied*) That conclusion is not disturbed by the particular measure used by the District Court to order equitable relief. Here, the District Court's adoption of two alternative measures of disgorgement in its September and December opinions makes the point even more salient. The Relief Defendants challenge

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<sup>170</sup> *SEC v Donald R Miller, Executor and Ors*, No. 14-4261-cv (2d Cir. Dec. 18, 2015), available at <<https://caselaw.findlaw.com/us-2nd-circuit/1720954.html>>.

only the tax measure set forth in the September opinion. In fact, the particular method of measurement used is immaterial.”

Similar issue arose in India, in the case of *Rakhi Trading*, The Hon’ble Supreme Court of India<sup>171</sup> did not determine the issue of tax evasion as the show cause notice was silent on that aspect but the following observations are noteworthy:

“Per Kurian, J:

SAT held that these trades were for the purpose of tax planning which is not violative of any regulation. We are not inclined to get in to the issue of tax planning as it was not mentioned in the show cause notices. (*emphasis supplied*)

We find it difficult to appreciate the stand taken by the SAT which is endorsed by the learned senior counsel appearing for the respondents. Mr. Chidambaram, learned senior counsel appearing for Rakhi Trading argues that the SAT decision is valid and proper. Reliance is also placed on the case of Ketan Parekh (*supra*) in which SAT held that synchronised trades are not per se illegal. As far as reversal of trades is concerned, the senior counsel has sought to distinguish Ketan Parekh (*supra*) as it pertained to dealings in the cash segment whereas the present case deals with the F&O segment. The learned senior counsel has strenuously argued that no rules of the game have been violated.

...

In the instant case, one party booked gains and the other party booked a loss. Nobody intentionally trades for loss. An intentional trading for loss per se, is not a genuine dealing in securities. The platform of the stock exchange has been used for a non-genuine trade. Trading is always with the aim to make

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<sup>171</sup> *SEBI v Rakhi Trading Pvt. Ltd.*, C.A. 3174-3177 & 3180/2011. Order dated 08.02.2018, available on <[https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi\\_data/attachdocs/feb-2018/1518429932105.pdf](https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi_data/attachdocs/feb-2018/1518429932105.pdf)>.

profits. But if one party consistently makes loss and that too in pre-planned and rapid reverse trades, it is not genuine; it is an unfair trade practice. *(emphasis supplied)*

...

According to SAT, only if there is market impact on account of sham transactions, could there be violation of the PFUTP Regulations. We find it extremely difficult to agree with the proposition. *(emphasis supplied)*

...

The traders thus having engaged in a fraudulent and unfair trade practice while dealing in securities, are hence liable to be proceeded against for violation of Regulations 3(a), 4(1) and 4(2)(a) of PFUTP Regulations. Appeal Nos.1969/2011, 3175/2011 and 3180/2011 are hence allowed. The orders of the Securities Appellate Tribunal are set aside and that of the SEBI are restored to the extent indicated above.

Per R. Bhanumathi, J (concurring):

When there were no other transactions in the market affecting the price of the underlying shares or F&O Segment and the price in both the segments had remained static, then there was no reasonable ground to get apprehensive and panic. Therefore, squaring off the position appears to adjust the financial results with a view to avoid the tax incidence through an unfair trade practice or for some ulterior purpose. *(emphasis supplied)*

...

An act to fall within Regulation 4(2)(a), it is not necessary that the transactions entered into by the party was with intention to manipulate the market and that the market was in fact manipulated. Market manipulation is a deliberate attempt to interfere with the free and fair operation of the market and create artificial, false or misleading appearances with respect to the price, market, product, security and currency.

...

In the quasi-judicial proceeding before SEBI, the standard of proof is preponderance of probability. (*emphasis supplied*)

...

The market, as already observed, is so widespread that it may not be humanly possible for the Board to track the persons who were actually induced to buy or sell securities as a result of manipulation and the Board cannot be imposed with a burden which is impossible to be discharged. (*emphasis supplied*)

...

Intense supervision might distort the path of securities market development; but SEBI cannot be a silent spectator to unfair trade practices/manipulative market for some ulterior purpose like tax evasion etc. (*emphasis supplied*) To find the right balance between market forces and Regulatory body's intervention, SEBI has to deal sternly with those who indulge in manipulative trading and deceptive devices to misuse the market and at the same time ensuring the development of the market.

...

Before I conclude, it is necessary to refer to the findings of SAT on 'tax planning'. SAT held that even assuming that non-genuine synchronized trades have been entered into for the purposes of tax planning, such trade could be held objectionable only if they have resulted in influencing the market in one way or other. For its finding that every person is entitled to arrange his affairs as to avoid taxation. SAT relied upon *Viram Investment Pvt. Ltd. and Ors. v. SEBI* (MANU/SB/0046/2005) decided on 11.02.2005. Contention of the respondents is that transactions which have been entered into with a view to achieve tax planning are not illegal and respondents placed reliance upon *Viram Investment Pvt. Ltd.* case. The learned counsel for SEBI contended that the market cannot be manipulated by fictitious transactions either for tax planning or for some ulterior purposes like money laundering etc. (*emphasis supplied*)

No grounds have been raised in the show cause notice alleging that the impugned fictitious transactions have been entered into with a view to avoid payment of tax and was an act of tax planning. Adjudicating officer also has not gone into this aspect. Hence, I am not inclined to go into this aspect, whether the impugned transactions were intended to reduce the brunt of taxation and an act of tax planning. The correctness of findings of SAT in the case of *Viram Investment Pvt. Ltd.* is left open. (*emphasis supplied*)

...

The impugned transactions are manipulative/deceptive device to create a desired loss and/or profit. Such synchronized trading is violative of transparent norms of trading in securities. If the findings of SAT are to be sustained, it would have serious repercussions undermining the integrity of the market and the impugned order of SAT is liable to be set aside. (*emphasis supplied*)”

The judgement of the Hon’ble Supreme Court is noteworthy for the following reasons:

- i. The issue of tax planning/evasion arose only because the transactions were defended *inter alia* on those grounds. It became relevant to do so since there was no other logical explanation for the noticees to knowingly engage in structured loss making transactions;
- ii. Though the issue of tax planning through non-genuine trades was kept open the Court has laid down the principle that for a transaction to be a fraudulent and unfair trade practice actual impact on the market is not necessary. A fraudulent trade is a fraud, whether or not a particular identifiable individual or the market is affected in a demonstrable way. To that extent the law in India and USA are similar;
- iii. In respect of tax planning, though the correctness of SAT’s judgment in *Viram Investment Pvt. Ltd.* was kept open, the validity of underlying



transactions through which desired losses are knowingly bought and sold stands eroded and in effect *Viram Investment Pvt Ltd. (SAT)*<sup>172</sup> may no longer be good law;

- iv. The concurring judgment is clear that SEBI cannot be a silent spectator to unfair trade practices/manipulative market for some ulterior purpose like tax evasion, etc. This leaves the door open for further developments in Indian jurisprudence on the lines of USA SEC where disgorgement was successfully obtained on the basis of taxes avoided by a fraudulent scheme.

In cases where a few persons create a scheme for their own benefit it may be possible to disgorge benefits linked to unpaid taxes avoided due to such a scheme. In cases where a brokers run investment schemes primarily designed for tax evasion and attract several clients offering their 'services' for such purposes, it may cast an impossible burden on the enforcement mechanism of the Board to prosecute each and every investor. In such cases, the joint and several liability may be appropriate and the intermediaries may be made liable for the entire scheme profits, including those of their clients (based on taxes avoided) and not just their own, since such large scale structured transactions cannot be done without their active participation.<sup>173</sup>

## 7. FINANCIAL ECONOMICS

A discussion on advanced mathematical methods is necessary as violations in securities markets now involve 100's or 1000's of crores. Notably, the magnitude of securities laws

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<sup>172</sup> *Viram Investment Pvt. Ltd. v SEBI*, SAT Appeal no. 160/2004, decided on 11.02.2005, available at <[https://www.sebi.gov.in/enforcement/orders/feb-2005/in-the-matter-of-viram-investment-pvt-ltd\\_11029.html](https://www.sebi.gov.in/enforcement/orders/feb-2005/in-the-matter-of-viram-investment-pvt-ltd_11029.html)>.

<sup>173</sup> See *US v Royer and Anr*, 549 F.3d 886 (2d Cir. 2008) (US CA), available at <<https://caselaw.findlaw.com/us-2nd-circuit/1261811.html>>: The gains made by the defendant and by the subscribers of his investment website. The Court found that the investments scheme was a coordinated effort between the defendant who made the website and the subscribers.

violations has increased to such a level that they have been found fit to be included under the Fugitive Economic Offenders Act, 2018 which must necessarily involve violations of at least Rs. 100 crores.

Advanced mathematical methods are essentially statistical methods that are useful in instances where large sums are involved and simpler arithmetic and rule of thumb methods may have large divergences from the approximate values obtainable through statistical methods, which help to isolate the effect of market-related factors and default-related factors in calculating the disproportionate gains made.

However, statistical methods are not easily employed in low value matters. Experts may be needed, as is the practice in USA-SEC, to justify the particular method chosen, since within statistical methods there may be divergences based on the methods and the data set chosen. This is where SEBI's role as a regulator regulating a financially and technically complex market comes into play.

Statistical methods are used in all fields and not just the financial world, including weather forecasting, big data analysis, census data analysis and formed an important aspect of the Mandal Commission's classification which utilised extrapolation of caste census data from 1891 and 1931 censuses.<sup>174</sup> Statistical methods are often employed by asset management companies, fund managers to forecast returns on investment in order to take investment decisions. Statistical methods are used for all kinds of forecasts including investment returns, setting margin requirements. Take for example the statistical Black-Scholes Model<sup>175</sup> of option pricing and pricing of employee stock options<sup>176</sup> which has also been considered by some to be at the root of the financial crisis

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<sup>174</sup> See *Nandini Sundar*, Professor of Sociology at the Delhi School of Economics, 'Will counting caste help to reduce inequality?' <[http://censusindia.gov.in/Ad\\_Campaign/press/Will%20counting%20caste%20help%20to%20reduce%20inequality.pdf](http://censusindia.gov.in/Ad_Campaign/press/Will%20counting%20caste%20help%20to%20reduce%20inequality.pdf)>.

<sup>175</sup> <<https://economictimes.indiatimes.com/definition/black-scholes-model>>

<sup>176</sup> See Ministry of Corporate Affairs: Ind AS 102 including the principles for valuation of share options to employees available at <[http://mca.gov.in/Ministry/pdf/Ind\\_AS102.pdf](http://mca.gov.in/Ministry/pdf/Ind_AS102.pdf)>.

of 2008.<sup>177</sup> Though statistical methods seem complex, these methods are in fact commonly used in the securities markets by the large number of financial experts and economists the world over.<sup>178</sup> Several software exist for carrying out such calculations.<sup>179</sup>

The Board also hires a large number of financial experts (economists, statisticians, MBAs, CAs, etc.) like other global regulators and is thus well placed to adopt the best practices of global securities regulators. These methods of calculating return are not confined to securities regulators but are also used by market making investment decisions based on a mathematically anticipated return that the investment may generate.

**CHASING THE ALPHA ( $\alpha$ ) OR THE ABNORMAL RETURNS OR EXCESS RETURN<sup>180</sup> OF INSIDERS/FRONT-RUNNERS:** Legal scholars<sup>181</sup> and other securities regulators have supported the use of financial economics in securities litigation, including disgorgement. Calculating the excess returns using an event study uses statistics to assess the impact of an event on the value of a firm's stock and the trading done. It enables determination of the abnormal returns generated in cases of informational advantage and it is the standard methodology used by the USA SEC in insider trading analysis, however it is not required in all cases.<sup>182</sup> It is 'abnormal' because it varies from the normal: 'expected rate of return'.

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<sup>177</sup> See *Ian Stewart*, Emeritus professor of Mathematics at the University of Warwick, 'The mathematical equation that caused the banks to crash', available at <<https://www.theguardian.com/science/2012/feb/12/black-scholes-equation-credit-crunch>>; Also see, *NSE-NCFM Options Trading (Advanced) Module*, available at <<https://www.nseindia.com/learn/self-study-ncfm-modules-advanced-modules>> (explaining the various methods adopted for valuation of exchange-traded *options in securities*).

<sup>178</sup> <<https://www.motilaloswal.com/article.aspx/1625/What-do-we-mean-by-Alpha-from-a-fund-managers-perspective>>

<sup>179</sup> See <<https://wrds-www.wharton.upenn.edu/pages/analytics/>>; <<https://www.r-project.org/>>; <[https://www.sas.com/en\\_in/home.html](https://www.sas.com/en_in/home.html)>; <<https://www.stata.com/>> and <<https://www.eventstudytools.com/>>.

<sup>180</sup> See <<https://www.investopedia.com/terms/a/abnormalreturn.asp>>; <<https://investinganswers.com/financial-dictionary/stock-valuation/abnormal-rate-return-3105>>.

<sup>181</sup> Janet c Alexander, *The Value of Bad News in Securities Class Actions*, 41 UCLA L. Rev. 1421, 1433 (1994); Macey, Miller, Mitchell, Mitchell & Netter, *Lessons from Financial Economics: Materiality, Reliance, and Extending the Reach of Basic v Levinson*, 77 Va. L. Rev. 1017, 1021-28 (1991), available at <<https://www.jstor.org/stable/1073445>>; Fischel, *Use of Modern Finance Theory in Securities fraud Cases Involving Actively Traded Securities*, 38 Bus. Law, 1, 1-20 (1982), available at <<https://www.jstor.org/stable/40686405>>.

<sup>182</sup> *SEC v Wyly*, 71 F. Supp. 3d 399 (S.D.N.Y. 2014), available at <<https://casetext.com/case/sec-amp-exch-commn-v-wyly#N197547>>:

"Moreover, I do not agree that the SEC should have employed **the standard method used for measuring the ill-gotten gains in insider trading cases, i.e., performing an event study for each trade.** (*emphasis supplied*) First, this is not an insider trading case. Though the SEC alleges that the Wylys used an informational advantage

It can be positive or negative. ('Ideally' a fund manager who can generate a positive alpha or positive abnormal returns beats the market and is highly sought after).

Statistical methods are usually employed in cases where the defaulter does not close his position and determination of profit is difficult or the illegal profit is mixed with legal gains. Event studies (econometric methodology) in conjunction with the abnormal rate of returns methods are useful to assess the returns of defaulters in comparison with the normal returns of market to assess the amount of profit to be disgorged. The Committee notes that existing methods adopted relating to profit calculation indicate an attempt to develop a simpler methodology vis-a-vis statistical methods. However in doing so there are several trade-offs which limit the application and reliability of current methods; the Committee notes that those methods are not in public domain and nor are they designed specifically for illiquid securities nor are they designed for eventualities where the defaulter has an open position at the end of the fraud or in line with the approach adopted by various Court nor do they help differentiate the legitimate gains from disproportionate gains as is the requirement under the securities laws. As such they are not really an alternative to statistical methods adopted by various securities regulators, courts and tribunals globally. Invariably, the Committee notes that the Board is a specialist organisation regulating a very complex financial market and its technical edge needs to

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to trade opportunistically, they did this in the context of the offshore system where the Wyls could choose between securities from four different Issuers where they had an informational advantage. In this context, the Wyls could have information that while one Issuer stock was poised to rise moderately, another Issuer stock would rise more during the same period.

In this case, using an event study would not detect any use of informational advantage in a sale of the first stock, even though the decision to sell was motivated by an informational advantage.

Second, this approach is simply not feasible given the length of the fraud period here—thirteen years—and the hundreds of trades at issue. Because of the unique facts of this case, I credit Dr. Becker's testimony that the established methodologies for measuring the value of secrecy and informational advantage would not reasonably approximate the Wyls' ill-gotten gains. Moreover, given the absence of an established methodology, I agree that Dr. Becker's method, that of comparing the Wyls' profits to those of a buy-and-hold investor could reasonably approximate the profits causally connected to the Wyls' violations.

Based on the unique facts here and the testimony of the experts, I conclude that Dr. Becker's choice of method was reasonable.”

be sharpened if the Board is to make a determined effort to maintain a cutting edge enforcement arm.

**‘ $\alpha$ ’ AS AN IMPORTANT RED FLAG:** Since it is difficult for any person to actually get a substantial ‘ $\alpha$ ’ without appropriate justification, calculating ‘ $\alpha$ ’ of trades by insiders and connected persons may be a very good indication of insider trading or front-running having taken place. The failure to substantiate the trade on the basis of actual access to reliable data (other than unpublished price sensitive information) which led to the investment decision, in comparison to the general market or even professional fund managers, is useful indicator of fraud especially if such persons were in a position to access unpublished price sensitive information. Statistics enables such analysis of fraudulent trades.

The exact formulae and methods are not discussed in this report as these methods are well understood in the financial world and are adopted and developed by different securities regulators globally<sup>183</sup> as well as by market participants in making investment decisions. However, the Committee will briefly discuss the concepts underlying the Event Study methodology which is the most basic method used by securities regulators globally for cases relating to information advantage.

**EVENT STUDY MECHANISM<sup>184</sup>:** An event study is a statistical technique developed by economists that estimates the stock price impact of occurrences such as mergers, earning

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<sup>183</sup> For a detailed study of SEC methodology and how it may be adopted in the context of other markets see the study in respect of the Italian market by the *Italian Companies and Exchange Commission* using the event study analysis method and the probabilistic method used as an alternative method: Marcello Minenna, ‘*Insider Trading, Abnormal Return and Preferential Information: Supervising through a Probabilistic Model*’, 27 (2003) *Journal of Banking & Finance*, Issue 1, 59-86, available at <<https://nscpolteksby.ac.id/ebook/files/Ebook/Journal/2015/Banking%20and%20Finance/Vol.%2027/Volume%2027%20Issue%201/Page%2059-86/Insider%20trading-abnormal%20return%20and.pdf>>, <<https://www.sciencedirect.com/science/article/abs/pii/S0378426601002096>>. Also see <<http://marcello.minenna.it/wp-content/uploads/2015/08/riskeu2003.pdf>>.

<sup>184</sup> For details see Mark L. Mitchell and Jeffrey M. Netter, ‘*The Role of Financial Economics in Securities Fraud Cases: Applications at the Securities and Exchange Commission*’, *The Business Lawyer*, Vol. 49, No. 2 (February 1994), pp. 545-590, available at < [https://www.jstor.org/stable/40687469?seq=1#metadata\\_info\\_tab\\_contents](https://www.jstor.org/stable/40687469?seq=1#metadata_info_tab_contents)>; A. Craig

announcements, and so forth. The basic notion is to disentangle the effects of two types of information on stock prices- information that is specific to the firm under examination (e.g. dividend announcement) and information that is likely to affect stock prices market wide.

In securities investigation, the execution of an event study by an economist is quite simple. It involves the identification of an event that causes investors to change their expectations about the value of a firm. The Investigator compares a stock price movement contemporaneous with the event to the expected stock price if the event study had not taken place. There are three basic steps in conducting an event study: (i) define the event window; (ii) calculate the abnormal stock price performance around the event and (iii) test for statistical significance of the abnormal stock price performance.

(i) THE EVENT WINDOW: The first step in the event study is selecting an event window. The event window is the period when information about the event becomes available to the stock market and thus may affect the relevant company's stock price. For most publicly-traded corporations, the event is disseminated publicly by newswire sources or the stock exchange. Because the efficient markets hypothesis, supported by considerable empirical evidence, suggests that stock prices react quickly to the release of new information, in many cases the event window will be relatively short, sometimes as short as one trading day. In determining the length of an event window, an important trade off exists. The longer the event window, the more likely the window includes the period during which all new information about the event is released. The trade-off, however, is that long event windows may include noise and information from other events, making it difficult to isolate the impact of the relevant event. The extent of difficulty in defining the event window length varies across events. In those instances, where the release of new information is a complete surprise to the market, it is relatively easy to establish the beginning of the event period. Consider an airline crash, for example. Because airline crashes are

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Mackinlay, 'Event Studies in Economics and Finance', (1997) 35 Journal of Economic Literature, 13-39, available at <<https://pdfs.semanticscholar.org/aac6/83a678a12a3dcd73389aac7289868847ea73.pdf>>.

unanticipated, the first day of the event period is either the day of the crash or the subsequent trading day if the crash occurred after the market close. Even when it is easy to identify the beginning of an event window, it can be difficult to establish an end of the event window. In the airline example, the end of the period would depend on when all of the relevant information regarding the crash was made available to market participants. For some crashes, it may take several days or perhaps even weeks before the market receives all the relevant information; in these cases, a longer event window is more necessary than for a crash in which all the information is available within a few hours following the crash. In most cases, however, the bulk of the information is released at the announcement of the event. Because the market processes information rapidly, it is conventional to expand the window for a short period after the announcement. It is standard to extend the event period to close of the trading on the day after the release of the pertinent information.

For those events that are subject to leakage, defining the beginning of the event window can be problematic. Consider the case of a merger in which the target company is rumoured to be “in play” prior to the announcement. For such a case, the event window should begin prior to the actual merger announcement, perhaps as long as a week or two. Ideally, the first day of the event window corresponding to a merger would be the date on which investors began trading on news about the upcoming merger, regardless of whether the news was based on rumours, inside information, regulatory filing, or a public announcement that merger talks were in process. In practice, this date is difficult to define and some degree of judgment is required generally based on price and volume movements prior to the merger announcement. With respect to securities fraud cases, there is substantial variation in the complexity of determining the length of an event window. In some fraud cases, choosing the appropriate event window is straightforward. An example is an insider trading case where the information used by the investor is revealed subsequently in a single public announcement. On the other hand, in many securities fraud cases the relevant information is revealed slowly over time, while during the same period investors receive other, sometimes unrelated, information about the firm(s) in

question. In the latter case, it is relatively difficult to choose an appropriate window. The main advice is to carefully identify the exact dates during which the information in question reached the market, and then restrict the window to a short period if possible, generally two or three days around each release of new information.

(ii) CALCULATING ABNORMAL STOCK PRICE PERFORMANCE: The question is whether the absolute value of the return is large enough so that the investigator can indicate with confidence that the return made by the defaulter is relatively unusual. The goal is to isolate the effect of the event on the contemporaneous stock price movement. Stated differently, the investigator attempts to determine whether the stock price behaviour around the event is abnormal. A large abnormal price movement occurring at the same time the market receives news about an event suggests that the event caused the abnormal price movement. Furthermore, the link between the event and the price movement is even stronger if there is no other new information reaching the market at the same time that could affect the stock price. The degree to which the stock price movement is small or big depends not only on the absolute value of the movement but also on the movement relative to the historical patterns and to contemporaneous overall market movements.

It is important to account for market-wide movement in stock, especially during periods when the market is volatile. The basic method for accounting for market-wide factors subtracts the market-wide return from the individual stock's return. This estimate is called the net-of-market return. Several choices of market indices are available as proxies for a market wide return- wider the market index the better it is considered as representative of the market. There are several statistical models depending on stock behaviour that can be used to determine returns, such as (a) the Constant Mean Return Model which assumes that the mean return of a given security is constant through time and is perhaps the simplest model, (b) the Market Model which assumes a stable linear relation between the market return and the security return (c) restricted approaches in special cases such as the Market-Adjusted Abnormal Return which is a constrained model used in cases of under-



pricing of initial public offerings. There are also Economic Models which can be cast as restrictions on the statistical models to provide even more constrained models. The use of other models is dictated by data availability. An example of a normal performance return model implemented in situations with limited data is the market-adjusted return model. A general recommendation is to only use such restricted models if necessary, and if necessary, consider the possibility of biases arising from the imposition of the restrictions. The main potential gain from using a model based on the arbitrage pricing theory is to eliminate the biases introduced by using the CAPM. However, because the statistically motivated models also eliminate these biases, for event studies such models dominate.

Further, although net-of-market returns, in many cases, provide an appropriate estimate of stock price effects of new information, there are instances where computation of market adjusted returns requires a more refined analysis to account for the fact that not all stocks are affected identically by economy-wide factors. This requires the investigator to use beta ( $\beta$ )-adjusted stock market performance. The difference between the predicted return and the actual return on a given date during the event window is known as 'abnormal return'. *Why abnormal? It is assumed that the unexplained part is due to some "abnormal" event that is not captured by the model.* Event windows can extend beyond one trading day. For these cases, the abnormal returns are cumulated to create 'cumulative abnormal returns'. Cumulative abnormal returns only measure the impact of company specific information. In a real sense, the value of the information to the trader is best represented by how the information would have affected the stock price in the absence of any other factors – the cumulative abnormal return.

(iii) TESTING FOR STATISTICAL SIGNIFICANCE: The question is whether the absolute value of the return is large enough so that the investigator can indicate with confidence that the return made by the defaulter is relatively unusual. The importance of historical average and standard deviation of the daily returns is highlighted in making the assertion that a given daily return is different from the

typical daily return given the context of a normal-bell shaped- distribution. Statistical tests of significance are useful both in establishing materiality and in calculating disgorgement. A finding that a stock return associated with the release of information is large enough that it is unlikely that the return occurred by chance is strong evidence that the information was important. Therefore, if that information was used allegedly in securities fraud, the finding that the associated stock return is large enough to be statistically important implies that the information is material. Furthermore, a finding of statistical significance for stock returns data used in calculations of disgorgement is an indication that the estimates are accurate.

E.g. suppose a company's stock price increases 7 % on the day that management releases a favourable earnings announcement. Suppose, also, that the prior day a company insider purchased stock based on his knowledge of the forthcoming announcement. The insider is subsequently charged with insider trading. A finding that the 7% return on the earnings announcement day is statistically significant is strong empirical evidence that the news was important. Stated differently, it is unlikely that the 7% increase in stock price occurred by chance. Furthermore, in calculating the profits for disgorgement based on stock price increase on the announcement day, if the return is statistically significant, then a more credible argument can be made that the 7% return represents the value of the insider's information. (This example does not imply that only positive increases in stock price are statistically significant, the historical and other contemporaneous factors need to be taken into account to determine what change in price is statistically significant.)

Thus, statistical methods not only enable the quantification of profits but also enable the adoption of a statistical method to test the materiality of any information.

The Board needs to develop new legal theories and adopt these statistical methods if the Board needs to maintain a cutting edge enforcement mechanism. Wherever difficulty is

faced by the Board in using these methods the assistance of experts like fund managers, auditors, lawyers, mathematicians, economists can be taken.

Though there are several shortcomings in using each and every kind of statistical methods in all circumstances,<sup>185</sup> new methods<sup>186</sup> get developed over time, like other securities regulators, to enable a best judgment assessment, which is better than no assessment at all. These methods need to be assessed in detail, adopted and developed by the Board, since different methods can be used depending on the facts of each case and the shortcoming of each method, such as liquidity of stock, recently quoted stock, etc.

## **8. GENERAL GUIDELINES**

In view of the above, the Committee is of the view that non-mandatory public guidelines (based on globally acknowledged methods of quantification, accounting standards and principles applied by judicial bodies, etc.) applicable for all new cases for quantification of profit made and loss caused as a result of violation of securities laws may be issued for the technical authorities that undertake investigation, inspection or audit under securities laws. These authorities may quantify the approximate profit made or loss caused based on the aforesaid in their Reports which shall be relevant for the Board for initiating appropriate enforcement action as well as serve as a guide for the quasi-judicial authority while considering the appropriate penalty to be levied or the amount to be disgorged. In general, before doing a full calculation, a back of the envelope/rough estimation can be made by the investigation authorities to determine which mode is to be adopted. If the earlier methods are more appropriate to a particular matter, the same can be adopted

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<sup>185</sup> <<https://economictimes.indiatimes.com/mf/analysis/how-to-calculate-risk-adjusted-returns-on-funds/articleshow/12208746.cms>>

<sup>186</sup> See Jeng, Metrick and Zeckhauser, 'Estimating the Returns to Insider Trading: A Performance-Evaluation Perspective', Harvard University and MIT Press: The Review of Economics and Statistics, May 2003, 85(2): 453-471, available at <<https://sites.hks.harvard.edu/fs/rzeckhau/InsiderTrading.pdf>>.

after recording reasons. The selection of the final profit/loss amount is left to the exercise of judicial discretion of the quasi-judicial authority. The Board can seek information from any person, including the defaulter. If after reasonable time, the noticee does not provide the relevant information, the calculation made by SEBI at the highest value will be final. (See the principle established in *Armory v Delamirie*<sup>187</sup>). The guidelines have been framed after taking into account any foreseeable needs in the near future that the Board may have.

On comparison with global regulators, it becomes clear that the enforcement processes of the Board needs a major overhaul. The Committee takes notice of the practices of the Japanese Regulator<sup>188</sup> - the Securities and Exchange Surveillance Commission (SESC) - which issues a Recommendation for Administrative Monetary Penalty to the Prime Minister of Japan and the Commissioner of the Financial Services Agency (FSA), which is confirmed by the FSA. The Recommendations<sup>189</sup> made by the Securities and Exchange Surveillance Commission and the Orders<sup>190</sup> issued by the Financial Services Agency (which is part of the Prime Minister's Office) contain detailed calculations on how the penalty was levied, taking into account every transaction and ¥ as far as possible. This practice needs to be adopted by the Board in its investigation/inspection/audit reports to further transparency and clarify the basis of its penalty, disgorgement and refund orders.

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<sup>187</sup> [1722] EWHC KB J94, (1722) 1 Strange 505, 93 ER 664 (KB), available at <<https://www.bailii.org/ew/cases/EWHC/1722/J94.htm>>

<sup>188</sup> See <<https://www.fsa.go.jp/sesc/english/aboutsesc/all.pdf>>.

<sup>189</sup> See, *Recommendation dated 02.02.2016 for administrative penalty for market manipulation by Evo Investment Advisors*, available at <<https://www.fsa.go.jp/sesc/english/news/reco/20160202-1.htm>>; *Recommendation dated 04.03.2016 for administrative penalty for market manipulation by Blue Sky Capital Management Pty Ltd*, available at <<https://www.fsa.go.jp/sesc/english/news/reco/20160304-1.htm>>; *Recommendation dated 06.12.2016 for administrative penalty for market manipulation by Morgan Stanley MUFG Securities Co. Ltd.*, available at <<https://www.fsa.go.jp/sesc/english/news/reco/20161206-1.htm>>; *Recommendation dated 17.03.2017 for administrative penalty for market manipulation by Caspian Trading Ltd.*, available at <<https://www.fsa.go.jp/sesc/english/news/reco/20170317-1.htm>>; *Recommendation dated 26.06.2018 for administrative penalty for market manipulation in shares of Cocokara Fine Inc.*, available at <<https://www.fsa.go.jp/sesc/english/news/reco/20180626.htm>>.

<sup>190</sup> See, *Order dated 24.04.2018 imposing Penalty Surcharge for market manipulation of stocks of Yurtec Co. Ltd and Maeda Road Construction Co. Ltd.*, available at <<https://www.fsa.go.jp/news/30/shouken/20180424-8.html>>; *Order dated 24.04.2018 imposing penalty surcharge in case of insider trading relating to Misawa Home stock by officers of its subsidiary*, available at <<https://www.fsa.go.jp/news/30/shouken/20180424-7.html>>; *Order dated 24.04.2018 imposing penalty surcharge for insider trading by officer of Escrow Agent Japan Ltd*, available at <<https://www.fsa.go.jp/news/30/shouken/20180424-6.html>>. (Translated from Japanese using Google Translate).

**RECOMMENDATION:**

- i. The Board may consider issuing the following public Guidelines at the earliest (w.e.f. Oct 01, 2021) to enable advance notice to market participants, including the members of the bar and Bench:

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**GUIDELINES FOR QUANTIFICATION OF THE AMOUNT OF DISPROPORTIONATE GAIN  
INCLUDING UNFAIR ADVANTAGE  
&  
AMOUNT OF LOSS CAUSED TO AN INVESTOR OR GROUP OF INVESTORS**

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**QUANTIFICATION OF AMOUNT OF DISPROPORTIONATE GAIN MADE AND LOSS CAUSED  
AS A RESULT OF THE VIOLATION OF SECURITIES LAWS**

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**CHAPTER I**

**INTRODUCTION**

The securities laws provide guidance to the adjudicating officer and the Board for the purpose of arriving at an appropriate penalty to be levied and enable the consideration of relevant factors, including the following factors, -

- (i) the amount of disproportionate gain or unfair advantage, wherever quantifiable, as a result of the default;
- (ii) the amount of loss caused to an investor or group of investors as a result of the default; and
- (iii) the repetitive nature of default.

Quantification of disproportionate gain is also relevant for the purpose of disgorgement from defaulters.

Whereas, Chapter VII of the Second Schedule to the Securities and Exchange Board of India (Settlement Proceedings) Regulations, 2018 read with Regulation 32 of those Regulations, provides guidance for consideration of the ‘repetitive nature of the default’.

Whereas, the Board considers it necessary to provide the following guidance for quantification of the amount of disproportionate gain or unfair advantage and the amount of loss caused to an investor or group of investors as a result of the default,-

## CHAPTER II

### GLOSSARY OF IMPORTANT TERMS

<u>SR. No.</u>	<u>TERM/ ABBREVIATION</u>	<u>EXPLANATION</u>
1.	<b>Accounting for profits method</b>	Based on incremental sales or profits achieved by the defaulter as the result of the harmful event.
2.	<b>Arbitrage</b>	The act of simultaneous buying and selling of securities, currency, or commodities in different markets or in derivative forms in order to take advantage of differing prices for the same asset.
3.	<b>Asset-based approach</b>	Involves analyzing the plaintiff’s tangible and intangible assets net of liabilities.
4.	<b>Average loss to the victims method</b>	The number of shares held by holders who are aggrieved multiplied by the average loss [based on the difference between the average price during the fraud (or relevant period selected) and average price during the averaging period selected after the fraud]
5.	<b>Before-and-after method</b>	Compares profits before the default event to profits made after the default event.

6.	<b>Beta (<math>\beta</math>)</b>	Describes the movement in a stock's or a portfolio's returns in relation to that of the market returns. For all practical purposes, the market returns are measured by the returns on the indices, since an index is a good reflector of the market.
7.	<b>Board</b>	Securities and Exchange Board of India
8.	<b>Bucketing</b>	Promising a certain price in respect of buying or selling of a security to a client and waiting till a discrepancy arises in the price of such security
9.	<b>Capping and Pegging</b>	<p>Capping is the practice of selling large amounts of a commodity or security close to the expiration date of its options in order to prevent a rise in the underlying's price. The writer or seller of an options contract has an interest in keeping the price of the underlying below the strike price in order for the options to expire worthless.</p> <p>Pegging is the opposite practice of buying large amounts of a commodity or security close to the expiration date of its options in order to prevent a decline in its price</p>
10.	<b>Churning and Burning</b>	Practice of an intermediary conducting excessive trading in a client's account mainly to generate commissions.
11.	<b>Correlation</b>	Is a statistic that measures the degree to which two securities (or stock exchange indices) move in relation to each other. Correlations are used in advanced portfolio management and calculated by various stock exchanges and intermediaries, computed as the correlation coefficient, which has a value that must fall between -1.0 and +1.0.
12.	<b>CTT (Commodity Transaction Tax)</b>	Commodities transaction tax (CTT) is a tax similar to Securities Transaction Tax (STT), levied in India, on transactions done on the domestic commodity derivatives exchanges.
13.	<b>Delta (<math>\Delta</math>)</b>	A ratio comparing the change in the price of an asset, usually a marketable security, to the corresponding change in the price of its derivative. Delta values can be positive or negative depending on the type of option.

14.	<b>ESOPS (Employee Stock Ownership Plan)</b>	An employee-owner program that provides a company's workforce with an ownership interest in the company.
15.	<b>IETF (Investor Education and Protection Fund)</b>	A fund formed under the Companies Act, 2013 for promotion of investors' awareness and protection of the interests of investors.
	<b>Income approach</b>	Involves calculation of a business's value by applying a discount or capitalization rate to a measure of its expected future earnings to arrive at a present value of the future benefit streams.
16.	<b>Inter-positioning</b>	<p>Illegal practice of employing a second intermediary in order to generate an additional commission and can take various forms. In one form, the broker purchases stock for the brokerage firm's proprietary account from the customer sell order; and then fills the customer buy order by selling from the brokerage firm's proprietary account at a higher price — thus locking in a riskless profit for the brokerage firm's proprietary account.</p> <p>A second form of inter-positioning involves the broker selling stock into the customer buy order, and then filling the customer sell order by buying for the brokerage firm's proprietary account at a lower price — again, locking in a riskless profit for the brokerage firm's proprietary account. In both forms of inter-positioning, the broker participates on both sides of the trade, thereby capturing the spread between the purchase and sale prices, disadvantaging at least one of the parties to the transaction.</p>
17.	<b>IPEF (Investor Protection and Education Fund)</b>	A fund constituted by SEBI (Investor Protection and Education Fund) Regulations, 2009
18.	<b>IPR (Intellectual Property Rights)</b>	Legal rights that protect creations and/or inventions resulting from intellectual activity in the industrial, scientific, literary or artistic fields.
19.	<b>Market Approach</b>	Uses pricing multiples taken from guideline companies or transactions and applies these multiples to the appropriate performance measure of the company being valued



20.	<b>Market Capitalization</b>	The total market value of a company's outstanding shares.
21.	<b>Market Capitalization Method</b>	<p>The actual loss attributable to the change in value of the security is the amount determined by—</p> <p>(I) calculating the difference between the immediate price of the security during a suitable period prior to the disclosure/stoppage of the fraud (usually the closing price the day before the disclosure/stoppage) and the immediate price of the security after the fraud was disclosed to the market/stopped (usually the closing price after the disclosure/stoppage) (or next day price), and</p> <p>(II) multiplying the difference by the number of shares out-standing after excluding those held by the defaulters themselves (if they amount to substantial holdings) throughout the period of the default, if available.</p> <p>In determining whether the amount so determined is a reasonable estimate of the actual loss attributable to the change in value of the security, the Board may consider, among other factors, viz.- the extent to which the amount so determined includes 'significant changes' in value not resulting from the default (<i>e.g.</i>, changes caused by external market forces, such as changed economic circumstances, changed investor expectations, and new industry-specific or firm-specific facts, conditions, or events that appear to impact the price movement by more than 20%) by fixing if possible, a suitable percentage on the amount determined above:</p> <p>Provided that in case of companies which become entirely worthless after the default, i.e. If the company whose securities is sold has no activities, assets, facilities, or any other source of value, so that the "company" has no underlying equity; in such cases instead of taking the difference take the entire value of stock prior to the fraud coming to light.</p> <p>Explanation. – The fact that the stock cannot be traded at all after the fraudulent scheme</p>

		came to light or the stock has been traded only by “insiders” in the fraudulent scheme shall be relevant to decide if the stock was worthless.
22.	<b>Market Share Method</b>	The method is based on the market share the person would have attained, “but for” the default event.
23.	<b>Marking the Close</b>	Involves deliberately buying or selling securities or derivatives contracts at the close of the market in an effort to alter the closing price of the security or derivatives contract
24.	<b>Modified Market Capitalization Method</b>	Comparing the change in stock value of other, stock of similarly placed but unaffiliated companies after irregularities in those companies were disclosed to the market. The average depreciation may be taken as loss caused.
25.	<b>Modified Recessionary Method</b>	<p>The actual loss attributable to the change in value of the security is the amount determined by—</p> <p>(I) calculating the difference between the average price of the security during the period that the fraud occurred and the average price of the security during the relevant period (<i>choice of appropriate time period may be made to inter alia consider the time when the market could be said to have absorbed the information and reflect the same in the price of the security. There may be delay with which the market may start correcting itself or extended periods for the market to correct itself. This depends on individual stock and market conditions</i>) after the fraud was disclosed to the market or after the misconduct ended, as may be applicable, and</p> <p>(II) multiplying the difference in average price by the number of securities out-standing after excluding those held by the defaulters themselves (if they amount to substantial holdings) throughout the period of the default, if available.</p> <p><i>Explanation 1. – Average price may be calculated by using the closing price of each trading day of the time period selected or by using any other relevant price, including weighted average price or other method. It is</i></p>

not necessary that the relevant period may refer to the entire period from which the default occurred and the fraud came to a stop, the 'relevant' period may refer to a sub-period during which substantial trades took place or which was immediately connected to the fraud.

*Explanation 2. – ‘relevant’ period for averaging: In case of illiquid securities* [including related exchange traded derivatives and debt instruments]: the price on the day (or the next trading day, whichever is appropriate) the true and fair information/fraud has been become publicly disseminated/stopped may be selected or the average price for a period not exceeding seven trading days, to the extent possible, after the true and fair information/fraud has been become publicly disseminated/stopped may be selected, as may be deemed fit.

*Explanation 3. – ‘relevant’ period for averaging: In case of liquid securities* [including related exchange traded derivatives and debt instruments]: the period may be a multiple of fifteen trading days to be selected after the true and fair information/fraud has been become publicly disseminated/stopped provided that it shall not exceed ninety days, to the extent possible, especially in relation to securities which are part of any index [including related exchange traded derivatives and debt instruments]. Shorter periods may be selected in case extraneous factors demonstrably affect the price.

In determining whether the amount so determined is a reasonable estimate of the actual loss attributable to the change in value of the security, the Board may consider, among other factors, the extent to which the amount so determined includes 'significant changes' in value not resulting from the default (*e.g.*, changes caused by external market forces, such as changed economic circumstances, changed investor expectations, and new industry-

		specific or firm-specific facts, conditions, or events that appear to impact the price movement by more than 20%) by fixing if possible, a suitable percentage of the amount determined above.
26.	<b>Net Profit Approach</b>	The approach considers the total increase in value realized through trading in securities. Gain is the total profit actually made from a defendant's illegal securities transactions.
27.	<b>Portfolio-pumping</b>	Bidding up the value of a fund's holdings right before the end of the period, when the fund's performance is measured. This is done by placing a large number of orders on existing holdings, which drives up the value of the securities within the fund portfolio.
28.	<b>Quasi-judicial Authority</b>	A Member of the Board or an Adjudicating Officer exercising quasi-judicial functions.
29.	<b>Relevant Authority</b>	Includes an investigating officer, designated authority, inspecting authority and a quasi-judicial authority.
30.	<b>Sales Projection Method</b>	The method compares forecasted profits before the harmful event to actual profits after the harmful event
31.	<b>Scalping</b>	Recommending a security for investment and selling it at a profit while making the recommendation
32.	<b>Securities Laws</b>	Includes all laws pertaining to securities market which are administered by the Board
33.	<b>Simple Recessionary Method</b>	the actual loss attributable to the change in value of the security is the amount determined by calculating the difference between the price paid by the affected set of investors and the price existing after the fraud was disclosed to the market/stopped
34.	<b>Standard of the Compliant Person</b>	The defaulter's behaviour has to be compared vis-à-vis the behaviour of a person who complies with securities laws. The monetary and non-monetary benefits received by a defaulter has to be compared with the costs incurred and benefits received by the compliant person to determine the illegal gain.
35.	<b>Standard of the Reasonable Investor</b>	In order to determine loss caused to investors or to determine the obligation of defaulters which is dependent on the prior exercise of any right associated with securities, etc., the

		investors are presumed to have behaved in a reasonable way.
36.	<b>Tailgating</b>	When a broker, financial advisor or another sort of investing agent buys or sells a security for a client, and then proceeds to make the same transaction for himself.
37.	<b>Touting</b>	To strongly encourage investors to buy a particular security. Touting means an intermediary recommending sale to the investors without disclosing that the person recommending has received any direct or indirect benefit from another for making such recommendation.
38.	<b>Uttering of Securities</b>	The issue of securities without proper approvals or continued holding of fraudulent or forged securities, exercise of corporate rights and acquisition of further securities on account of such securities.
39.	<b>Yardstick Method</b>	The method compares profits to a quantifiable yardstick, before and after the harmful event.
40.	<b>Zero-Sum Game</b>	<p><b>A mathematical representation of a situation in which each participant's gain or loss of utility is exactly balanced by the losses or gains of the utility of the other participants.</b></p> <p><b>In the context of securities market it means that the investors affected are the same as the investors from whom the gain has been derived from and the loss caused to such investors thereabouts equals the gain derived</b></p>
<p>Words and expressions used but not defined in these Guidelines but defined in the Securities and Exchange Board of India Act, 1992 the Securities Contracts (Regulation) Act, 1956 the Depositories Act, 1996 the Companies Act, 2013 or any of the rules or regulations made thereunder, shall have the same meanings respectively assigned to them in those Acts, rules or regulations or any statutory modification or re-enactment thereto.</p>		

## CHAPTER III

### GENERAL PRINCIPLES

1. These Guidelines provide non-mandatory guidance and depending on the facts and circumstances of each case the relevant authority may deviate from or modify these guidelines as may be deemed fit or use any method not detailed in these guidelines or any combination or modification thereof, for reasons to be recorded.
2. These Guidelines may be applied, to the extent possible, to all fact-finding inquiries such as investigations, inspections, inquiries, enquiries, audits initiated on or after October 01, 2021 and consequential legal proceedings.
3. **Application of Multiple methods:** The relevant fact-finding authority may use the available information and indicate in the relevant Report, all or any of the possible methods for calculating approximate disproportionate gain derived or loss caused to investors as deemed appropriate.

*Explanation.* - Where it is possible to apply more than one methodology for the purpose of quantification of a particular amount, it is not necessary for the relevant authority to apply all possible methods in its report/fact finding/examination instead any appropriate method(s) may be applied for the benefit of the quasi-judicial authority.

4. **Joint liability of offenders:** In cases of joint liability for any alleged default, generally, the relevant authority, may calculate the gain derived or loss caused holistically on a joint, several or 'joint and several liability basis', as may be deemed fit.

**5. Persons who may be charged jointly:** The following persons may be charged jointly and their gains and losses quantified jointly, namely, -

(a) persons accused of the same violation committed in the course of the same conduct;

Explanation 1. – Any person who is in charge of and responsible for the activities of any other person may be charged jointly with the person he is in charge of.

Explanation 2. – “in the course of the same conduct” means a group of facts so connected together by reason of continuity of action or purpose or cause and effect, or as principal and subsidiary acts.

(b) persons accused of a non-compliance/violation of securities laws and persons accused of abetment of, or attempt to commit, such violation;

(c) persons accused of a non-compliance/violation of securities laws in the nature of breach of fiduciary obligation and persons accused of misappropriation of money or other property which was the subject of such fiduciary duty;

(d) persons accused of different violations of securities laws committed in the course of the same conduct;

(e) persons accused of a non-compliance/violation of securities laws in the nature of fraudulent and unfair trade practices, insider trading or misappropriation, and persons accused of receiving or retaining, or assisting in the disposal or concealment of, property possession of which is alleged to have been transferred by any such violation committed by the first-named persons, or of abetment of or attempting to commit any such last-named violation;

(f) an acquirer and persons acting in concert with such acquirer;

(g) in case of failure to make, or making of incorrect or false or misleading, disclosures, reports, filings, statements, offer documents, or information, the

person which signs or issues such document along with persons who prepare such document (including experts involved) and persons who approve the same; and

(h) any other classes of persons, as may be deemed fit.

Explanation 1. – The classes of persons mentioned in this guideline may or may not be charged jointly depending on the facts and circumstances of each case.

Explanation 2. – Where there are multiple charges, it is not necessary that all persons to be heard jointly be charged together in respect of each and every charge.

**6. Quantification when not required:** Quantification may not be required, *inter alia*, in the following cases, -

- i. Where the relevant authority is satisfied that the penalty imposed would be higher than any possible disproportionate profit derived from the default or is the maximum imposable penalty under securities law; or
- ii. Where multiple defaulters are involved and one or more than one person but not all, have been held jointly or jointly and severally liable for a particular default(s), quantification may not be required for other defaulter(s) in respect of such default(s); or
- iii. In violations which are generally considered to be victim-less defaults, such as insider trading, loss caused to investors may not require quantification.

**7. Zero-sum game scenario:** Where loss to the investors and profit made out of the default are more or less same, then either profit made or loss caused may be calculated using any available methodology.



*Explanation.* – In cases where the default does not entail a ‘zero-sum game scenario’, the refund or disgorgement wherever permitted under law shall be based on the disproportionate gains made, jointly or severally, and not the loss caused to investors.

- 8. Determination of gain or loss “as a result of the default”:** Wherever possible, gain derived or loss caused which is causally connected with the default should be segregated from gain derived or loss caused which is not so connected, in accordance with these Guidelines, to arrive at the disproportionate gain and loss caused to investors, as a result of the default.

*Explanation 1.* - Uncertainty is inherent in the act of the defaulter, hence the defaulter shall bear the risk of uncertainty and be liable for any uncertainty in the estimation of disproportionate gain made (and loss caused to investors) since the defaulter’s conduct has created the uncertainty in estimation of non-legitimate gain derived (or loss caused to investors).

*Explanation 2.* – Any gain derived or loss caused is said to be causally connected if such gain or loss is a direct or proximate result of, or such gain or loss was reasonably foreseeable as a result of the violation of securities laws.

*Explanation 3.* - Disproportionate gain could be direct or indirect, in cash or kind, and includes notional gain or unfair advantage of any kind, including any loss avoided.

*Explanation 4.* - “Loss to investors” for the purpose of these Guidelines does not include emotional distress, harm to reputation or other non-economic harm.

*Explanation 5.* -Where disproportionate gain or loss caused to investors, cannot be estimated with reasonable approximation, then quantification to the extent possible or on ‘at least’ basis may be done.

*Explanation 6.* – The following standards may be relied upon to determine the gains derived or losses caused as a result of the default, -

- i. Standard of the Compliant Person;
- ii. Standard of the Reasonable Investor; or
- iii. Any other standard that may suitably analyse the conduct of the defaulter and segregate and identify the gain made or loss caused by the defaulter as a result of the default.

9. **Application of the principle of *Armory v Delamirie*:** The defaulter shall be responsible to supply to the satisfaction of the Board, the necessary information required to calculate disproportionate gain made (or loss caused to investors), which is within his possession or that which he is in a position to obtain. On failure to provide the relevant information, the entire gain derived (or loss caused to investors) may be deemed to be as a result of the default and such calculation shall be final and any windfall accruing to investors on account of such uncertainty which is inherent in the misconduct of the defaulter may be made available to the investors in appropriate proceedings resulting from disgorgement.

10. **Application of average values:** (a) Average may be applied wherever considered appropriate and average includes weighted averages, mean, median or mode as may be considered appropriate.

(b) Wherever appropriate, actual price, average price, weighted average, closing prices or average of closing prices during the relevant period may be used;

11. **Averaging period:** Averaging period may be of a very short duration in case of illiquid securities or long (but not exceeding 90 days) in case of liquid securities.

Averaging period may be used to calculate appropriate acquisition or sale price when no price is available or the price available is misleading or does not consider the market factors affecting price.

In *non-insider trading matters*, if inspite of averaging period, the price is affected by significant market factors (i.e. factors that appear to impact the price movement by more than 20%) an approximate deduction as deemed fit may be given.

12. Manipulation of securities may be done by fraudulent trading or dissemination of false information or any other fraudulent device designed to manipulate the securities markets.
13. **Default period:** Default period means the period during which the default was committed and may also include any period during which the relevant prior events and acts or omissions that enabled the default took place, as well as any consequential events, acts or omissions; or any relevant sub-period thereof including the period under investigation, audit or inspection, etc.
14. **Application of multiple guidelines:** On account of the nature of the act or omission of the defaulter(s) the quantification of profit made or loss caused may include quantification under more than one guideline;
15. **Presumption against influence of extraneous factors:** For the purpose of quantification, the relevant authority may presume that the change in price of securities excludes any depression or inflation in the price of security caused by factors other than the misconduct, unless the defaulter proves the relevance thereof and such factors are capable of being assessed based on the record and as per these guidelines.
16. **Other Presumptions:** The following presumptions may be relied upon, -
  - i. The relevant authority may presume the existence of any fact which it thinks likely to have happened, due regard being had to the common

course of natural events, human conduct and public and private business, in their relation to the facts of the particular case, including, -

- a. That evidence which could be and is not produced would, if produced, be unfavorable to the person who withholds it (or any other related person);
  - b. That when a document creating an obligation is in the hands of the obligor, the obligation has been discharged, save in case where the circumstances of the case are such that he may have stolen it, or procured by duress or false representation; and
  - c. That the common course of business has been followed in particular cases.
- ii. Where a document would *ex facie* be relevant to any inquiry, investigation, audit, examination or other proceeding and the defaulter knew or reasonably could have known that the violation of securities laws was detected or about to be detected by the Board, the non-production of such document on the ground of non-maintenance due to the mere lapse of a period longer than the period for which such document is required by law to be maintained shall be no defence.
- iii. Where there is a question as to the good faith of a transaction by one who is in a position of active confidence, the burden of proving the good faith of the transaction is on such person.  
*Explanation.* - The burden of proving that unpublished price sensitive transaction has been communicated for a lawful purpose shall be on the person so communicating.
- iv. When a person does an act with some purpose other than that which the character and circumstances of the act suggest, the burden of proving that purpose is upon him.

*Explanation.* - The burden of proving that unpublished price sensitive information has not been communicated shall be on the person who enters into a communication with a person who trades or enables another to trade in a manner which is suggestive of have been done on the basis of such information.

- v. When any fact is especially within the knowledge of any person, the burden of proving that fact is upon him.
- vi. The burden of proving any fact necessary to be proved in order to admit any document as evidence or to enable any person to give evidence of any other fact is on the person who wishes to rely on such evidence.
- vii. Fraudulent funding through transfers shown as 'loans' for the purpose of enabling a default or which arise as a consequence of such default, which a person receiving has no intention to repay or which are repaid from funds relating to such default, may be included as siphoned off funds or disproportionate gain or considered as his own funds, as the case may be.  
*Explanation 1.* – Where a person repays a loan subsequent to the time of detection of misconduct, he shall be deemed to have no intention to repay unless he makes appropriate submissions indicating that such repayment, if any, was not on account of such detection.

*Explanation 2.* – Where a person submits that a particular transaction is a legitimate loan transaction or reversal thereof, it shall be necessary to give evidence indicating that the actual net transfers of money took place as well as admissible evidence (duly stamped, registered and disclosed wherever required by law) indicating the purpose for which the transfers were made at the relevant time.

17. Wherever, any information, including price is not available for the purpose of quantification, these guidelines may be applied to the extent possible.

*Explanation.* – In cases where data is not made available even after being sought, the data may be presumed as ‘o’ or not applicable or arrived at by extrapolation or by using another other means or reasonable assumptions may be made and the methodology modified appropriately.

18. **When UPSI comes into existence:** Where information relating to the contravention of securities laws is in the nature of unpublished price sensitive information, such unpublished price sensitive information shall deem to come into existence when the contravention was committed and concealed, and not when the contravention was detected.

*Explanation.* – Where the unpublished price sensitive information pertains to the existence of any investigation, inspection, audit or inquiry against a company the unpublished price sensitive information shall come into existence when such company or the persons in charge of such company first become aware of such investigation, inspection, audit or inquiry.

19. **Relevance of accounting standards:** The accounting standards required to be followed by the defaulter shall be relevant but not binding for the purpose of quantification and may be applied to the extent possible.

20. **Assumption of sale:** Where a security has not been sold during the default period, for the purpose of quantification, the security shall be deemed to have been sold and sale price shall be calculated as per these guidelines.

21. **Round-off:** The relevant authority may round-off the disproportionate gains or losses caused quantified to the next multiple of 1000.

22. Mere irregularity or error which is not substantial shall not affect, any approximation of disproportionate gains or losses caused.

## CHAPTER IV

### GUIDELINES ON DEDUCTIONS

1. **Deductions, if any, may be permitted in accordance with these guidelines.** The defaulter shall be responsible to provide to the satisfaction of the Board the necessary information required to determine the deduction claimed, failing which such claim shall be denied.
  
2. **Deduction of monies:** Where monies raised by issue of securities is refundable,-

**In proceedings for levy of penalty:** No deduction may be given to the defaulters in case of monies/assets are returned/refunded/d disgorged, -

- i. to avoid detection or to perpetuate ongoing contravention,
  
- ii. after detection of the contravention, or
  
- iii. payments made in respect of initial investments to entice additional investments or to conceal the contravention.

*Explanation.* – For the purpose of these guidelines, the time of detection of the contravention is the earliest of, -

- A. the time the misconduct was discovered by a Government Agency, including the Board or a securities market infrastructure institution or a self-regulatory organization, leading to an examination into the facts being directed by the relevant authority;  
*or*
  
- B. the time the defaulter knew or reasonably could have known that the violation was detected or about to be detected under (1).

**In proceedings for disgorgement/refund:** Deduction may be given in respect of the assets returned by the defaulters and duly reported to the Board before the issuance of any interim direction, cease and desist order or direction of disgorgement/refund, as the case may be.

*Explanation.* – Where a claim is made that monies have been duly refunded to investors, the defaulter shall be liable to prove, -

- A. the existence of sufficient funds from which monies were refunded;  
and
- B. the proof of refund through banking means or by way of direct credit in the bank account through NEFT/RTGS/IMPS or any other mode allowed by RBI.

*Explanation.* – Where despite a refund opportunity being provided, monies have not been claimed by investors or where investors to whom monies are due cannot be found within reasonable time, such monies shall be deposited in the IEPF or IPEF as the case may be.

3. **Deduction for costs of illegal activity:** As a general principle, no deduction shall be given for costs incurred in respect of conducting the violation of securities laws.

4. **Deduction for costs directly related to the transaction and specifically for transaction:** Deduction in relation to costs incurred while doing the unlawful transaction in securities which are *direct and transaction-specific*, such as stamp duties, STT and CTT shall be allowed;

*Explanation.* – General costs including costs incurred for employees' remuneration are not a transaction-specific cost.



5. **Deduction for costs incurred but which remain unpaid:** No deduction for costs (including taxes) which are due but which remain unpaid shall be allowed;
6. **Deduction for leveraged funds:** Wherever the trading is done on the basis of leveraged funds, no separate deduction shall be allowed for the cost of leveraging, beyond the price of acquisition;
7. **Deduction for taxes paid in refund matters:** Deduction for taxes paid (other than STT or CTT) shall not be allowed in case of refund obligations under securities laws;
8. **Deduction for taxes paid in disgorgement matters:** Deduction for taxes paid (other than STT or CTT) shall not be allowed in case of disgorgement obligations under securities laws where disbursement to identifiable investors may be possible;  
*Explanation.* - Deduction under this guideline may be allowed where disgorgement is directed for victimless defaults such as insider trading.
9. **Deduction for taxes against different revenue streams:** No deduction shall be allowed for taxes paid from gross receipts based on the portion of receipts used for payment of taxes in respect of activities other than the activity under consideration;  
*Explanation.* – Where the defaulter has paid taxes for more than one activity, including activities not connected to the default, the burden of proving which portion of taxes paid is relevant to the default shall be on the defaulter, failing which no deduction may be allowed.
10. **Deduction for taxes in penalty proceedings:** Deduction of taxes paid (other than STT or CTT) is not relevant for the purpose of quantifying gain derived while levying penalty.

**11. Fraudulently providing financial products and services without proper license or approval:** When the defaulter(s) poses as a registered/authorized financial service provider and *represents* that the financial products or services are authorized by the Board or any other Government Agency, including a securities market infrastructure institution or a self-regulatory organization even though they are not or fraudulently obtains such authorization for financial goods or services, the defaulter shall receive no deduction for the value of the financial products or services are misbranded or falsely represented regardless of the actual fitness or performance of those products.

**12. Deductions for taxes (other than STT or CTT) paid for unlawful activity:** Save as otherwise provided in this Chapter, deduction for taxes (other than STT or CTT) paid from gross receipts based on the portion of receipts used for payment of taxes in respect of unlawful activity may be allowed in cases, where the defaulter is able to compute and prove to the satisfaction of the Board, the co-relation of the relevant portion of taxes for which deduction is claimed with the activity under consideration.

13. Nothing in these guidelines shall affect any right of the defaulter, if any, to seek appropriate remedy before the relevant tax authority.

## CHAPTER V

### GENERAL GUIDELINES RELATING TO QUANTIFICATION OF DISPROPORTIONATE GAIN

**1. Disproportionate Gain quantification:** The quantification of disproportionate gain or unfair advantage under these guidelines is only an

approximation, to the extent possible since uncertainty is inherent in the act of the defaulter, who shall bear the burden of the uncertainty.

2. **Misconduct affecting derivatives, arbitrages, etc.:** It is possible for the misconduct to involve manipulation of price and/or volume of a security in one segment or stock exchange and that the disproportionate gains accrue in a different segment or stock exchange in the same security or in a security related to such security and that it would amount to manipulation of the security where such disproportionate gains accrue.

*Explanation.* – It is not necessary for the disproportionate gain to only occur in the security of the listed company whose unpublished price sensitive information is disclosed. It may also be in relation to a security related to such security.

3. **Interest to avoid unjust enrichment from what would amount to an interest free loan from investors:** For the purpose of refund or disgorgement, unless otherwise provided by law, disproportionate gain, wherever quantified, shall include simple interest at the rate of 1% per month from the time when gain was accrued till the date of repayment to investors.
4. ***Zero Sum scenario in an unregistered investment scheme or fraudulent default.* - Disproportionate gains made or loss to investors as a result of unregistered investment schemes (PMS/AIF/CIS, etc.) or those investment schemes that fail by reason of a fraudulent or unfair trade practice, etc.:** Loss caused to investors equal the amounts originally invested by the investors and the earnings re-invested in such schemes, even though those earnings accrued as a result of such schemes. However, the most recent promised or reported earnings shall be excluded unless re-invested.

*Explanation.* – Investment schemes in these guidelines also include services of portfolio manager, an alternative investment fund and other pooled investment arrangements required to be registered with the Board.

5. **Fees earned in respect of any misconduct:** In case the defaulter's misconduct included the provision of services of an intermediary or securities market infrastructure institution or a professional, the ill-gotten gains shall include the *gross* fees, commissions, etc. earned in respect of the misconduct.

*Explanation 1.* - Where the gross fees are for unlawful as well as lawful activities, if the substantial nature of the services provided was in relation to unlawful activities, then the entire fees shall be considered as undue advantage. Else a fraction of such gross fees may be taken based on the clarification provided by the defaulter.

*Explanation 2.* - In these guidelines an '*intermediary or securities market infrastructure institutions*' shall include any person required by securities laws to be registered or recognized by the Board.

6. **Regulatory charges avoided:** In case of any un-authorized or un-recognized or un-registered activity, including unauthorized issue of securities, the monies that would have been payable as fess, charges, etc., for conducting such activity including those payable to the Board, Government, stock exchange, depository or clearing corporation, but not paid, shall be included in the disproportionate gain made as losses avoided.
7. **Loss avoided while in possession of negative information:** Where front running or insider trading is done to avoid loss due while in possession of negative unpublished information, the loss avoided is the value of shares sold multiplied by the difference in price during the relevant period after the publication of such information.

8. **Gains made by the person in charge of a juridical person:** In case of a director, partner, employee or any other person in charge of the actions of a body corporate or firm, subject to appropriate quantification made by such defaulter, the disproportionate gains may include the entire remuneration, commission (including secret commissions), share of profits, bonuses, stock options, sweat equity, stock sales, any other corporate or pecuniary benefit is received by such person (or part thereof) during the relevant period, as may deemed fit after considering relevant factors:

Provided that, where the default is such that it enables the defaulter to gain control of the body corporate or the compensation was substantially tied to the default or the body corporate is required to restate its accounts due to substantial non-compliance of securities laws due to the default, the entire such benefit may be considered to be due as disproportionate gains.

9. **Failure to comply with fiduciary duties:** In case of any auditor or other professional who has failed to comply with the fiduciary duties under securities laws, the disproportionate gain may also include the gross remuneration received for conducting his duties or a portion thereof.

**Undisclosed profit:** Where a person under a fiduciary duty to investors makes an unauthorized secret commission, profit, etc. while managing the funds of investors such gains shall amount to disproportionate gains.

## CHAPTER VI

### GENERAL GUIDELINES RELATING TO QUANTIFICATION OF LOSS

1. **Loss quantification:** Loss quantification under these guidelines is only an approximation on a class basis and serves as a guide for considering the

appropriate penalties to be levied within the range provided by law and does not vest in any particular person(s), the right to seek compensation from the Board;  
*Explanation.* – In these guidelines, unless otherwise proved, loss calculation is for guidance only and not restitutory in nature, as direct co-relation with disproportionate gains made and loss caused to investors may not exist.

2. Loss to investors may accrue even when no trades are made by the defaulters, such as order log manipulation (which amounts to a fraudulent statement made to investors through the stock exchange mechanism by entering orders which create the impression of a false demand), false tips and messaging, etc.
3. **Loss in non-zero-sum cases:** In cases involving fraudulent and unfair trade practices cases, where the default does not entail a Zero-sum game scenario, in addition to the methods detailed in these guidelines, the loss to investors or group of investors may be calculated *inter alia* using the following methods:
  - i. Simple Recessionary method;
  - ii. Modified Recessionary method;
  - iii. Market Capitalization method;
  - iv. Modified Market Capitalization method;
  - v. Average loss to the victims method;
  - vi. Any other method determined to be suitable in the given circumstances; or
  - vii. A combination of the aforesaid.

## **CHAPTER VII**

### **GUIDELINES RELATING TO CONTRAVENTION INVOLVING UNPUBLISHED PRICE SENSITIVE INFORMATION, ETC.**

1. **Communication of unpublished price sensitive information related to Intellectual Property Rights (IPR):** In case of unlawful

communication of unpublished price sensitive information related to any IPR which is not required to be disclosed at the time of communication and loss of such information may result in substantial loss of stock valuation, with or without any trading done by the defaulter,-

- i. the disproportionate gain shall include the fair market value of such information, failing which the gain shall equal the cost of developing such information;

Explanation. – Valuation of the information may be done based on the applicable accounting principles and cost of developing the information can be derived from the costs maintained by the relevant company.

- ii. loss caused may include loss of profit or loss of business value, as the case may be.

Explanation 1. – *Loss of business value* may be calculated through the following methods, -

- d. *The asset-based approach;*
- e. *The market approach;*
- f. *The income approach; or*
- g. Any other suitable method or combination of methods.

Explanation 2. – *Loss of profit* may be calculated through the following methods, -

- a. *The sales projection method;*
- b. *The before-and-after method;*
- c. *The accounting for profits method;*
- d. *The yardstick method;*
- e. *The market share method; or*
- f. Any other suitable method or combination of methods.

## **2. Special case of default involving unfair informational advantage:**

Where the conduct involves informational advantage which results in trading, including insider trading, trading while in possession of true information when false, incorrect or misleading information is circulated in securities market, front-running or tailgating by persons in fiduciary capacity, etc., to determine the gains from such default, the following methods may be employed, -

- i. Statistical methods (such as calculation of abnormal returns using event studies, probabilistic methods, etc., as may be considered fit) wherever appropriate, preferably if the monies involved exceed Rs. 3 crore;
- ii. Non-statistical and approximation methods as detailed in these guidelines for sale or purchase of securities or both, as the case may be; or
- iii. A combination of i. and ii.

## **CHAPTER VIII**

### **GUIDELINES RELATING TO CONTRAVENTION INVOLVING HOLDING NORMS AND FAILURE TO PROVIDE EXIT OPPORTUNITY**

1. **Contravention of holding norms:** In case of failure/delay to dilute the securities holding as per the required holding norms, the disproportionate gains may include the following, -
  - i. the gains based on the difference in price between the prevailing market price when the excess securities are actually disposed (whether or not as per the direction of the Board) and the prevailing market price when the securities were required to be diluted as per applicable norms,  
*Explanation.* – any loss caused due to disposal of excess holding shall not be used to set-off any other gains made.
  - i. the gains made in nature of excess dividends, bonus shares, and other corporate rights in proportion to the excess holding during the delay



period, unless such corporate rights were part of a dilution scheme permitted by the Board,

- ii. the gains during the period of excess holding on account of any salary, esops, fees, etc. on account of any position held in the company which would have otherwise not been held without the excess holding.

2. **Failure to give exit Opportunity:** In case of failure to give an exit opportunity (open offer/delisting, etc.), the disproportionate gains may include the following, -

**In case of illiquid securities:**

- i. The costs avoided based on an approximation using similar issue sizes, wherever possible,
- ii. The difference between the price at which the exit offer is required to be given and prevailing market price, multiplied by the exit size.

*Explanation 1.* – In case of an open offer, the entire open offer size may not be taken, if it is proven to the satisfaction of the Board that the investors would not have taken the exit opportunity in the illiquid securities and the failure did not prejudice the investors.

*Explanation 2.* – In case of an open offer, (ii.) may not apply where the prevailing market price, at the time when the open offer is due (without delay), is higher than the price at which the offer is to be given.

*Explanation 3.* – In case of any act or omission caused or allowed by the defaulter for making the giving of the exit opportunity infructuous, such as compulsory delisting, strike-off, triggering insolvency, etc., the entire exit size may be taken instead of the difference based on price. The defaulter shall not be allowed to take the benefit of his default, including cases where the defaulter's delay has made the exit infructuous due to the

prevailing price being higher than the price (inclusive of interest) at which the exit may be given.

**In case of liquid securities:** Similarly, as in case of illiquid securities, the costs avoided and the difference in price shall amount to the gain, save that, -

- i. in case the open offer is required to be given solely by persons existing in control and their related group entities, the open offer size shall be taken as at least 50% thereof or such other lower percentage, as the facts permit, if it is proven to the satisfaction of the Board that at the relevant time, the investors would not take the exit opportunity in the liquid securities and that the failure did not prejudice the investors;
- ii. in case the open offer is required to be given by any other person(s), the entire open offer size shall be taken as the relevant open offer size or such other lower percentage, as the facts permit, if it is proven to the satisfaction of the Board that at the relevant time, the investors would not take the exit opportunity in the liquid securities and that the failure did not prejudice the investors;

*Explanation.* – In liquid securities, the Board may assume that the investors would seek exit in the open offer, where the prevailing market price, at the time when the open offer is due (without delay), is higher than the price at which the offer is to be given.

- iii. in case of any act or omission caused or allowed by the defaulter for making the giving of the exit opportunity infructuous, such as compulsory delisting, strike-off, triggering insolvency, etc., the entire exit size may be taken instead of the difference based on price. The defaulter shall not be allowed to take the benefit of his default, including cases where the defaulter's delay has made the exit infructuous due to the prevailing price being higher than the price (inclusive of interest) at which the exit may be given.

## CHAPTER IX

### GENERAL GUIDELINES RELATING TO DEFAULT INVOLVING SALE OR PURCHASE OF SECURITIES OR BOTH

1. **Difference in purchase and sale price to indicate profit:** Unless otherwise provided in these guidelines or otherwise considered fit by the relevant authority, in a default involving sale or purchase or both, the disproportionate profit may include the difference between the sale and purchase of securities, subject to one or more of the following guiding principles, -
  - i. The onus to prove the relevant sale or purchase price (including cases of notional profit) of the transactions done within the relevant period, for the purpose of quantifying the disproportionate gains, shall be on the defaulter(s), failing which the Board may adopt any reasonable method of quantifying the same:

Explanation. – Wherever required, the defaulter may rely on or be required to furnish his certified income tax records, bank records, telecommunication records, transaction details and any other document or statement, which is admissible as evidence, in accordance with any law relating to stamp duty, registration or any other applicable law, unless otherwise permitted.
  - ii. For the sale/purchase carried out within the default period, the disproportionate gain may be the difference between the acquisition price and sale price. Where, the relevant acquisition or sale purchase price is not available or the available value is not relevant to the default period, an approximate value in accordance with these guidelines may be used to arrive at the relevant gains or losses resulting from the default;

## 2. Computation of Acquisition Price:

- i. **When historical acquisition price not relevant or price not available, etc.:** Where the acquisition price of a security is not available and/or the acquisition was made one year or more prior to the default period, then a relevant acquisition price as may be deemed reasonable from the following may be selected, -
  - a. an averaging period not exceeding 90 days immediately prior to the default period may be selected to determine the acquisition price for determining the disproportionate gain and removing any legitimate gains;
  - b. in case of listing related defaults, where the shares were held prior to allotment of the public issue, any of the following deemed reasonable may be used, -
    - (i) allotment price or a suitable fraction thereof; or
    - (ii) a fraction of the price average for one month post listing or other suitable data set.
  - c. Any other method considered reasonable.
- ii. **Where securities are acquired within a year before the start of the default period:** Where securities are acquired within a year before the start of the default period, the price at which it is acquired shall be relevant acquisition price and if such price is not available, then a price deemed reasonable from the following may be selected, -
  - a. Where securities have been acquired after listing and the acquisition price is not available, the last available closing price for the day(s) on during which the securities were acquired/credited to the account of the defaulter (or person

holding on his behalf)/debited from the account of the seller, whichever is earlier;

- b. in case of listing related defaults, the allotment price may be used;
- c. in case of listing related defaults, where the shares were held prior to the allotment process of public issue, any of the following deemed reasonable may be used, -
  - (i) allotment price or a suitable fraction thereof; or
  - (ii) a fraction of the price average for one month post listing or other suitable data set.
- d. Any other method considered reasonable.

### **3. Computation of Sale Price:**

- i. **Sale price in general:** Where securities are sold within the default period, the sale price shall be the relevant price, and where such price is not available or the securities have not been sold during the default period, the sale price may be selected from any of the following as deemed reasonable, -
  - a. to treat the relevant profit as that profit gained when the information was made public and the market had a reasonable opportunity to digest the information. The gain is to be measured by reference to the market value of the securities at that date;
  - or
  - b. the price based on the averaging period not exceeding 90 days may be selected from the end of the relevant period.

ii. **Where securities were purchased illegally:** Where securities were purchased illegally by using funds provided directly or indirectly, by the issuer or through diversion of issue proceeds, -

a. the entire sale price of the securities sold, which were acquired through such means, shall be deemed to be the disproportionate gains;

or

b. in case the securities are not sold during the default period, the acquisition price or the price based on the averaging period not exceeding 90 days may be selected as a sale price from the end of the default period, whichever is higher.

4. **Sale of securities subject to lock-in:** Where securities subject to a lock-in of any kind are sold, the disproportionate gain (including loss avoided) shall mean the entire sale with deduction for the price immediately after the expiry of the lock-in requirement, if available;

5. **Scalping:** Disproportionate gains equals the sum of the gross fees charged for making the recommendation, the gross fees for facilitating investors to purchase through an intermediary and the profits made from personal sales of securities;

6. **In case of acquisition of securities by issue of fraudulent or counterfeit securities, or issue of securities without proper approvals mandated by law:** The disproportionate gains shall equal the difference between:

(i) the market value of such securities as on the date of purchase, allotment, issue, etc. (or the next trading day, if no price is available) by/to the defaulter(s) or the present market value of such securities as on the date of order in case the securities continue to be held, whichever is higher; and (ii) the actual consideration paid for acquiring the securities, if any:

Provided that where such securities have been sold at a higher price, such price may be relevant for calculating the disproportionate gain.

*Explanation 1. – Uttering of securities:* Where the misconduct relates to the issue of fraudulent or forged securities, or the issue of securities without proper approvals (which voids such issue of securities), the continued holding of such securities, exercise of corporate rights and acquisition of further securities on account of such securities shall amount to a continuing violation and the disproportionate profit shall include the accrued benefits.

*Explanation 2. -* Where bonus securities or dividends have been received on such securities, the market value of such bonus securities or dividends received shall be included as part of the disproportionate gain.

## **CHAPTER X**

### **GUIDELINES RELATING TO DEFAULT INVOLVING RELATED PARTY TRANSACTIONS**

1. In addition to any other guideline applicable, the Director's profit in relation to undisclosed related party transaction shall include profit (or part thereof) made on any trades/ESOPS/sweat equity, etc. prior to the disclosure made while in possession of such material unpublished price sensitive information relating to the transaction;
2. Directors' profit in relation to undisclosed related party transaction shall include any undue benefit given directly or indirectly, to the related party if the related party is a closely held company i.e. a private company or a public company which is not in compliance with minimum public share-holding norms and substantially controlled by the relatives of the director concerned or the director himself, singly or in concert with such relatives at the time of the transaction:

*Explanation 1.* – ‘undue benefit’ includes, transactions shown as ‘loans’ which the person receiving has no intention of paying back or fraudulently obtained, and includes any difference in interest when the loan is given at lower than commercial rate or penal rate, etc. as would have been otherwise applicable. Due regard may be given to the value of monies returned prior to the detection of the default or the security/collateral provided.

*Explanation 2.* - A person shall be deemed to have fraudulently obtained a ‘loan’ if,- (1) such loan was not in accordance with the applicable norms and practices and such person has ceased to pay his debts in the ordinary course of business, or cannot pay his debts as they become due, or (2) the monies were fraudulently siphoned off.

*Explanation 3.* - Unless contrary to the context, ‘Director’ means every director who was aware that the transaction was a related party transaction and expressly or impliedly approved the transaction with the knowledge that such approval was in contravention of law.

*Explanation 4.* – ‘relative’ means a relative as defined under section 2(77) of the Companies Act, 2013 and includes a member of the promoter group.

3. Loss caused to the company and indirectly to the share-holders may include, loss on account of the undisclosed related party transaction, any penalty levied on the company by any financial sector regulator for non-compliance, cost of financial restatements and entering into new arrangements on account of the default;

*Explanation.* – ‘loss’ includes, monies received by the entity who fails to pay back.



## CHAPTER XI

### GUIDELINES RELATING TO FRAUDULENT AND UNFAIR TRADE PRACTICES, ETC.

1. **Overvaluation of Securities due to non-disclosure or manipulation:**

In case of the issue of securities that are overvalued because of disclosure failings or by reason of manipulation (to which the issuer is a party) and such securities are allotted to the public, the disproportionate gain made, shall include:

[Allotment price – Closing Price of such security as on the date immediately following the day when the misconduct ends or after the public dissemination of true information, whichever is appropriate] \* total number of shares allotted to public investors:

*Explanation 1.* – It is possible that the manipulation may be done in already existing securities to make a further issue of securities attractive to investors.

*Explanation 2.* - In these guidelines, dissemination of true information is dissemination of any information which is contrary to the false information and such information is absorbed by the market, though it is not the complete truth.

2. **Bucketing by an intermediary:** In case of bucketing by an intermediary, the disproportionate gain shall equal the difference in prices retained by the intermediary and the gross brokerage, commission, fees, etc. charged.

3. **Churning and burning by intermediaries:** In case of churning and burning by intermediaries to generate more commission-based income, the disproportionate gains shall include the gross remuneration earned on the client account, for the period of default.

4. **Capping and Pegging:** In case of 'Capping and Pegging', the disproportionate gains shall include:

- i. **In case of capping:** the premium collected, if any and the loss avoided based on the difference between the strike price and the closing price on the day after the manipulation has ended/expiration date, whichever is later;
- ii. **In case of pegging:** the value gained is based on the difference between the strike price and the closing price on the day after the manipulation has ended/expiration date, whichever is later;  
*[in case forecasting using statistical methods is possible for options, the same may be used to calculate the difference between the expected and the actual deviated prices.]*

5. **Misconduct to inflate, deflate or maintain the price of securities:**

- i. In case of misconduct to inflate or maintain the price of securities to avoid losing pledged or loaned shares or to avoid a margin call, the disproportionate gains shall include the amount of money that the defaulter would have been required to pay to avoid the sale of the pledged shares or the value of the margin to be called, whichever is applicable:  
*Explanation.* - It is sufficient that the pledgor has knowledge that the misconduct inflates or maintains the price or it is done at his behest or instruction.
- ii. Similarly, in case of misconduct to inflate or maintain price of securities to force a conversion of a convertible debt instrument into equity, the disproportionate gains shall include the difference between the value of the debt converted (inclusive of interest) and the value of the equity instruments allotted on conversion, based on an averaging period not exceeding 90 days after the misconduct has ended or after the public dissemination of true information, whichever is appropriate.

- iii. In case of misconduct to deflate the price of securities in order to purchase the securities at a lower price, the gains shall include the notional gains based on the difference between the price before the manipulation (or the price after the manipulation, whichever is higher) and the price at which the securities are acquired;
6. **Fraudulent dealing to avoid tax burden:** In case of fraud in connection with the dealing of securities for intentional 'buying of losses' by fraudulent dealing, the disproportionate gains shall include the tax avoided through the fraudulent dealing, if any;
7. **Default done to ensure success of public issue:** In case the default is done to ensure the success of an issue of securities, the disproportionate gains shall include, the loss aversion of the sunk cost of the issue process and the cost of refund avoided;
8. **Touting and Mis-selling:**
- i. In case of touting, the disproportionate gains shall include the commissions received from the investors and the value of the benefit received.
  - ii. In case of mis-selling, the disproportionate gains shall include the commissions, fees earned in relation to the mis-selling or the period during which the mis-selling was done, as deemed fit.
  - iii. In case of touting and mis-selling, the loss caused to investors as a result of the failure or subsequent sale of the related security shall be considered as loss caused due to such default, if the default is the proximate cause of the loss.

9. In case of **inter-positioning** by an intermediary to generate risk-less profit on proprietary account by inter-posing between client orders, the disproportionate gains shall include the gains made on such trading and the commissions made;
10. In case of **portfolio-pumping** of fund's holding, the gains made shall include any commissions, fees, etc. made during the period from the manipulation to the closing of the day after the manipulation has ended (or the announcement of the relevant results, whichever is later); and loss to the investors shall include the trading costs incurred by the fund (MF/AIF/REIT/InVIT/PMS, etc.) to undertake the portfolio pumping including the losses incurred by the fund for making the default;
11. **Unlawful conversion, misappropriation or destruction of securities including physical securities resulting in permanent loss:** The value of the funds and the fair market value of the securities and other corporate assets (e.g. non-demat securities) are unlawfully taken and disposed of or destroyed, or if it is impracticable to determine the fair market value or such value inadequately measures the harm caused, the cost of replacing that property may represent the disproportionate gain made or loss caused to investors.  
If for some reason, the market value of the security cannot be determined, the following methods may be used -
  - i. The manageable profit-basis method (the Earning Per Share Method);
  - ii. The net worth method or the break value method, or
  - iii. Any other suitable method.

Provided that if third party assets have been misused in contravention of segregation norms and if such assets have been restored then instead of full value of the assets, the profit shall be determined at the rate of 1% per month

simple interest on the value of such assets, to remove any financial benefit derived from the interest-free use of such assets.

12. In case of **marking the close**, the gains made can be based on the difference in value of the future/option or quarterly/annual portfolio or index reference/valuation points during the period of the manipulation and on the closing of the day after the manipulation has ended (or the announcement of the relevant results, etc., whichever is later).

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- ii. Determination of profits made and losses caused are an essential complement for proving the violation of securities laws and in fact supplement the fact-finding inquiry and does not require a separate inquiry. Hence, investigation, inspection, inquiry and audit processes of the Board should require the relevant authority to examine the aspects necessary to quantify, during the investigation, inspection, inquiry and audit process itself, as doing so will also serve as an *aperçu* to form the line of inquiry, since *'following the money'* is a salutary principle of any investigation.
- iii. A positive mandate be given to the Department of Economic and Policy Analysis, Legal Affairs Department and IVD (dealing *with* Forensic Accounting) of the Board to undertake an ongoing analysis of the various methods employed by various regulators globally to enable their adoption by the Board and updation of the quantification approaches recommended in this report and explore the possibility of utilizing available software for carrying out complex calculations<sup>191</sup> or their in-house development;
- iv. A permanent technical standing committee be formed consisting of officers of the Board, economists, lawyers, statisticians, auditors and fund managers to help the

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<sup>191</sup> See <https://wrds-www.wharton.upenn.edu/pages/analytics/>; <https://www.r-project.org/>; [https://www.sas.com/en\\_in/home.html](https://www.sas.com/en_in/home.html); <https://www.stata.com/> and <https://www.eventstudytools.com/>.

Board on an ongoing basis to review of the manner of quantification to be carried out by the Board;

- v. Wherever the investigative/inspection/audit authority require assistance, including matters requiring statistical methods, they may seek the assistance of the Department of Economic and Policy Analysis for quantification. Wherever required SEBI may refer the matter to the permanent technical standing committee for guidance.
- vi. The Board may also consider corresponding with the USA-SEC and Italian Companies and Exchange Commission to gain from their experiences and incorporate their methods of quantification. While we have recommended many of the well-established methods adopted by global regulators, closer contacts with such regulators will help the Board and its staff in making appropriate decisions for determining the parameters to be employed in using these methods.
- vii. As a mid-term goal, the Board may consider developing an in-house software or such software through suitable service providers<sup>192</sup>, for the purpose of quantification of disproportionate gains and loss to investors based on the experience gained after implementing the suggested guidelines.
- viii. Unlike settlements in other kinds of disputes which are privately negotiated, settlement amounts in securities laws are arrived at using publicly available formula. This has been done to further transparency in matters of public interest. However, it is seen that transparency in settlement mechanism is open to arbitrage and defaulters try to game the enforcement mechanism by not going for settlement because there is no similar guidance for adjudication of penalties. Further, there is no uniformity even with respect to penalties levied by different adjudicating officers in respect of the same defaults. The Finance Act, 2018 has also empowered the Board to levy penalties, thus there is a possibility that different WTMs may impose differing penalties for the same kind of violation. Though there are existing internal circulars on levy on penalty

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<sup>192</sup> See <https://wrds-www.wharton.upenn.edu/pages/analytics/>; <https://www.r-project.org/>; [https://www.sas.com/en\\_in/home.html](https://www.sas.com/en_in/home.html); <https://www.stata.com/> and <https://www.eventstudytools.com/>.

they do not appear to have been applied consistently. The Hon'ble Supreme Court in *Adjudicating Officer, SEBI v Bhavesh Pabari*<sup>193</sup> has *inter alia* held that various relevant factors can be taken into account while adjudicating the levy of penalty and clauses (a) to (c) [factors relating to profit made, loss caused and repetitive nature of default] in Section 15-J of the SEBI Act are merely illustrative and are not the only grounds/factors which can be taken into consideration while determining the quantum of penalty. Accordingly, Regulation 32 of the recently issued SEBI (Settlement Proceedings) Regulations, 2018 *inter alia* provides that the *Schedule –II (dealing with quantification of settlement amount) of those regulations shall be relevant to proceedings before the Board or the Adjudicating officers and they may apply the same to the extent possible*. Hence to raise the standard of administration of justice and to ensure that defaulters do not game the enforcement mechanism of the Board, it may be essential to issue non-mandatory public guidelines for the purpose of levy of penalty to ensure the application of Schedule-II with appropriate modification and various judicial pronouncements while preserving the discretion of quasi-judicial authorities. Hence the Board may consider issuing the following guidance to the officers, -

### **GUIDELINES FOR LEVY OF PENALTY**

#### **GENERAL PRINCIPLES FOR DETERMINATION OF APPROPRIATE PENALTY**

For the purpose of arriving at an appropriate penalty to be levied on the persons who violate securities laws, the consideration of relevant factors, including the following factors is also required, -

- (i) the amount of disproportionate gain or unfair advantage, wherever quantifiable, as a result of the default;
- (ii) the amount of loss caused to an investor or group of investors as a result of the default; and
- (iii) the repetitive nature of default.

<sup>193</sup> 2019 (3) SCALE 447, available at [https://www.supremecourtfindia.nic.in/supremecourt/2013/36291/36291\\_2013\\_Judgement\\_28-Feb-2019.pdf](https://www.supremecourtfindia.nic.in/supremecourt/2013/36291/36291_2013_Judgement_28-Feb-2019.pdf).

In view of the same the following non-mandatory guidance is being issued by the Board for levy of penalty under securities laws in rescission of existing internal circulars,-

- A. This guidance may be applied to all proceedings for the levy of penalty initiated on or after the date of issuance of these guidelines;
- B. Deviation from this guidance may be for reasons to be recorded in the order imposing penalty;
- C. Second Schedule to the Securities and Exchange Board of India (Settlement Proceedings) Regulations, 2018 read with Regulation 32 of those Regulations, is relevant for determining the Indicative Penalty (IP) which may be levied.

In doing so, -

- a. Chapter VII of the Second Schedule provides guidance for consideration of the 'repetitive nature of the default' and hence repetitive defaults may be considered accordingly.

Explanation 1. - A 'repetitive' default shall not include a 'continuing' default.

Explanation 2. - A default may be a 'continuing' default if depending upon the language of securities laws which create that default, the nature of the default, and above all, the purpose which is intended to be achieved by securities laws constituting the particular act as a continuing default, and such contravention is not of a procedural or formal nature or it goes against the very grain of the statutory provision under consideration or is expressly recognized to be a continuing default or provides a penal liability or an injury which continues until the requirement is complied with.

- b. The IP may be calculated *mutatis mutandis* on the lines of calculating the IA under the Second Schedule. For determining the IP, -
  - i. PCF shall be 0.85;
  - ii. Reputation risk factor shall not be applicable;
  - iii. The IP shall not be less than the minimum penalty to be levied under securities laws and not exceed the maximum penalty permitted under securities laws; and
  - iv. Quantification of profit made and loss caused may be based on the guidelines issued by the Board, if any.

- D. For defaults where the maximum penalty under securities laws is not a multiple of the disproportionate profit made, -
  - a. If the profit made is less than the maximum penalty under law, then if considered appropriate, the penalty shall not be less than the profit made or the minimum penalty under law, whichever is higher;



b. If the profit made is more than the maximum penalty under law, then if considered appropriate, the penalty shall be the maximum penalty under law.

E. For defaults where the maximum penalty under securities laws extends to three times the profit made, but disgorgement or refund of the disproportionate profit made is contemplated or direction to disgorge has been issued but not been complied with, if considered appropriate, the penalty imposed may not be less than the profit made or the minimum penalty under law, whichever is higher.

F. In cases where the penalty under securities laws extends to three times the profit made and if the loss caused to investors exceeds the profit made by a multiple of 500 or more, then if considered appropriate, the penalty may not be less than the profit made but be not more than twice such profit or twice the minimum penalty under law, whichever is higher.

G. In cases the where the penalty under securities laws extends to three times the profit made and if the loss caused to investors exceeds the profit made by a multiple of less than 500, then if considered appropriate, the penalty may not be less than twice the profit made or thrice the minimum penalty under law, whichever is higher.

H. For the purpose of levying penalty, the profit made may be calculated jointly, severally or jointly and severally.

I. The IP may be adopted and levied as penalty if deemed appropriate to the nature of the default.

Explanation. -It is clarified that any approximations, errors or irregularities while calculating in accordance with these guidelines shall not invalidate the penalty levied, if the quasi-judicial authority imposing penalty is satisfied that the penalty levied is appropriate.

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- ix. Economic litigation is becoming more and more complex every day; a defaulter guided by greed may trigger regulatory responses that he may not fully fathom. Such instances are not unique to securities laws, but are found in various economic litigation such as taxation, anti-dumping/injury margin calculation. This does not mean that advanced regulatory responses should be confined to a highly educated defaulter, well versed in law, economics, statistics, etc. The law requires that the defaulter be given an opportunity to reply to the charge either by himself or by

competent professionals that he may appoint. The proposed guidelines permit such response. It must be made clear at the outset that the Committee is not recommending the creation of any 'new' statistical approaches. It is only suggesting the adoption *mutatis mutandis* of existing approaches for which literature and competent professionals exists. Though defaulters may cite difficulty in understanding these approaches, they are primarily responsible for the adoption of these methods and like the Board, they too may seek relevant competent professional assistance. However, mindful of the difficulties in these methods, the Committee recommends that the Board may also consider including course material in relation to quantification in the securities courses conducted by the NISM, Government law College, Mumbai and any other legal institution or establishment imparting a course in securities laws. Similarly, in line with the international practices, presentations may be made to the Tribunal on a regular basis by its specialist officers, to enable incorporation of views of the Bench to be considered while developing the Board's quantification methodology and enable market participants, the Bar and the Bench to become conversant with the manner of quantification to be adopted by the Board and enable exchange of ideas.

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**PART-D**

**INTERFACE BETWEEN SECURITIES LAWS AND INSOLVENCY LAW**

## INTERFACE BETWEEN SECURITIES LAWS AND INSOLVENCY LAW

### **AN INTRODUCTION**

The promulgation of the IBC has a significant ongoing impact on the enforcement of laws and the securities laws are no exception. Due to the low threshold levels for filing an insolvency petition and due to time-bound resolution process envisaged under the IBC a large number of corporate insolvency cases have been initiated. However due to the evolving nature of the IBC there is lack of clarity on several legal issues leaving them open to diverging interpretation by courts, tribunals, government agencies and the IBBI from time to time. For e.g. in the matter of *ACPC Enterprises v Affinity Beauty Salon Pvt Ltd*,<sup>194</sup> the NCLT held that when subscription money advanced for purchase of shares was refundable it was not a ‘financial debt’, hence the applicant was not a ‘financial creditor’ and thus refused to order the initiation of insolvency proceedings. However, in relation to Collective Investment Schemes, where monies became refundable the NCLT held that this as an “operational debt” and admitted the application for insolvency.<sup>195</sup> SEBI has taken the consistent stand before various forums that such monies are refundable as ‘monies held in trust’. This argument is in accordance with its statutory mandate and in the interest of investors since it would safeguard such monies from being pooled into the ‘Liquidation Estate’ or the ‘Bankruptcy Estate’ to satisfy the claims of creditors, including secured creditors. In the face of such conflicting decisions with the interest of investors at stake, this issue therefore warrants a detailed examination by the Committee.

The Committee is guided by the statutory triple mandate of the Board [(i) to protect the interests of investors in securities; (ii) to promote the development of, and (iii) to regulate the securities market] while considering the effect of the IBC on the enforcement process of the Board. Further, the Committee has examined various

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<sup>194</sup> Order dated 10.11.2017 [2018] 145 SCL 47 (NCLT-Delhi).

<sup>195</sup> *Eknath Aher v Royal Twinkle Star Club Ltd.*, NCLT order dated 02.05.2017, available at <<https://ibbi.gov.in/webadmin/pdf/order/2017/Jun/2ndMay2017RoyalTwinkleStarClub.pdf>>, and *Sayali Rane v Cytrus Check Inns Ltd.*, NCLT order dated 02.05.2017, available at <<https://ibbi.gov.in/webadmin/pdf/order/2017/Jun/2ndMay2017CytrusCheck.pdf>>. Presently the Hon’ble Supreme Court has appointed a joint sale-cum-monitoring committee vide order dated 10.05.2018 in the matter of *Anant Kajare v Eknath Aher*, available at <<https://indiankanoon.org/doc/194062162/>>.

aspects of the Indian, UK and USA law to further the point that the basic principles of law relating to insolvency are same irrespective of jurisdiction and that the interests of investors need to be recognised accordingly.

**I. TRUSTS, INCLUDING QUISTCLOSE TRUST<sup>196</sup>: THE NATURE OF MONIES DUE TO INVESTORS UNDER SECURITIES LAWS.**

The nature of monies due to investors under securities laws is an important aspect since the Board issues a large number of refund orders relating to deemed public issue and other issues by unregistered entities. Different courts and tribunals have espoused different views without clear and cogent reasons. Due to the nascent development of private securities litigation in India, this issue needs in-depth examination for the benefit of all.

When investors make a subscription to an issue of securities, the allotment and listing of securities should be done in compliance with securities laws and in the absence thereof, the entire amount becomes refundable.<sup>197</sup> In *re Nanwa Gold Mines Ltd.*<sup>198</sup> the court dealt with this issue for the first time under the company law and *inter alia* held as follows,-

“Is the relationship of the subscribers to the company that of creditor and debtor, or had they a lien on this fund or an equity against it so as to be able to attach it for the payment of their debt without allowing other creditors of the company to share with them?

...

Section 51 of the Companies Act, 1948, is (according to the side-note to the section of the statute) concerned with “Allotment of shares and debentures to be dealt in on stock exchange”; and it refers to statements in prospectuses

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<sup>196</sup> This particular kind of trust is known as a quistclose trust after the landmark judgment of the House of Lords in *Barclays Bank Ltd. v. Quistclose Investments Ltd.* [1968] 3 All ER 651 ; [1969] 39 Comp Cas 105 (HL); this principle has been applied in Indian securities litigation also, see *Bank of Baroda v Fairgrowth Financial Services Ltd.*, [1994] 80 Comp 857 (Bom); *RBI v Bank of Credit and Commerce International (Overseas) Ltd.* [1993] 78 Comp Cas 230 (Bom), 1992 (3) BomCR 81 *Raymond Synthetics Ltd. & Ors. v Union of India & Ors.*, AIR 1992 SC 847 : 1992 (73) CompCas 762 (SC) : 1992 (2) SCC 255 : 1992 (1) SCR 481; *Universal Incast Ltd. v Appellate Authority, SEBI & Ors.*, 2002 (108) CompCas 248 (P&H) : 2000 (125) PLR 256; *Rich Paints Ltd. v Vadodara Stock Exchange Ltd.*, 1998 (92) CompCas 282 (Guj); *RBI v Bank of Credit and Commerce International (Overseas) Ltd. (No. 1)*, 1993 (78) Comp Cas 207 (Bom); *RBI v Bank of Credit and Commerce International (Overseas) Ltd.*, 1993 (78) Comp Cas 230 (Bom).

<sup>197</sup> Sections 69 and 73 of the Companies Act, 1956; Sections 39 and 42 of the Companies Act, 2013 and Companies (Prospectus and Allotment of Securities) Rules, 2014

<sup>198</sup> [1955] 1 WLR 1080.

about applications for leave to deal with shares proposed to be allotted, and provides that the company shall repay the money where permission is refused.

...

That appears to be an attempt to erect, so to speak, by statute a kind of trust for applicants in a case of this sort. It is irrelevant here, because in this case the directors promised to do this very thing. No doubt that was only a compliance with the statute; but they did promise to do so, and I think that their promise is of contractual effect, so I need not consider whether, if there was no promise but only the statutory obligation, the position would be the same. I incline to think it would be so, and that the object of section 51 (3) was to provide protection for persons who pay money on the faith of promises of this kind.

...

I am accordingly of opinion that the moneys in question are repayable to the persons who subscribed in answer to the circular dated July 28, 1953, and do not form part of the general assets of the company.”

Monies advanced for subscription to securities are advanced conditionally. Hence the law impresses them with a trust. If the conditions of a lawful allotment (including listing) are not fulfilled, the monies are refundable and cannot be claimed by the creditors of an insolvent debtor. It is this refundable obligation flowing from the law of trust that forms the basis of SEBI’s refund orders. This principle has been accepted by Indian courts and extended even to the banks i.e. to the banker to the issue who is appointed by the issuer through the merchant banker to hold these proceeds. The introduction of subscription through ASBA makes no difference since the monies continue to be held in trust for the purpose of the issue. The trust is not extinguished merely on the allotment of securities without compliance of applicable law, it continues till the moneys are actually returned by the bank to the company and/or to the subscribers and even thereafter till the statutory obligations pertaining thereto are actually complied with.<sup>199</sup> The Indian company law and courts have adopted the

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<sup>199</sup> *RBI v Bank of Credit and Commerce International (Overseas) Ltd.* [1993] 78 Comp Cas 230 (Bom), 1992 (3) BomCR 81, *inter alia* holding as follows:

“The trust continues till the moneys are actually and factually handed over by the bank to the company and/or to the subscribers and even thereafter till the statutory obligations pertaining thereto are actually complied with.

...

In the abovereferred judgment of the House of Lords [*Barclays Bank Ltd. v. Quistclose Investments Ltd.*], it was held that even moneys advanced as a loan could be treated as impressed with trust when the moneys were advanced for a specific purpose, the same were duly earmarked and the relevant stipulation attached to the advance of moneys for a specific purpose were brought to the knowledge of the bank while depositing the amount in a separate account. It was held by the court that the mere fact that the transaction originated as a loan by itself did not destroy the character of the amount being trust fund or the amount being considered as impressed with a trust for a specific purpose

....

I hold that the relevant provisions of the statute already referred to hereinabove create a statutory trust in respect of the amounts forwarded by the subscribers, whether lying with the company or with the bank, to

principle of *quistclose* trust in commercial law in line with the approach of UK law. Such a trust is an automatic trust imposed by securities law and not a discretionary remedial trust.<sup>200</sup>

Thus, it makes no difference whether the funds have been raised without following the issue process or without obtaining the registration certificate<sup>201</sup> required under the SEBI Act. In both cases, the law of trusts is applicable and the monies are impressed with a trust. Trust property does not form part of the estate of the company so as to be available for the company's creditors. Trust property is excluded whether the trust is express, implied, constructive or resulting or is imposed by statute.<sup>202</sup>

In such cases, it is immaterial if the scheme is not registered or authorized under any enactment. It makes no difference whether the funds have been raised without following the issue process and obtaining the registration certificate or without

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the extent of allotment money for the benefit of the company and to the extent of the balance for the benefit of the subscribers. The moneys were forwarded as specific deposits for a specific purpose. The moneys in question were duly earmarked and segregated. Apart from statutory trust referred to hereinabove, I further hold that the first respondent-bank received the said amount in a fiduciary capacity under the contractual arrangement as a banker to the issue and the concept of trust and fiduciary capacity is clearly spelt out from the terms of the prospectus on which the company, the subscribers as well as the bank acted. I hold that the applicants are entitled to receive the amounts in question from the respondents in full. I allow the claim of Ceeta Polymers Ltd. with interest at 15% per annum from July 12, 1992. I allow the claim of Varun Shipping Company Ltd. without interest.”

<sup>200</sup> *Bailey & Anr. v Angove's PTY ltd.*, [2016] UKSC 47, available at <<https://www.bailii.org/uk/cases/UKSC/2016/47.html>>, *inter alia* holding that,-

“27. English law is generally averse to the discretionary adjustment of property rights, and has not recognised the remedial constructive trust favoured in some other jurisdictions, notably the United States and Canada. It has recognised only the institutional constructive trust: *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] AC 669, 714-715 (Lord Browne-Wilkinson), *FHR European Ventures LLP v Cedar Capital Partners LLC* [2015] AC 250, at para 47. In the former case, the difference was explained by Lord Browne-Wilkinson in the following terms:

“Under an institutional constructive trust, the trust arises by operation of law as from the date of the circumstances which give rise to it: the function of the court is merely to declare that such trust has arisen in the past. The consequences that flow from such trust having arisen (including the possibly unfair consequences to third parties who in the interim have received the trust property) are also determined by rules of law, not under a discretion. A remedial constructive trust, as I understand it, is different. It is a judicial remedy giving rise to an enforceable equitable obligation: the extent to which it operates retrospectively to the prejudice of third parties lies in the discretion of the court.””

Also see *S Kotrabasappa v Indian Bank* AIR 1987 Kant 236.

<sup>201</sup> See *G. R. Deo, Liquidator, C.P. and Berar Government Clerks' Mutual benefit Fund, Nagpur v F Karim and Anr*, AIR 1946 Nag 196.

<sup>202</sup> Royston Miles Goode, *Principles of Corporate Insolvency Law*, 4<sup>th</sup> edition, pp 212-213, available at <<https://books.google.co.in/books?id=mtK4kQIhEowC&printsec=frontcover&dq=principles+of+corporate+insolvency+law&hl=en&sa=X&ved=0ahUKEwi6u5f-45NgAhXLso8KHaPdA7kO6AEILTAA#v=onepage&q=principles%20of%20corporate%20insolvency%20law&f=false>>.

obtaining the registration certificate<sup>203</sup> In both cases, the law of trusts is applicable and the monies are impressed with a trust. Recently, SEBI successfully obtained judgment from the Federal Court of Australia in the matter of *Kadam & Ors. v MiiResorts Group 1 Pty Ltd & Ors.*<sup>204</sup>, by utilising the law of trusts in respect of monies siphoned off from an unregistered collective investment scheme. In this respect of super-priority of beneficiaries, a cue may be had from insolvency law, where courts generally deal with claims from beneficiaries and creditors over the assets of the debtor on the ground that the assets did not become part of the property of the debtor and are therefore not divisible among its creditors, whether or not they have been held formally in trust as long as the monies have been impressed with a character which prevents it from becoming the property of the debtor.<sup>205</sup>

In the case of *Ganesh Export & Import Co. v Mahadeolal Nathmal*,<sup>206</sup> the Hon'ble Calcutta High Court, inter alia, held as follows:

*“7. A truster of monies can claim a refund from an insolvent company in priority over all creditors, not on the ground that an obligation to return trust property must be discharged before an obligation to repay debts, but on the ground that the monies never became the property of the company and are not therefore divisible among its creditors. If the monies have been kept separate, they must be handed back. Even if they have been mixed up with other funds of the company, an equal amount, if available, must first be extracted and paid over to the truster, subject to such deductions, if any, as may be provided for by the trust itself. In order, however, that a property*

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<sup>203</sup> See *G. R. Deo, Liquidator, C.P. and Berar Government Clerks' Mutual Benefit Fund, Nagpur v F Karim and Anr*, AIR 1946 Nag 196. Also see, *Securities and Investment Board v Pantell SA (No. 2)*, (1992) BCLC 58 (Ch D); and on appeal *Sub nom Securities and Investment Board v Pantell SA (No. 2)*, (1993) BCLC 146 (CA).

<sup>204</sup> Judgment dated 20.07.2018 available at <[https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi\\_data/attachdocs/sep-2018/1536728840793.pdf](https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi_data/attachdocs/sep-2018/1536728840793.pdf)>; Order dated 23.07.2018 available at <[https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi\\_data/attachdocs/sep-2018/1536728821892.pdf](https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi_data/attachdocs/sep-2018/1536728821892.pdf)>.

<sup>205</sup> *Ganesh Export & Import Co. v Mahadeolal Nathmal*, AIR 1956 Cal 188 : 1955 (25) CompCas 357 (Cal); *Baroda Spinning & Weaving Mills Co. Ltd v Baroda Spinning & Weaving Mills (Rajratna Sheth Zaverchand Laxmichand) Co-operative Credit Society Ltd., Baroda & Anr*, 1976 (1) GLR 555 : 1976 (46) CompCas 1 (Guj); *The Official Assignee of Madras v Krishnaji Bhat*, AIR 1933 PC 148 : 60 IA 203 : ILR 56 Mad. 570; *Official Liquidator v N. Chandranarayanan*, 1973 (43) CompCas 244 (Mad).

<sup>206</sup> AIR 1956 Cal 188 : 1955 (25) CompCas 357 (Cal)



*may be excluded from the assets of a company, divisible among its creditors, it is not necessary that it should be held formally in trust for a third party. Where there is such a trust, the company has obviously no beneficial interest in it of the nature divisible among creditors upon insolvency. But there may also be a trust in effect. Property held by an insolvent in a fiduciary capacity is treated as property held in trust for the purposes of the insolvency laws and property held for a specific purpose is treated as clothed with a species of trust, subject to the same principles as trust property. In all these cases, the property concerned is outside "the divisible assets of the company. The party who put the property in the hands of the company can claim it back in a winding up as his property, while the creditors cannot claim that it should be brought into the distribution.*

*8. The present case was argued before us as if the decision turned on there being or not being a full and complete trust. It was also argued on the footing that unless an agency could be made out from the agreement, no trust could be established and, conversely, if there was an agency, a trust would necessarily follow. None of those assumptions was correct. As I have already pointed out, in order that a sum of money can be claimed from an insolvent company without diminution and in priority over all creditors, it is not necessary that there should be, with respect to it, a full and complete trust. All that is required is that it should be impressed with a character which prevents it from becoming the property of the company and keeps it outside the flux of the company's fortune as respects its own funds by virtue of the special purpose for which it is placed in the hands of the company. Secondly, in order that a deposit made with a company may be said to be held in trust or on terms in the nature of a trust, it is by no means essential that the depositor should be an agent. Nor can, it be said that a deposit made by an agent must always be a deposit made on trust. A deposit made by a customer may well partake of the nature of a trust and a deposit made by a trade agent may well be an advance or advance payment made in the ordinary course of business."*

SEBI's powers are much wider than the remedies available to beneficiaries of the trust and is statutorily vested with the power to enforce equitable obligations of refund by directing recovery against all the assets of the defaulter, rather than just the assets acquired through illegal proceeds.<sup>207</sup> Recently, SEBI successfully obtained judgment from the Federal Court of Australia in the matter of *Kadam & Ors. v MiiResorts Group 1 Pty Ltd & Ors.*<sup>208</sup>, by utilising the law of trusts in respect of monies siphoned off from an unregistered collective investment scheme.

## II. 'BUSINESS TRUSTS'<sup>209</sup> AND 'MONIES HELD IN TRUST': WHAT IS THE NATURE OF 'TRUST VEHICLES' REGISTERED UNDER INDIAN SECURITIES LAWS AND THOSE WHO FAIL TO REGISTER?

There are several fund raising vehicles permitted under the SEBI Regulations. One of the more unique modes of issue and raising of capital is through 'Trusts'. (Mutual Funds<sup>210</sup>, REITs, InvITS, AIFs, etc. are permitted to raise capital through a 'Trust' vehicle.) In general, the issue and raising of capital relates to an investment in an artificial person. It is not possible for an individual to issue equity or debentures or convertibles. However, between the process of 'incorporation of an artificial entity' and 'individuals' lies the concept of 'business trusts.' 'Business trusts'<sup>211</sup> originated in USA, more specifically in the Commonwealth of Massachusetts, and permitted for the raising of capital through unincorporated business trusts. They are also referred to as unincorporated business organizations. Mutual Funds and REITs in the USA are frequently structured as Massachusetts business trusts by convention, though there are other states also that by law (including taxation statutes) permit a business trust

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<sup>207</sup> Power of Recovery officers under securities laws, extends to all assets of a defaulter and not just those purchased from the illegal proceeds.

<sup>208</sup> Judgment dated 20.07.2018 available at [https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi\\_data/attachdocs/sep-2018/1536728840793.pdf](https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi_data/attachdocs/sep-2018/1536728840793.pdf); Order dated 23.07.2018 available at [https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi\\_data/attachdocs/sep-2018/1536728821892.pdf](https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi_data/attachdocs/sep-2018/1536728821892.pdf).

<sup>209</sup> For more clarity on Business Trusts, see Jared W. Speier, 'Clarifying the Business Trust in Bankruptcy: A Proposed Restatement Test', Pepperdine Law Review, Vol. 43 (2016) 1065.

<sup>210</sup> UTI was the only mutual fund which was conferred with body corporate status of a corporation under section 3 of the Unit Trust of India Act, 1963.

<sup>211</sup> Most generally, the goal of the business trust is not to preserve the trust property but rather to use the property to conduct business and make a profit.

to be a “*separate unincorporated association.*”<sup>212</sup> This has enabled the recognition of such business trusts, to have a separate personality without being legal persons. The Supreme Judicial Court of Massachusetts<sup>213</sup> in *Larson v Sylvester*<sup>214</sup> *inter alia* held as follows,-

**“Speaking generally, a trust is not a legal personality.** (emphasis supplied) With the exception later to be dealt with, it cannot be sued. It is represented by the trustee. He embodies it. He holds title. He deals with the property in which trust rights exist. Contracts with regard to the rights and property affected by trusts are the contracts of the trustee. He, in person, is liable upon them. He is not acting as representative or agent of another. He is acting for himself, but with fiduciary obligations to others. It differs from a corporation or a partnership. The former is a legal person. The latter, in the law of Massachusetts, is an association of individuals united for transaction of business. The former can be sued as a body corporate in its own name. The latter must be sued, ordinarily, in the names of the partners. Many purposes are served if persons may unite in placing property in the hands of a trustee and allowing him to transact business not as an agent or a partner of theirs but as owner of the property subject only to equitable obligations. The device has been acted upon. Trust instruments appeared dealing with property in equity owned by people, voluntarily associated, whose rights were represented by transferable certificates, but, at law, owned and managed by a trustee or trustees. This court had to pass on their nature and decide whether trusts or partnerships had come into being....

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....Save for the purpose of being sued, the trust, as distinguished from the trustee, is not made a separate legal entity; and only the peculiar trusts

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<sup>212</sup> E.g. *Minnesota State Statutes Business, Social, and Charitable Organizations (Ch. 300-323A) General provisions*, § 318.02, available at, <<https://codes.findlaw.com/mn/business-social-and-charitable-organizations-ch-300-323a/mn-st-sect-318-02.html>>. The subdivision 2., reads as follows,-

“Any such association heretofore or hereafter organized shall be a business trust and a separate unincorporated association, not a partnership, joint-stock association, agency, or any other relation except a business trust. A business trust is also known as a common law trust and Massachusetts trust for doing business.”

<sup>213</sup> Dealing with *Commonwealth of Massachusetts, General Laws, Part I, Title XXII, Chapter 182, Section 6* (Suits against associations or trusts.), available at <<https://malegislature.gov/Laws/GeneralLaws/PartI/TitleXXII/Chapter182/Section6>>.

<sup>214</sup> 185 N.E. 44, (Mass. 1933), available at <<https://casetext.com/case/larson-v-sylvester>>.

organized under a written instrument with beneficial interests divided into transferable certificates of participation or shares are suable at law. (emphasis supplied)”

In India till the decision of the Securities Appellate Tribunal in *PCS Industries Ltd. v SEBI*<sup>215</sup> it was not clear whether a mutual fund organised as a trust (as opposed to the UTI which is specifically recognised as a body corporate<sup>216</sup> by statute) could issue securities due to an earlier order passed by the Hon’ble Bombay High Court in the matter of *Canbank Financial Services Ltd. v V. B. Desai and Anr.*<sup>217</sup> The Tribunal noted that the definition of ‘securities’ in clause (h) of Section 2 of Securities Contracts (Regulation) Act, 1956 is an inclusive one; it reads as follows,-

““securities”—include

(i) shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate;

(ia) derivative;

(ib) units or any other instrument issued by any collective investment scheme to the investors in such schemes;

(ic) security receipt as defined in clause (zg) of section 2 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002;

(id) units or any other such instrument issued to the investors under any mutual fund scheme;

Explanation.—For the removal of doubts, it is hereby declared that "securities" shall not include any unit linked insurance policy or scrips or any such instrument or unit, by whatever name called, which provides a combined benefit risk on the life of the persons and investment by such persons and issued by an insurer referred to in clause (g) of section 2 of the Insurance Act, 1938 (4 of 1938);

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<sup>215</sup> *PCS Industries Ltd. v SEBI*, SAT Appeal No. 31/2001, available at <<https://www.sebi.gov.in/satorders/PCSIndustries.html>>.

<sup>216</sup> Section 3 of the Unit Trust of India Act, 1963.

<sup>217</sup> 2002 (112) CompCas 142 (Bom), AIR 2002 Bom 247.

- (ie) any certificate or instrument (by whatever name called), issued to an investor by any issuer being a special purpose distinct entity which possesses any debt or receivable, including mortgage debt, assigned to such entity, and acknowledging beneficial interest of such investor in such debt or receivable, including mortgage debt, as the case may be;
- (ii) Government securities;
- (iia) such other instruments as may be declared by the Central Government to be securities; and
- (iii) rights or interest in securities”

The Securities Appellate Tribunal decision in the *PCS Industries* has implied that the units issued by such funds are ‘securities’ even prior to the 2004 inclusion of sub-clause (id)<sup>218</sup> [i.e. *units or any other such instrument issued to the investors under any mutual fund scheme*] since all such instruments ‘*which are marketable and which have an ease or facility of selling and/or which have a high degree of liquidity and or/are capable of being sold in a market i.e. stock exchange are considered to be included.*’ It is not necessary for marketable securities to be issued by a body corporate or company. In particular, the inclusion in 1992 of clause (iia) [i.e. *such other instruments as may be declared by the Central government to be securities*] has not changed the inclusive nature of the definition. This clause was inserted by the SEBI Act, 1992 itself when mutual fund units were already in existence and specifically mentioned in the SEBI Act, 1992. The 1995 amendment<sup>219</sup> to the SEBI Act, *inter alia* introduced penalty provisions for defaults in units of mutual funds, though till 2004, there was no specific mention of mutual fund units in the definition of ‘securities’ in the SCRA. It is merely an additional power given to the Central Government to recognise those instruments as securities which could not by implication have been included under the said definition in SCRA.<sup>220</sup> Further, clause (iia) was already in the statute book and noted by the Tribunal in its decision in *PCS Industries* matter. Thus

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<sup>218</sup> Inserted by the Securities Laws (Amendment) Act, 2004, Sec. 2, w.e.f. 12-10-2004. It merely removed the confusion created by the order in *Canbank Financial Services Ltd. v V. B. Desai and Anr.*, AIR 2002 Bom 247.

<sup>219</sup> Securities Laws (Amendment) Act, 1995 *inter alia* amending the Securities and Exchange Board of India Act, 1992 and the Securities Contracts (Regulation) Act, 1956.

<sup>220</sup> As on date, ‘Onshore Rupee Bonds’ issued by multilateral institutions have been declared to be securities. These institutions have international personality but are not a ‘company’ or ‘body corporate’ under the Companies Act, 1956 or Companies Act, 2013.

on similar reasoning, units issued by REITs, InvITS, etc. are also securities even though they have not been specifically mentioned in the definition of ‘securities’ in the SCRA since they satisfy the test for determining whether an instrument is a security as laid down by the Tribunal in the *PCS Industries* matter, - *an instrument that is marketable and has an ease or facility of selling and/or has a high degree of liquidity and or/is capable of being sold in a market is a security.*

Thus, in the present context, the Indian securities law jurisprudence though developed independently from American securities laws jurisprudence, also provides for creation of unincorporated trusts to issue securities, even though, like USA, in India also a trust is not suable as a corporation as in the USA. In this context, it may be noted that the SEBI Act, does not provide for powers of ‘incorporation’, it only provides for ‘registration.’ Further, there is no ‘incorporation’ or ‘registration’ ‘under’ the Indian Trusts Act, 1882. A ‘trust’ is an obligation annexed to property, it arises simultaneously with the entrustment of property.<sup>221</sup> In view of the same, the actual formation of trust occurs, when the trust property is entrusted, i.e. funds are raised. Registration under the SEBI Act, 1992 does not ‘create’ a trust. Before a trust can arise, the property that is to be its subject matter must be linked with the trustee via a binding trust obligation. When the property is so linked it is described as being “impressed” with the trust, and the trust can then be said to be established or completely constituted. The SEBI Act provides only for the registration of certain intermediaries and not their incorporation. Generally speaking, a MF/REIT/InvIT/CIS, etc. at the time of registration with SEBI, is an empty vehicle, that has no property. It is only after the scheme documents are issued and funds are actually raised that a ‘trust’ can be said to have formed in the eyes of law. Thus a distinction needs to be made between the formation of the ‘trust’ under the law of trust and registration of that ‘trusts’ as a special purpose vehicle under securities laws.

This can be more easily understood in the context of charitable public trusts. A charitable public trust may be express or constructive. In certain states, there is an additional requirement for registration under State laws. e.g. Section 18 of the Maharashtra Public Trusts Act, 1950. Failure to register the public trusts amounts to

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<sup>221</sup> Section 3 of the Indian Trusts Act, 1882.

a breach of such State law and penal consequences will follow, but it does not render such public trust totally void so that the trustee can appropriate such funds to its private use. The trust is created once the property is entrusted or dedicated to the trust.

Thus, failure to register under the SEBI Act is not fatal to recognising a 'trust' in favour of investors/beneficiaries, as various judicial authorities earlier cited indicate. The 'trust' arises in view of the fund raising activity being carried out and the funds being entrusted for a particular purpose. Hence a defaulter cannot and should not be allowed to take the benefit of his own default, since the obligation to register is not on the investors but on the person who carries out the activity of MF/REIT/InvIT/CIS, etc., a failure to register would not allow him or his liquidator (or the resolution professional who undertakes the management of the affairs of the corporate debtor) to appropriate the funds of investors required to be held in trust towards the dues of his creditors. The correct test to determine whether a trust has arisen is whether 'entrustment' of investors' funds has taken place or not.

It is possible that the assets may not have been segregated; this however will not affect the issue of trust. In *SEC v. Better Life Club of Am., Inc.*<sup>222</sup> the court *inter alia* held that, "[W]hen legitimate assets are co-mingled with illegitimate ones such that the assets cannot be separated out, a constructive trust may extend over the entire asset pool." Similarly, the global bankruptcy of Lehman Bros tested the insolvency laws and protection provided to assets of investors held in trust vis-à-vis other creditors. Ch.7 of the Client Asset Sourcebook (CASS7) of UK's Financial Services Authority required that monies received by a broker for clients are required to be segregated from the broker's own monies. Lehman Bros. International (Europe) [LBIE] provided services for clients wishing to invest in securities and operated an "alternative approach", which was permitted by CASS7, for the receipt of client funds. This meant that monies received from clients were paid into an account or accounts of LBIE and then segregated into client accounts each day according to a reconciliation of client monies conducted as at the end of the close of business on the preceding day. In other words, to the extent that the aggregate client entitlement to client monies exceeded the

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<sup>222</sup> 995 F. Supp. 167, 181 (D.D.C. 1998), available at <<https://casetext.com/case/sec-v-better-life-club-of-america-inc#p181>>. Also See *S.E.C. v Byers*, 637 F. Supp. 2d 166 (S.D.N.Y. 2009), available at <<https://casetext.com/case/sec-v-byers-5>>.

aggregate of the net amount which LBIE held for each client to the credit of that client's bank accounts and transaction accounts, the balance would be transferred to the segregated client bank accounts held by LBIE for its clients. If the balance was the other way, the relevant client bank accounts would be debited and the money would be transferred to the house accounts of LBIE. On 15 September 2008, Lehman went into administration, a 'primary pooling event' under CASS 7, so the funds in each 'client money account' were to be treated as pooled and then distributed so that each client received a sum rateable to their 'client money entitlement'. The administrators asked the High Court for directions under the Insolvency Act 1986 Schedule B1, about how to apply CASS 7 to the client money that Lehman held. There was a lot of unsegregated client money in the firm's house accounts because of the operation of the alternative approach, and also significant non-compliance of Lehman with CASS 7 over a long time. The High Court<sup>223</sup>, the Court of Appeals<sup>224</sup> and the UK Supreme Court<sup>225</sup> held that non-segregation did not impact the 'trust' as the 'trust' arose on the receipt of client monies and not on their segregation; and the fiduciary duties imposed by CASS 7 were owed by LBIE in respect of all client money, not just balances standing to the credit in the client accounts. The decision that fiduciary duties were owed by a firm in respect of all client money was relevant to construe CASS 7. If there was a choice of interpretations, then the one chosen should be the highest level of protection.

A similar interpretation in relation to investments and assets of securities investors in India has to be adopted in order for India's securities markets to be globally competitive, thus the protections afforded by the law of trust and the higher protections afforded by securities laws must be read together to protect the interest of investors.

### **III. RECOVERY OF MONIES DUE TO INVESTORS IN SECURITIES IN CASE OF INSOLVENCY OF TRUSTS.**

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<sup>223</sup> *In the matter of Lehman Bros International (Europe)*, [2009] EWHC 3228 (Ch), available at <<https://www.bailii.org/ew/cases/EWHC/Ch/2009/3228.html>>.

<sup>224</sup> *In the matter of Lehman Bros International (Europe)*, [2010] EWCA Civ. 917 (Ch), available at <<https://www.bailii.org/ew/cases/EWCA/Civ/2010/917.html>>.

<sup>225</sup> *In the matter of Lehman Bros International (Europe)*, [2012] UKSC 6, available at <<https://www.bailii.org/uk/cases/UKSC/2012/6.html>>.



The following interplay of securities laws, law of trust and insolvency law arises when considering recovery under the securities laws,-

- a. In case of disgorgement due to be ordered or executed, the Indian securities laws confer wider power on SEBI as compared to that the American securities laws confer on USA-SEC. The power of disgorgement, as it developed in USA, does not confer priority to the USA-SEC (and other regulators who may direct disgorgement) vis-à-vis other creditors.<sup>226</sup> Disgorgement is not sought because SEBI/USA-SEC has the superior right and title to the illegal proceeds, rather it is sought to ensure that the defaulter does not benefit from his illegal activities and is not required to prove tracing. On consequential reasoning, when the defaulter goes insolvent, his creditors also cannot have a better title. Creditors cannot seek to enrich themselves from the illegal proceeds of illegal activities.<sup>227</sup>

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<sup>226</sup> See *Federal Trade Commission v. Bronson Partners, LLC*, 654 F.3d 359 (2d Cir. 2011), available at <<https://www.courtlistener.com/opinion/223605/ftc-v-bronson-partners-llc/>>:

“Nor, having obtained a disgorgement award, are public entities required to make any particular effort to compensate the victims that they can identify. See *Fischbach*, 133 F.3d at 176; see also *SEC v. Wang*, 944 F.2d 80, 88 (2d Cir.1991) (affirming a distribution plan that engaged in "line-drawing[.] which inevitably leaves out some potential claimants"). While agencies may, as a matter of grace, attempt to return as much of the disgorgement proceeds as possible, the remedy is not, strictly speaking, restitutionary at all, in that the award runs in favor of the Treasury, not of the victims.

Finally, and most importantly for this case, unlike an equitable lien or a constructive trust, disgorgement does not require the district court to apply equitable tracing rules to identify specific funds in the defendant's possession that are subject to return. *Tracing is necessary where a private plaintiff seeks to impose a constructive trust, because liability is premised on the fiction that the victim at all times retained title to the property in question, which the defendant merely holds in trust for him.* (emphasis supplied) Consequently, a plaintiff who has obtained a constructive trust is generally entitled to priority over other creditors in satisfying his judgment from the proceeds of the traceable funds or property. But when a public entity seeks disgorgement it does not claim any entitlement to particular property; it seeks only to "deter violations of the laws by depriving violators of their ill-gotten gains." *Fischbach*, 133 F.3d at 175. Nor is an agency that has won a disgorgement order entitled to priority over the other creditors of the defendant. In this case, the FTC asks only to have a judgment for the amount of Bronson's ill-gotten gains, which, if Bronson is insolvent, will simply permit the Commission to share with other creditors on an equal basis. (emphasis supplied)

In light of this distinction, it is unsurprising that Bronson can point to no case in which a public agency seeking to obtain equitable monetary relief has been required to satisfy the tracing rules.[9] To the contrary, the Federal Reporter is replete with instances in which judges of this Court deeply familiar with equity practice have permitted the SEC to obtain disgorgement without any mention of tracing. (emphasis supplied) See, e.g., *Commonwealth Chem.*, 574 F.2d at 95-96 (Friendly, J.). Indeed, it is by now so uncontroversial that tracing is not required in disgorgement cases that we recently rejected an argument to the contrary via summary order. *SEC v. Rosenthal*, Nos. 10-1204-cv, 10-1253-cv, 426 Fed.Appx. 1, 1-3, 2011 WL 2271743, at \*1 (2d Cir. June 9, 2011) (Summary Order); see also *SEC v. Banner Fund Int'l*, 211 F.3d 602, 617 (D.C.Cir.2000) (reasoning that "disgorgement is an equitable obligation to return a sum equal to the amount wrongfully obtained, rather than a requirement to replevy a specific asset").”

<sup>227</sup> *Standard Chartered Bank & Ors v Deputy Director, Directorate of Enforcement, Mumbai*, PMLA Appellate Tribunal, order dated 02.08.2018 available at <[http://atfp.gov.in/writereaddata/upload/Judgement/Judgement\\_FMSMWJERQT\\_78805.PDF](http://atfp.gov.in/writereaddata/upload/Judgement/Judgement_FMSMWJERQT_78805.PDF)>.

It is important to note that proceeds resulting from fund raising activities in violation of securities laws are considered as 'proceeds of crime' under the Prevention of Money-Laundering Act, 2002 ("PMLA").<sup>228</sup> Recently the Delhi High Court in the matter of *Deputy Director, Directorate of Enforcement v Axis Bank & Ors.*<sup>229</sup> vide order dated 02.04.2019 has on similar lines *inter alia* held as follows,-

"141. This court finds it difficult to accept the proposition that the jurisdiction conferred on the State by PMLA to confiscate the "proceeds of crime" concerns a property the value whereof is "debt" due or payable to the Government (Central or State) or local authority. The Government, when it exercises its power under PMLA to seek attachment leading to confiscation of proceeds of crime, does not stand as a creditor, the person alleged to be complicit in the offence of money-laundering similarly not acquiring the status of a debtor. (emphasis supplied) The State is not claiming the prerogative to deprive such offender of ill-gotten assets so as to be perceived to be sharing the loot, not the least so as to levy tax thereupon such as to give it a colour of legitimacy or lawful earning, the idea being to take away what has been illegitimately secured by proscribed criminal activity.

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146. A Resolution Professional appointed under the Insolvency Code does not have any personal stake. He only represents the interest of creditors, their committee having appointed and tasked him with certain responsibility under the said law. The moratorium enforced in terms of Section 14 of Insolvency Code cannot come in the way of the statutory authority conferred by PMLA on the enforcement officers for depriving a person (may be also a debtor) of the proceeds of crime. (emphasis supplied) A view to the contrary, if taken, would defeat the objective of PMLA by opening an escape route. After all, a person indulging in money-laundering cannot be permitted to avail of the

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<sup>228</sup> See Paragraph 8, of Part B of the Schedule referencing to Section 12A read with Section 24 of the SEBI Act. Inserted vide Prevention of Money-Laundering (Amendment) Act, 2009.

<sup>229</sup> Available at <[https://ibbi.gov.in/webadmin/pdf/whatsnew/2019/Apr/RKG02042019CRLA1432018\\_2019-04-03%2014:45:26.pdf](https://ibbi.gov.in/webadmin/pdf/whatsnew/2019/Apr/RKG02042019CRLA1432018_2019-04-03%2014:45:26.pdf)>.

proceeds of crime to get a discharge for his civil liability towards his creditors for the simple reason such assets are not lawfully his to claim. (emphasis supplied)”

- b. Forfeiture is of two types, - civil forfeiture and criminal forfeiture. Disgorgement is akin to civil forfeiture.<sup>230</sup> Civil forfeiture is very commonly used in USA and UK and is non-conviction based. It requires only probable cause to indicate that the property has been acquired pursuant to violation of public laws rather than a conviction of any person accused of such laws.<sup>231</sup> Since it is not based on actual determination of violation of law, but only on the

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<sup>230</sup> See *Cruz v Ghani*. No. 05-17-00566-CV (Tex. App. Aug. 20, 2018), available at <<https://casetext.com/case/erwin-cruz-the-erwin-a-cruz-family-ltd-v-ghani-2>>, inter alia holding that,-

“Courts may fashion equitable remedies such as disgorgement and forfeiture to remedy a breach of a fiduciary duty. *Cooper v. Campbell*, No. 05-15-00340-CV, 2016 WL 4487924, at \*10 (Tex. App.—Dallas Aug. 24, 2016, no pet.) (mem. op.) (citing *ERI Consulting Eng'r, Inc. v. Swinnea*, 318 S.W.3d 867, 874, 873-75 (Tex. 2010); *Burrow v. Arce*, 997 S.W.2d 229 (Tex. 1999); *Dernick Resources, Inc. v. Wilstein*, 471 S.W.3d 468, 482 (Tex. App.—Houston [1st Dist.] 2015, pet. denied)). Disgorgement is an equitable forfeiture of benefits wrongfully obtained. *Id.* (citing *In re Longview Energy Co.*, 464 S.W.3d 353, 361 (Tex. 2015) (orig. proceeding); *Swinnea v. ERI Consulting Eng'r, Inc.*, 481 S.W.3d 747, 752 (Tex. App.—Tyler 2016, no pet.)). A party may be required to forfeit benefits when a person rendering services to another in a relationship of trust breaches that trust. See *In re Longview Energy Co.*, 464 S.W.3d 361.

"We have said that such equitable forfeiture 'is not mainly compensatory . . . nor is it mainly punitive' and 'cannot . . . be measured by . . . actual damages.'" *Id.* (quoting *Burrow*, 997 S.W.2d at 240). Disgorgement is compensatory in the same sense attorney fees, interest, and costs are, but it is not damages. *Id.* As a result, equitable forfeiture is distinguishable from an award of actual damages incurred as a result of a breach of fiduciary duty.”

Also see, *SEC v Graham*, 823 F.3d 1357 (2016), available at <<https://www.leagle.com/decision/infco20160526098>>, holding that SEC disgorgement is a forfeiture. In *Kokesh V SEC*, 137 S. Ct. 1635 (2017), available at <[https://www.supremecourt.gov/opinions/16pdf/16-529\\_i426.pdf](https://www.supremecourt.gov/opinions/16pdf/16-529_i426.pdf)> applied the same standards as applicable to forfeiture [*Austin v. United States*, 509 U. S. 602, 610 (1993), available at <<https://supreme.justia.com/cases/federal/us/509/602/>>] to hold that disgorgement operated as a penalty for the purposes of limitation. See *US v Ursery*, 518 U.S. 267 (1996), available at <<https://supreme.justia.com/cases/federal/us/518/267/>>, inter alia holding that, “Forfeitures serve a variety of purposes, but are designed primarily to confiscate property used in violation of the law, and to require disgorgement of the fruits of illegal conduct.”

Also see, *In re Telsey*, 144 B.R. 563, 565 (Bankr. S.D. Fla. 1992), available at <<https://casetext.com/case/in-re-telsey>>, inter alia holding that,-

“The district court's disgorgement order in this case serves the purpose of deterrence. See, e.g., *S.E.C. v. First City Financial Corp.*, 890 F.2d 1215, 1230 (D.C. Cir. 1989); *Rowe v. Maremont Corp.*, 850 F.2d 1226, 1241 (7th Cir. 1988); *S.E.C. v. Blatt*, 583 F.2d 1325, 1335 (5th Cir. 1978); *S.E.C. v. Blavin*, 760 F.2d 706, 713 (6th Cir. 1985); *S.E.C. v. Manor Nursing Centers*, 458 F.2d 1082, 1104 (2nd Cir. 1972). This Court finds the deterrence purpose of the disgorgement order sufficiently penal to characterize the resulting debt as a "fine, penalty, or forfeiture" within the meaning of § 523(a)(7).”

<sup>231</sup> See *Austin v. United States*, 509 U. S. 602, 610 (1993), available at <<https://supreme.justia.com/cases/federal/us/509/602/>> for analysis of US and UK law relating to criminal and civil forfeiture.

determination of the lawful right of a person to enjoy a property, it can even be continued against heirs of an accused.<sup>232</sup>

An intriguing aspect of Indian law is the regular use of ‘confiscation’ or civil forfeiture provisions<sup>233</sup> under forest and wildlife laws.<sup>234</sup> [Indian courts have adopted the nomenclature of ‘confiscation’ for civil forfeiture and ‘forfeiture’ as exclusively criminal.] The nature of those proceedings can serve as an *aperçu* in respect of the application of forfeiture provisions in India. Under those laws, not only the illegally obtained forest produce can be confiscated by civil adjudication proceedings but also any other property that might be used for the purpose of carrying out the violation of those laws if the person had knowledge of such violation or had failed to take diligent care to avoid such use. The confiscatory proceedings are not dependent on actual prosecution<sup>235</sup> or conviction of the persons from whom the property is confiscated.<sup>236</sup> The

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<sup>232</sup> See Section 28B of the SEBI Act, 1992. Also See *Official Liquidator vs Parthasarathi Sinha & Ors.*, AIR 1983 SC 188 (The true doctrine is that whenever you find that the deceased person has by his wrong diverted either property or the proceeds of the property belonging to someone else into his own estate, you can then have recourse to that estate through his legal representative when he is dead, to recover it. The legal representative, of course, would not be liable for any sum beyond the value of the estate of the deceased in his hands.); *Official Liquidator, Supreme bank Ltd v P A Tendolkar (Dead) by Lrs and Ors.*, AIR 1973 SC 1104, in respect of matters relating to breach of trust and fiduciary duty by a director. Further See, *SEC v Wylly*, 860 F. Supp. 2d 275 (S.D.N.Y. 2012), available at <<https://casetext.com/case/sec-exch-commn-v-wyly>> for disgorgement to continue against the estate of the deceased in line with civil forfeiture analogy relied upon by the SEC.

<sup>233</sup> *Section 52 of the Indian Forest Act, 1927 which inter alia provides for confiscation ‘when there is reason to believe that a forest-offence has been committed in respect of any forest-produce, such produce, together with all tools, boats, carts or cattle used in committing any such offence, may be seized’.*

<sup>234</sup> For other laws see Section 6A (Confiscation of essential commodity) of the Essential Commodities Act, 1955.

<sup>235</sup> *Forest Development Corporation of Maharashtra Limited v Prakash Mallesh Cheraku & Anr.*, Bom. HC-Nag., order dated 09.01.2018, available at <<https://indiankanoon.org/doc/6853180/>>, *inter alia* holding that,-

“It is also well settled law that the confiscation proceedings are separate and independent from the prosecution that may be instituted against the offender and that even if no prosecution has been initiated against the owner of the seized vehicle, the seized vehicle would be liable to confiscation if the two conditions just mentioned are fulfilled. It is equally well settled that if the owner is not to lose the vehicle by way of confiscation to the State, it would be essential for him to prove that the seized vehicle was used without his knowledge for committing the forest offence and that the standard of proof, required to be tendered by the owner, will not be the same as is required for proving a criminal offence. The law is that in order to discharge such a burden, which is placed upon the shoulder of the owner of the seized vehicle, the owner has to bring on record a reasonable probability of his not possessing the requisite knowledge.”

<sup>236</sup> *Ghatge Patil Transport Ltd. vs. The State of Maharashtra*, 2008(2) Mh.L.J.(Cri.)69 (Bom.) *inter alia* holding that,-

“17. As regards the contention that the said provisions of law empower confiscation and forfeiture even before the chargesheet is filed and offence is proved, it is to be noted that the confiscation and forfeiture has nothing to do with the criminal proceedings for the offences committed under the said Act. The power of confiscation and forfeiture assured under the said provisions of law is in the adjudication proceedings which are totally different from the criminal proceedings and one is not subject to or control by another. In fact, the law on this point is well settled by the decision of the Apex Court in *S.P. Sales Agencies case* (supra) [*State of M.P. v. S.P. Sales Agencies and Ors.*].

Hon'ble Supreme Court in *State of West Bengal v Sujit Kumar Rana*<sup>237</sup> *inter alia* held that where a person does not have the right to enjoy property, its confiscation was the natural corollary and distinguished confiscation in civil proceedings and forfeiture in criminal proceedings consequent to conviction,-

“In *Indian Handicrafts Emporium and Ors. v. Union of India and Ors.*, [2003] 7 SCC 589, this Court was dealing with a situation where initially 'ivory' was legally imported, but the trade or possession thereof became subsequently barred by amendment made in the Wild Life (Protection) Act except for bona fide personal use. By reason of the provisions of the said Act, however, such imported ivory did not vest in the Government. This Court despite aforementioned situation applying the rule of purposive construction so as to give effect to the intent and purport of the statute held:

"A trader in terms of a statute is prohibited from carrying on trade. He also cannot remain in control over the animal article. The logical consequence wherefor would be that he must be deprived of the possession thereof. The possession of the animal article including imported ivory must, therefore, be handed over to the competent

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18. The Apex Court in *S.P. Sales Agencies case* (supra), while dealing with the question as to whether confiscation proceeding under the said Act can be initiated only after launching criminal prosecution or it is open to the forest authorities upon seizure of forest produce to initiate both or either, after taking note of various provisions of the said Act, held that "The power of confiscation, exercisable under Section 52 of the Act cannot be said to be in any manner dependant upon launching of criminal prosecution as it has nowhere been provided therein that the forest produce seized can be confiscated only after criminal prosecution is launched, but the condition precedent for initiating a confiscation proceeding is commission of forest offence." Taking note of earlier decisions in the case of *State of W.B. v. Gopal Sarkar*, and *Divisional Forest Officer and Anr. v. G.V. Sudhakar Rao and Ors.*, the Apex Court reiterated its earlier view that the power of confiscation is independent of any criminal prosecution for the forest offence committed. Indeed, in *Sudhakar Raos case* (supra), it was clearly ruled that:

The conferral of power of confiscation of seized timber or forest produce and the implements etc. on the Authorized Officer under Sub-section (2-A) of Section 44 of the Act [Andhra Pradesh Forest Act, 1967] on his being satisfied that a forest offence had been committed in respect thereof, is not dependent upon whether a criminal prosecution for commission of a forest offence has been launched against the offender or not. It is a separate and distinct proceeding from that of a trial before the Court for commission of an offence. Under Sub-section (2-A) of Section 44 of the Act, where a Forest Officer makes a report of seizure of any timber or forest produce and produces the seized timber before the authorized officer along with a report under Section 44(2) the authorized officer can direct confiscation to Government of such timber or forest produce and the implements etc. if he is satisfied that a forest offence has been committed, irrespective of the fact whether the accused is facing a trial”

<sup>237</sup> (2004) 4 SCC 129.

authority. In a case of this nature where a statute has been enacted in public interest, restriction in the matter of possession of the property must be held to be implicit. If Section 49(7) is not so construed, it cannot be given effect to.

We, therefore, are of the opinion that the appellants have no right to possess the articles in question. Keeping in view of the fact that the provisions of the statute have been held to be *intra vires* the question of compensating the appellants would not arise as vesting of possession thereof in the State must be inferred by necessary implication."

...

An order of confiscation of forest-produce in a proceeding under Section 59-A of the Act would not amount either to penalty or punishment. Such an order, however, can be passed only in the event a valid seizure is made and the authorized officer satisfies himself as regard ownership of the forest- produce in the State as also commission of a forest-offence. ...

...

... An order of confiscation in respect of a property must be distinguished from an order of forfeiture thereof. Although the effect of both confiscation and forfeiture of a property may be the same, namely that the property would vest in the State but the nature of such order having regard to the statutory scheme must be held to be different. A proceeding for confiscation can be initiated irrespective of the fact that as to whether prosecution for commission of a forest offence has been lodged or not. A confiscation proceeding, therefore, is independent of a criminal proceeding. We may also notice that the State has been made liable to refund the amount which has been deposited pursuant to an auction held in respect of the confiscated property only in the event the order of confiscation is set aside or annulled under Section 59-A(4)(b) thereof. No provision has been made in the statute unlike Section 6-C of the Essential Commodities Act, 1955 to the effect that the confiscated property or the amount deposited in the treasury pursuant to the

auction of the confiscated goods would be returned to the owner thereof in the event, the criminal trial ends in an acquittal.

This Court, in this case, is not concerned with the effect of acquittal vis-a-vis a confiscation proceeding. There may be a case where a judgment of acquittal has been rendered not on merit of the matter but by way of giving benefit of doubt or for certain reasons unrelated to the adjudication on merits as for example dropping of the proceeding as the prosecution witnesses did not turn up despite service of summons.

...

A confiscation envisages a civil liability whereas an order of forfeiture of the forest-produce must be preceded by a judgment of conviction. Although indisputably having regard to the phraseology used in subsection (2) of Section 59-A, there cannot be any doubt whatsoever that commission of a forest offence is one of the requisite ingredients for passing an order of confiscation; but the question as to whether the order of acquittal has been passed on that ground and what weight should be attached thereto is a matter which, in our opinion, should not be gone into at this stage.”

The Hon’ble Supreme Court in *Biswanath Bhattacharya v UoI & Ors.*<sup>238</sup> has recognized non-conviction based civil forfeiture in India based on non-conviction on the lines of US, UK and other countries. It *inter alia* noted as follows,-

“42. Whether there is a right to hold property which is the product of crime is a question examined in many jurisdictions. To understand the substance of such examination, we can profitably extract from an article published in the Journal of Financial Crime, 2004 by Anthony Kennedy.[11]

“..It has been suggested that a logical interpretation of Art. 1 of the First Protocol of the European Convention on Human Rights is:

‘Everyone is entitled to own whatever property they have (lawfully) acquired .....’

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<sup>238</sup> [2014] 1 SCr 885. Also see,

hence implying that they do not have a right under Art. 1 to own property which has been unlawfully acquired. This point was argued in the Irish High Court in *Gilligan v The Criminal Assets Bureau*, namely that where a defendant is in possession or control over assets which directly or indirectly constitute the proceeds of crime, he has no property rights in those assets and no valid title to them, whether protected by the Irish Constitution or by any other law. A similar view seems to have been expressed earlier in a dissenting opinion in *Welch v United Kingdom*: ‘in my opinion, the confiscation of property acquired by crime, even without express prior legislation is not contrary to Article 7 of the Convention, nor to Article 1 of the First Protocol.’ This principle has also been explored in US jurisprudence. In *United States v. Vanhorn* a defendant convicted of fraud and money laundering was not entitled to the return of the seized proceeds since they amounted to contraband which he had no right to possess. In *United States v Dusenbery* the court held that, because the respondent conceded that he used drug proceeds to purchase a car and other personal property, he had no ownership interest in the property and thus could not seek a remedy against the government’s decision to destroy the property without recourse to formal forfeiture proceedings. (emphasis supplied) The UK government has impliedly adopted this perspective, stating that:

‘... It is important to bear in mind the purpose of civil recovery, namely to establish as a matter of civil law that there is no right to enjoy property that derives from unlawful conduct.’ (emphasis supplied)

43. Non-conviction based asset forfeiture model also known as Civil Forfeiture Legislation gained currency in various countries: United States of America, Italy, Ireland, South Africa, UK, Australia and certain provinces of Canada.

44. Anthony Kennedy conceptualised the civil forfeiture regime in the following words:-



“Civil forfeiture represents a move from a crime and punishment model of justice to a preventive model of justice. It seeks to take illegally obtained property out of the possession of organised crime figures so as to prevent them, first, from using it as working capital for future crimes and, secondly, from flaunting it in such a way as they become role models for others to follow into a lifestyle of acquisitive crime. Civil recovery is therefore not aimed at punishing behaviour but at removing the ‘trophy’ of past criminal behaviour and the means to commit future criminal behaviour. While it would clearly be more desirable if successful criminal proceedings could be instituted, the operative theory is that ‘half a loaf is better than no bread’.”

45. For all the above-mentioned reasons, we are of the opinion that the Act is not violative of Article 20 of the Constitution....”

The aforesaid judgment follows its earlier decision in *Attorney General of India v Amratlal Prajivandas*<sup>239</sup> relying on the common law concept of forfeiture to uphold forfeiture contained in various other Indian statutes. The Hon’ble Supreme Court of India in *Delhi Development Authority v. Skipper Construction Co. Ltd.*<sup>240</sup>, has also observed that there is need to implement laws akin to Smugglers and Foreign Exchange Manipulators (Forfeiture of Property) Act, 1976 for effective deterrence of corporate crimes and applied the principle of forfeiture even in case which did not involve a fiduciary relationship or a holder of public office. It did so because a corporate structure was used to acquire properties by defrauding the people and it was necessary that the persons defrauded should be restored to the position in which they would have

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<sup>239</sup> AIR 1994 SC 2179. According to Section 3(c) of the Smugglers and Foreign Exchange Manipulators (Forfeiture of Property) Act, 1976, ‘illegally acquired property’ includes any property acquired by a person wholly or partly out of or by means of any income, earnings or assets derived or obtained from any activity prohibited by any law for the time being in force relating to any matter in respect of which Parliament has power to make laws; or assets the source of which cannot be proved and which cannot be shown to be attributable to any act or thing done in respect of any matter in relation to which Parliament has no power to make laws. Under this Act the burden to prove that any property forfeited is not illegally acquired property is on the person affected. The provisions of this Act have reflections of non-conviction based forfeiture as here forfeiture is not linked to the conviction for offence.

<sup>240</sup> AIR 1996 SC 2005.

been but for the said fraud. Thus, the necessary and correct approach to civil disgorgement requires that the Board discharge its duty to show probable cause of violation of securities laws as a consequence of which the proceeds to be disgorged may have arisen; the burden is on the person in possession of the property to indicate that the property has been obtained from otherwise lawful activities. Further, as seen from the various judicial precedents, disgorgement or forfeiture is applicable to a wide variety of violations and not just fraud.

- c. The securities laws were amended in 2014 to provide for a specific right of priority to the Board's recovery actions in respect of disgorgement actions over the claim of any other person. This needs to be seen in the light of the intention of the Insolvency and Bankruptcy Code, 2016 to expressly exclude 'assets held in trust' from the Liquidation Estate under Section 36 of the Code.
- d. Recently, the Chandigarh bench of the NCLT vide order dated 26.04.2019 in the matter of *Weather Makers Pvt. Ltd. v Parabolic Drugs Ltd.*<sup>241</sup>, has *inter alia* held that where application was filed for recovery of assets that were contractually required to be held in trust, the moratorium under the IBC is not applicable and recovery could be done. On closer analysis of the judgment it can be discerned that the nature of trust in the present case was in fact a *quistclose* trust. i.e. where goods or monies were given for a particular purpose only. In the event that the recipient uses the money for any other purpose, it is a breach of trust and the money or its asset equivalent can be returned.
- e. Further, the *Standing Committee on Finance (2018-19) in its 70<sup>th</sup> Report on the Banning of Unregulated Deposit Schemes Bills, 2018*,<sup>242</sup> *inter alia* recommended removing the priority given to the IBC and the SARFAESI Act while undertaking refund to investors. This is in line with the earlier draft Bill that had been formulated by the Inter-Ministerial Group. The Committee noted that repaying depositors' money is the most critical part of the process of

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<sup>241</sup> Available at <https://nclt.gov.in/sites/default/files/Interim-order-pdf/FINAL%20Orders%20on%20CA%20206%20of%2019%20in%20CP%20102%20of%2018%20-60%285%29-Weather%20Makers.pdf>.

<sup>242</sup> Available at [http://164.100.47.193/lsscommittee/Finance/16\\_Finance\\_70.pdf](http://164.100.47.193/lsscommittee/Finance/16_Finance_70.pdf).

restitution of depositors. Though the recommendation of the Committee was not accepted, the IBC itself excludes 'assets held in trust' from the Liquidation Estate. Thus, though the Standing Committee's recommendation was not accepted, in so far as securities investors are concerned, they continue to be in a privileged position since the issue of securities utilizes a *quistclose* trust.

- f. In this context, the nature of public and private trusts in securities laws need to be noted. Though the principles contained in the Indian Trusts Act, 1882 are also recognized by courts in respect of public trusts, the omission of Section 94 [*Constructive trusts in cases not expressly provided for.*] in the Indian Trusts Act, 1882 to curb the practice of 'benami' by the Benami Transactions (Prohibition) Act, 1988 has no effect on public constructive trusts. The concept of constructive trusts (trusts not expressly provided for but implied by law), continue to be applicable in securities laws. Unlike the private trusts (regulated by the Indian Trusts Act, 1882) which concern themselves with identifiable beneficiaries, public trusts are for the benefit of members of an uncertain and fluctuating body. Several public trust laws of India recognize that a public trust may be constructive.<sup>243</sup>
- g. The distinction between a public trust and a private trust, broadly speaking, is that in a public trust the beneficiaries of the trust are the people in general or some section of the people while in the case of a private trust, the beneficiaries are an ascertained body of persons.<sup>244</sup> Business trusts evolved from private trusts but are distinct from them and offer financial services to the public.<sup>245</sup> E.g. the SEBI (Mutual Funds) Regulations, 1996 define a 'mutual fund' as '*a fund established in the form of a trust to raise monies through the sale of units to the public or a section of the public under one or more schemes for investing*

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<sup>243</sup> See, clause (13) of Section 2 of the Bombay Public Trust Act, 1950 which inter alia defines a Public Trust as "*Public Trust' means an express or constructive trust for either a public, religious or charitable purpose or both and includes a temple, a math, a wakf, church, synagogue, agiary or other place of public religious worship, a dharmada or any other religious or charitable endowment and a society formed either for a religious or charitable purpose or for both and registered under the Societies Registration Act, 1860.*"

<sup>244</sup> *Srinivas Ramanuja Das v. Surjanarayan Das*, AIR 1967 SC 256.

<sup>245</sup> For more detailed discussion, see Tamar Frankel, *The Delaware Business Trust Act Failure as the New Corporate Law*, 23 *Cardozo L. Rev.* 325 (2001-2002), available at <<https://heinonline.org/HOL/LandingPage?handle=hein.journals/cdozo23&div=20&id=&page=>>>; <<http://people.bu.edu/tfrankel/Delaware%20bizs%20trust%2019.doc>>.

*in securities including money market instruments or gold or gold related instruments or real estate assets.'*

- h. There are certain private trusts in securities laws, such as Portfolio Management services, but they are not affected by the omission of Section 94 of the Indian Trust Act, 1882. Such trust is expressly mandated under the SEBI regulations and also covered under Section 88 [*Advantage gained by fiduciary.*] of the Indian Trusts Act, 1882. In particular SEBI (Portfolio Managers) Regulations, 1993 mandate the agreement to be in writing and *inter alia* provide that, '*the Portfolio Manager shall act in a fiduciary capacity and as a trustee and agent of the clients' account.*'<sup>246</sup>
  
- i. Similarly, a constructive trust may also arise in the case of violation of any law. E.g. The Hon'ble Supreme Court of India in the case of *Attorney General of India v Amratlal Prajivandas*<sup>247</sup> while dealing with the matter under

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<sup>246</sup> See, Regulation 14 and Schedule IV of the SEBI (Portfolio Managers) Regulation, 1993.

<sup>247</sup> AIR 1994 SC 2179:

“After all, all these illegally acquired properties are earned and acquired in ways illegal and corrupt at the cost of the people and the State. The State is deprived of its legitimate revenue to that extent. These properties must justly go back where they belong to the State. What we are saying is nothing new or heretical. (emphasis supplied) Witness the facts and ratio of a recent decision of the Privy Council in *Attorney General for Hong Kong v. Reid*. The respondent, Reid, was a Crown-prosecutor in Hong Kong. He took bribes as an inducement to suppress certain criminal prosecutions and with those monies, acquired properties in New Zealand, two of which were held in the name of himself and his wife and the third in the name of his solicitor. He was found guilty of the offence of bribe-taking and sentenced by a criminal court. The Administration of Hong Kong claimed that the said properties in New Zealand were held by the owners thereof as constructive trustees for the Crown and must be made over to the Crown. The Privy Council upheld this claim overruling the New Zealand Court of Appeals. Lord Templeman, delivering the opinion of the Judicial Committee, based his conclusion on the simple ground that any benefit obtained by a fiduciary through a breach of duty belongs in equity to the beneficiary. It is held that a gift accepted by a person in a fiduciary position as an incentive for his breach of duty constituted a bribe and, although in law it belonged to the fiduciary, in equity he not only became a debtor for the amount of the bribe to the person to whom the duty was owed but he also held the bribe and any property acquired therewith on constructive trust for that person. It is held further that if the value of the property representing the bribe depreciated the fiduciary had to pay to the injured person the difference between that value and the initial amount of the bribe, and if the property increased in value the fiduciary was not entitled to retain the excess since equity would not allow him to make any profit from his breach of duty. Accordingly, it is held that to the extent that they represented bribes received by the first respondent, the New Zealand properties were held in trust for the Crown, and the Crown had an equitable interest therein. The learned Law Lord observed further that if the theory of constructive trust is not applied and properties interdicted when 13 (1993) 3 WLR 1 143: (1994) 1 All ER 1 available, the properties "can be sold and the proceeds whisked away (emphasis supplied) to, some Shangri La which hides bribes and other corrupt moneys in numbered bank accounts" to which we are tempted to add one can understand the immorality of the Bankers who maintained numbered accounts but it is difficult to understand the amorality of the Governments and their laws

Conservation of Foreign Exchange and Prevention of Smuggling Activities Act [which defined ‘illegally acquired properties’] *inter alia* held that such properties are earned and acquired through illegal and corrupt means, at the cost of the people and the State, and hence these properties must justly go back where they belong. It also held that the said principle arises on account of a constructive trust and would also apply in the violation of any other law.

- j. In case of conflict between SEBI’s right to disgorgement (or that of securities investors to be restituted) and the right of secured creditors, the secured creditors/creditors cannot seek to enrich themselves from the proceeds of an illegal activity. However, they can seek assets not acquired from such proceeds.<sup>248</sup> Like Shylock, *they may extract their pound of flesh from the debtor, but shed no blood of the investors.*
  
- k. Where financial creditors, especially regulated businesses such as banks and financial institutions fail to exercise due diligence and give credit/lending to operators of unregulated securities schemes or schemes where fraudulent default is taken place, the law does not protect and give them priority and precedence. It does not incentivize lending to operators of unregulated schemes and those engaging in fraudulent default in regulated schemes. In this respect it may be noted that the US Bankruptcy Code<sup>249</sup> is more explicit in excluding from the bankruptcy estate, “[p]roperty in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest ... becomes property of the estate ... only to the extent of the debtor’s legal title to

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which sanction such practices in effect encouraging them. The ratio of this decision applies equally where a person acquires properties by violating the law and at the expense of and to the detriment of the State and its revenues where an enactment provides for such a course, even if the fiduciary relationship referred to in Reid is not present. (emphasis supplied) It may be seen that the concept employed in Reid" was a common law concept, whereas here is a case of an express statutory provision providing for such forfeiture. May we say in conclusion that "the interests of society are paramount to individual interests and the two must be brought into just and harmonious relation. A mere property career is not the final destiny of mankind, if progress is to be the law of the future as it has been of the past". (Lewis Henry Morgan: Ancient Society).”

<sup>248</sup> *Standard Chartered Bank & Ors v Deputy Director, Directorate of Enforcement, Mumbai*, PMLA Appellate Tribunal, order dated 02.08.2018 available at <[http://atfp.gov.in/writereaddata/upload/Judgement/Judgement\\_FMSMWJERQT\\_78805.PDF](http://atfp.gov.in/writereaddata/upload/Judgement/Judgement_FMSMWJERQT_78805.PDF)>. It may be noted that the violations of securities laws are now covered under the PMLA as scheduled offences by virtue of The Prevention of Money-Laundering (Amendment) Act, 2012.

<sup>249</sup> Title 11, U. S. Code, Section 541, (d), available at <<https://www.govinfo.gov/content/pkg/USCODE-2011-title11/pdf/USCODE-2011-title11-chap5-subchapIII-sec541.pdf>>

*such property, but not to the extent of any equitable interest in such property that the debtor does not hold.*” The property is part of the estate of the bankrupt only to the extent of his legal right, if he has any, and subject to the equitable interest of another. Thus, where the debtor holds bare legal title without any equitable interest, the estate acquires bare legal title without any equitable interest.<sup>250</sup> Especially given the fact that in cases where the defaulter did not have the legal authorization to collect monies through the issuance of securities, the defaulter may not even have the *prima facie* legal right to create a security interest in the trust asset. In this regard the Delhi High Court in the matter of *Deputy Director, Directorate of Enforcement v Axis Bank & Ors.*<sup>251</sup> vide order dated 02.04.2019 has on similar lines *inter alia* dealt with the burden of proving that a third party including a secured creditor, has “acted in good faith”, taking “all reasonable precautions”, as follows,-

“153....This court .... finds it difficult to accept that a property may be allowed escape from civil sanction under PMLA only on the plea of the third party claiming to be at "no fault" or to have acted "without notice" of the criminal activity engaged in by the person from whom interest is acquired. As would be elaborated hereinafter, the burden to prove facts to rebut the statutory presumptions necessitates more than mere ignorance to be shown. (emphasis supplied)

...

163. ..., it is clear that if a bonafide third party claimant had acquired interest in the property which is being subjected to attachment at a time anterior to the commission of the criminal activity, the product whereof is suspected as proceeds of crime, the acquisition of such interest in such property (otherwise assumably untainted) by such third party cannot conceivably be on account of intent to defeat or frustrate this law. In this view, it can be concluded that the date or period of the commission of criminal activity which is the basis of such action under PMLA can be safely treated as the cut-off. From this, it naturally follows

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<sup>250</sup> *In Re N S Garrett & Sons & Anr*, 772 F.2d 462 (U.S.C.A. 8<sup>th</sup> Circuit), available at <<https://www.courtlistener.com/opinion/457909/in-re-ns-garrott-sons-and-eastern-arkansas-planting-company-a-joint/>>.

<sup>251</sup> Available at <[https://ibbi.gov.in/webadmin/pdf/whatsnew/2019/Apr/RKG02042019CRLA1432018\\_2019-04-03%2014:45:26.pdf](https://ibbi.gov.in/webadmin/pdf/whatsnew/2019/Apr/RKG02042019CRLA1432018_2019-04-03%2014:45:26.pdf)>.

that an interest in the property of an accused, vesting in a third party acting bona fide, for lawful and adequate consideration, acquired prior to the commission of the proscribed offence evincing illicit pecuniary benefit to the former, cannot be defeated or frustrated by attachment of such property to such extent by the enforcement authority in exercise of its power under Section 8 PMLA.

...

170. But, the above exception cannot be applied to all cases of bona fide third party claimants so as to confer a general right to seek release of such property as last mentioned above from attachment even in cases where the encumbrance is created or interest acquired at a time around or after the date or period of criminal activity. In this category of cases, the third party will have the additional burden to prove that it had exercised due diligence having "taken all reasonable precautions" at the time of acquisition of such interest or creation of such charge, the jurisdiction to entertain and inquire into such claim and grant relief of release after order of attachment has attained finality, or of restoration after order of confiscation, vesting only in the special court under Section 8(7) & (8) PMLA. The due diligence is to be tested amongst others, on the touchstone of questions as to whether the party had indulged in transaction after due inquiry about untainted status of the asset or legitimacy of its acquisition." (emphasis supplied)

Though an attempt to arrive at tracing of assets is generally important when dealing with trusts, it must be noted that it is common experience in dealing with unregistered schemes that the funds raised by issue of securities generally represents the most important source of monies for the issuer. The interplay of trust law and insolvency law was discussed in the famous international bankruptcy cases relating to Lehman Bros. *In Re Lehman Brothers International (Europe) (in administration)*,<sup>252</sup> Patten LJ *inter alia* held as follows,-

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<sup>252</sup> [2009] EWCA Civ 1161; available at <<http://www.trusts.it/admincp/UploadedPDF/201102211153260.jEngLehman2009civ1161.pdf>>.

“33. The foundation of Mr Snowden's argument is that a beneficiary under a trust is not ipso facto a creditor of the trustee. Although the trust relationship may give rise to unsecured claims against the trustee for breach of trust or even negligence and may sometimes exist in a wider contractual framework, it remains at its core a different legal relationship. Subject to the terms of the trust instrument, the trustee holds the trust property for the benefit of those beneficially entitled to it and has a primary obligation to maintain those particular assets (or any which replace them) to the exclusion of all other claims. *The trust property does not form part of the trustee's estate in the event of insolvency so as to be available to meet the claims of general creditors and the beneficiary is entitled to the property in specie free of any such claims.* (emphasis supplied)

...

67. *A proprietary claim to trust property is not a claim in respect of a debt or liability of the company. The beneficiary is entitled in equity to the property in the company's hands and is asserting his own proprietary rights over it against the trustee. The failure by a trustee to preserve that property in accordance with the terms of the trust may give rise to a secondary liability to make financial restitution for the loss which results, but that is a consequence of the trust relationship and not a definition of it.* (emphasis supplied)

Further, the Master of the Rolls (concurring) *inter alia* held as follows,-

“75. However, I find it very hard to see how it could be said that a person ("a beneficiary") who has the beneficial interest in property ("trust property") held on trust by the company is thereby a "creditor" of the company, even bearing the wide meaning that word is to be given in section 895. (emphasis supplied)

76. As Mr Richard Snowden QC, appearing for the London Investment Banking Association ("LIBA" who oppose the appeal because of what they regard as the unfortunate implications for London as a world financial centre should the administrators succeed on this appeal), says, in relation to such property, *the beneficiary is "not a creditor of the [company] but ...*



*the owner of certain specific property in the possession of the [company]" – to adapt an observation of Romilly MR in Sinclair v Wilson (1855) 20 Beav 324, 331. The duty of a trustee is thus to account to the beneficiary for trust property. Although a breach of trust by the trustee will normally give rise to a claim which constitutes the beneficiary a creditor, the trustee-beneficiary relationship will not of itself give rise to the beneficiary having any "pecuniary claims" (to quote from the very passage relied on by the administrators in the judgment of Lindley LJ in Midland Coal [1895] 1 Ch 267, 277) against the trustee." (emphasis supplied)*

Thus, where a trustee becomes insolvent, all the assets belonging to the trustee are divided up amongst his or her creditors. *But if a beneficiary has an equitable property right to assets held by the trustee, it cannot be said that those assets belong to the trustee beneficially. Those assets are, therefore, removed from the pool of the trustee's assets, as they belong in equity to the beneficiary. Only the remaining assets that belong to the trustee beneficially are then distributed amongst the remaining creditors (generally pari passu, or proportionally). Clearly, this puts a beneficiary in a much stronger position than other creditors.* Similarly, if a claimant has a security interest in the property held by a defendant who becomes insolvent, that property interest will be satisfied before the claims of any other unsecured creditors are satisfied.<sup>253</sup> The beneficiary is not a 'creditor' for the purposes of insolvency law; his position is higher than that of a creditor.

This is not to say that the beneficiary can never be a creditor. If the loss caused to the beneficiaries is greater than the value of the original trust property recovered, then he has a right to recover the value of the balance out of the other general assets as a creditor. In *Schrider v. Schlossberg*<sup>254</sup> (*In re Greenbelt. Rd. Second Ltd. P'ship*), the Court *inter alia* held that,-

“While courts have used § 541(d) to impose constructive trusts ... § 541(d) is not an “equitable panacea” justifying the imposition of a constructive trust

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<sup>253</sup> Paul S Davies & Graham Virgo, *Equity & Trusts: Text, cases and materials*, Oxford Univ. Press, 2013, Part I: Introduction to Equity, p 11.

<sup>254</sup> 39 F.3d 1176. (4th Cir. 1994), available at <<https://law.justia.com/cases/federal/appellate-courts/F3/39/1176/511801/>>.

whenever a debtor's misconduct caused a creditor to suffer.... Constructive trusts, therefore, cannot arise by post hoc rationalizations provided by putative beneficiaries who are displeased because they are merely general, unsecured creditors. The party seeking to impose a constructive trust must "establish... that his funds can be traced to the account or property over which he seeks to impose a constructive trust...." If the trust ... "funds ha[ve] been dissipated or so mingled<sup>255</sup> and merged with the general assets of the insolvent estate as not to be separable or distinguishable therefrom, there is no identification, and the cestui que trust has no claim other than as a general creditor." (internal citations omitted).

Further, this does not mean that secured creditors can once again take a dip into the general assets if the value of the secured assets results in a shortfall; such creditors must be restricted to recovery from their collateral and not dip into assets over which a trust extends.<sup>256</sup> Further, it is possible that persons running the unlawful schemes, including employees and persons referring investors to the unlawful scheme, may be creditors. To a large extent, such persons must be excluded from claiming any priority over the right of investors.<sup>257</sup> Similarly, equity being the overarching principle of any trust, if some of the investors were also involved in perpetuating the scheme, they too may be excluded from recovering.<sup>258</sup> The present IBC is a work in progress and is not designed for dealing with claims arising out of trusts, hence several changes may be required.

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<sup>255</sup> In respect of commingling of assets, in the Indian context see *inter alia* section 66 of the Indian Trust Act, 1882 which is in line with the judgment in *SEC v Better Life Club of Am. Inc.*

<sup>256</sup> *S.E.C. v Byers*, 637 F. Supp. 2d 166 (S.D.N.Y. 2009), available at <<https://casetext.com/case/sec-v-byers-5>>.

<sup>257</sup> See *S.E.C. v Byers*, 637 F. Supp. 2d 166 (S.D.N.Y. 2009), available at <<https://casetext.com/case/sec-v-byers-5>>; *S.E.C. v. Basic Energy Affiliated Res.*, 273 F.3d 657, 660 (6th Cir. 2001) available at, <<https://casetext.com/case/sec-v-basic-energy-affiliated-resources?resultsNav=false#p660>>; *S.E.C. v. Merrill Scott Assocs.*, No. 02 Civ. 39, 2006 U.S. Dist. LEXIS 93248, (D. Utah Dec. 21, 2006), available at <<https://casetext.com/case/securities-exch-comm-v-merrill-scott-assoc-3?resultsNav=false>>; *S.E.C. v. Enter. Trust Co.*, No. 08 C 1260 (N.D. Ill. Oct. 7, 2008) available at <<https://casetext.com/case/securities-exchange-comm-v-enterprise-tr-co>>.

<sup>258</sup> See *S.E.C. v Byers*, 637 F. Supp. 2d 166 (S.D.N.Y. 2009), available at <<https://casetext.com/case/sec-v-byers-5>>; *S.E.C. v Credit Bancorp*, 99 Civ. 11395 (RWS) (S.D.N.Y. Nov. 29, 2000), available at, <<https://casetext.com/case/securities-and-exchange-commission-v-credit-bancorp-sdny-2000>>.

SEBI successfully obtained judgment from the Federal Court of Australia in the matter of *Kadam & Ors. v MiiResorts Group 1 Pty Ltd & Ors.*<sup>259</sup>, by utilising the law of trusts in respect of monies siphoned off from an unregistered collective investment scheme. The case is a landmark in SEBI's enforcement history and indicates that enforcement of securities laws is not merely based on explicit provisions of the SEBI Act and failure to obtain registration does not vitiate the trust obligation. Rather it is an amalgam of law of trusts, company law, etc. In respect of super-priority of beneficiaries, a cue may be had from insolvency law, where courts generally deal with claims from beneficiaries and creditors over the assets of the debtor on the ground that the assets did not become part of the property of the debtor and are therefore not divisible among its creditors, whether or not they have been held formally in trust as long as the monies have been impressed with a character which prevents it from becoming the property of the debtor.<sup>260</sup>

**Differentiating monies and assets held in trust:** There are several rules relating to identifying monies and assets required to be held in trust. While pooled assets such as those required to be kept by a collective investment scheme can only be traced to the level of pooling; un-pooled assets, such as an account in a portfolio investment scheme, can be traced to each investor provided co-mingling has not happened. Even in case of co-mingling several rules exist for enabling the benefit of the trust.

In dealing with monies raised from the public and managed by the debtor-company under insolvency process, it becomes important to identify and segregate the trust property or its equivalent from assets of the company. This burden cannot be placed on the millions of investors or the Board, who are outsiders to the management of the

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<sup>259</sup> Judgment dated 20.07.2018 available at [https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi\\_data/attachdocs/sep-2018/1536728840793.pdf](https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi_data/attachdocs/sep-2018/1536728840793.pdf); Order dated 23.07.2018 available at [https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi\\_data/attachdocs/sep-2018/1536728821892.pdf](https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi_data/attachdocs/sep-2018/1536728821892.pdf).

<sup>260</sup> *Ganesh Export & Import Co. v Mahadeolal Nathmal*, AIR 1956 Cal 188 : 1955 (25) CompCas 357 (Cal); *Baroda Spinning & Weaving Mills Co. Ltd v Baroda Spinning & Weaving Mills (Rajratna Sheth Zaverchand Laxmichand) Co-operative Credit Society Ltd., Baroda & Anr*, 1976 (1) GLR 555 : 1976 (46) CompCas 1 (Guj); *The Official Assignee of Madras v Krishnaji Bhat*, AIR 1933 PC 148 : 60 IA 203 : ILR 56 Mad. 570; *Official Liquidator v N. Chandranarayanan*, 1973 (43) CompCas 244 (Mad).

company. In this respect, the rationale of the Court in *Wolff v. United States (In re FirstPay, Inc.)*,<sup>261</sup> which *inter alia* held as follows may be referred to,-

“We do not read Levin to have held, as the Trustee here suggests, that funds must be segregated in order to be traceable and subject to a trust. “[C]ourts have consistently rejected the notion that commingling of trust property, without more, is sufficient to defeat tracing.” *In re Dameron*, 155 F.3d at 723–24 (4th Cir.1998). In another case, the Maryland Court of Appeals held that “[i]t is not essential to a sufficient identification that the fund or property delivered to the trustee be traced in the precise or identical form in which it was received[.]” *Cnty. Comm'rs of Frederick Cnty. v. Page*, 163 Md. 619, 164 A. 182, 190 (1933) ; see also *MacBryde v. Burnett*, 132 F.2d 898, 900 (4th Cir.1942) (holding that, under Maryland law, “it is not necessary in asserting the rights of the cestui que trust that the trust funds be specifically traced”).

A beneficiary's entitlement to a trust fund fails for insufficiency of identification “where it appears that the trust fund has been dissipated or so mingled and merged with the general assets of the insolvent estate as not to be separable or distinguishable therefrom [.]” *Page*, 164 A. at 191. However, “if a trustee or fiduciary mixes trust funds with his own, the whole will be treated as trust property, except so far as he may be able to distinguish what is his from that which belongs to the trust[.]” *MacBryde*, 132 F.2d at 900 (4th Cir.1942) (quoting *Englar v. Offutt*, 70 Md. 78, 16 A. 497, 499 (1889) ). “So long as a trust fund can be traced, the court will always attribute the ownership thereof to the cestui que trust, and will not allow the right to be defeated by the wrongful act of the trustee or fiduciary in mixing or confusing the trust fund with funds of his own, or even those of a third party.” *Englar*, 16 A. at 499.”

**The *Berkeley Applegate* principle:** Since the previous management of the company admitted to insolvency loses the power to deal with the company assets, it cannot discharge the burden of identifying the trust assets vis-à-vis the company

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<sup>261</sup> 773 F.3d 583, 594 (4th Cir. 2014), available at <<https://casetext.com/case/wolff-v-united-states-in-re-firstpay-inc>>.

assets. Under the IBC, the power to deal with the company assets, the right to manage the company and deal with its books of accounts primarily vest with the Insolvency professional. The Berkeley Applegate principle [first identified in *Re Berkeley Applegate (Investment Consultants) Ltd. (No.3)*, (1989) 5 B.C.C. 803 per Gibson J. p.805<sup>262</sup>] is useful for making the insolvency discharge the duty of differentiating the trust assets from other assets of the company and to be paid out of such funds. As a corollary of the rule that only the company's assets are available to the creditors, the liquidator has no power as the liquidator, to sell assets not beneficially owned by the company. However if the company is a trustee with management powers under an active trust, the liquidator may, with the consent of the beneficiaries or under an order of the court, manage the trust property on behalf of the beneficiaries and realise the trust property as part of that management.<sup>263</sup> Where the liquidator does so, his remuneration and expenses for so doing cannot be treated as expenses of the

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<sup>262</sup> The principle is now defined as the '*Berkeley Applegate principle*' first identified in *Re Berkeley Applegate (Investment Consultants) Ltd. (No.3)*, (1989) 5 B.C.C. 803 per Gibson J. p.805, cited in *Elliot Green v Timothy Bramston & Anr*, [2010] EWHC 3106 (Ch) available at <<https://www.bailii.org/ew/cases/EWHC/Ch/2010/3106.html>> :

"The point is to my mind a short one, and largely one of first impression. Looking at s 115 [of the Insolvency Act 1986], for my part I have no doubt that the remuneration of the liquidator for administering trust assets which are not the assets of the company and the costs and expenses incurred by the liquidator, again not in getting in or paying out or distributing the assets of the company, but in administering trust assets, are outside the wording of the section. To my mind it is clear that the section is simply dealing with the winding up of the company, involving as it does the getting in of the assets of the company, ascertaining its creditors, paying its liabilities in accordance with the statutory provisions and distributing any surplus. I do not think that on any ordinary reading "expenses properly incurred in the winding up, including the remuneration of the liquidator" would include expenses and remuneration which the liquidator has incurred and has been awarded by the court in respect of the work he has done administering the trust property held by the company as trustee, and in my judgment the section must be construed as limited to the liquidator's expenses in, and remuneration for, dealing with assets of the company. Take the reference to the remuneration of the liquidator. There is no doubt to my mind that that does not include what the court in its inherent jurisdiction has awarded to the liquidator in respect of the work he has been doing not as liquidator but as trustee in administering the trust assets. Similarly the other expenses that are referred to as being incurred in the winding up cannot be expenses in relation to what are not the assets of the company.

On that short point therefore, I would hold that the remuneration in question and the costs and expenses are outside what it is permissible to pay out of the company's assets... The effect therefore is that if there be any surplus of corporate assets over expenses of the liquidation alone, unsecured creditors will be entitled to claim in respect thereof."

; *Re French Caledonia Travel Service Pty Ltd.*, (2003) 204 A.L.R. 353 (NSW Supreme Court) dealing with the principles of trust law to be applied to enable identification and distribution by the liquidator, available at <<https://iknow.cch.com.au/document/atagUio378049sl10433168/re-french-caledonia-travel>>.

<sup>263</sup> Royston Miles Goode, *Principles of Corporate Insolvency Law*, 4<sup>th</sup> edition, pp 95-96, available at <<https://books.google.co.in/books?id=mtK4kQIhEowC&printsec=frontcover&dq=principles+of+corporate+insolvency+law&hl=en&sa=X&ved=0ahUKewi6u5f-45NgAhXLso8KHaPdA7kO6AEILTAA#v=onepage&q=principles%20of%20corporate%20insolvency%20law&f=false>>.

liquidation, being for the benefit of the trust beneficiaries rather than the company, and must be borne by the trust assets. Conversely, any portion of the liquidator's work and expenses not attributable to the trust property ought to be borne by the general creditors out of the company's free assets. Nevertheless, the courts have in exceptional cases been prepared to allow these to be taken, wholly or in part, from the trust assets, as where the trust assets form part of a commingled fund and it is difficult to distinguish between trust assets and assets beneficially owned by the company. In some cases, the liquidator's total remuneration has also been paid out of the trust funds in the same proportion that the trust assets bore to the aggregate fund.

**Protecting *bonafide* third parties:** Similar difficulty may arise in case of assets being transferred to third parties. The Delhi High Court in the matter of *Deputy Director, Directorate of Enforcement v Axis Bank & Ors.*,<sup>264</sup> vide order dated 02.04.2019 *inter alia* gave elaborate directions on how the rights of bonafide third parties, including secured creditors, will be protected,-

“(viii). The PMLA, RDBA, SARFAESI Act and Insolvency Code (or such other laws) must co-exist, each to be construed and enforced in harmony, without one being in derogation of the other with regard to the assets respecting which there is material available to show the same to have been "derived or obtained" as a result of "criminal activity relating to a scheduled offence" and consequently being "proceeds of crime", within the mischief of PMLA.

(ix). If the property of a person other than the one accused of (or charged with) the offence of money-laundering, i.e. a third party, is sought to be attached and there is evidence available to show that such property before its acquisition was held by the person accused of money-laundering (or his abettor), or it was involved in a transaction which had inter-connection with transactions concerning money-laundering, the burden of proving facts to the contrary so as to seek release of such property from attachment is on the person who so contends.

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<sup>264</sup> Available at <[https://ibbi.gov.in/webadmin/pdf/whatsnew/2019/Apr/RKG02042019CRLA1432018\\_2019-04-03%2014:45:26.pdf](https://ibbi.gov.in/webadmin/pdf/whatsnew/2019/Apr/RKG02042019CRLA1432018_2019-04-03%2014:45:26.pdf)>.

(x). The charge or encumbrance of a third party in a property attached under PMLA cannot be treated or declared as "void" unless material is available to show that it was created "to defeat" the said law, such declaration rendering such property available for attachment and confiscation under PMLA, free from such encumbrance.

(xi). A party in order to be considered as a "bonafide third party claimant" for its claim in a property being subjected to attachment under PMLA to be entertained must show, by cogent evidence, that it had acquired interest in such property lawfully and for adequate consideration, the party itself not being privy to, or complicit in, the offence of money-laundering, and that it has made all compliances with the existing law including, if so required, by having said security interest registered.

(xii). An order of attachment under PMLA is not illegal only because a secured creditor has a prior secured interest (charge) in the property, within the meaning of the expressions used in RDBA and SARFAESI Act. Similarly, mere issuance of an order of attachment under PMLA does not ipso facto render illegal a prior charge or encumbrance of a secured creditor, the claim of the latter for release (or restoration) from PMLA attachment being dependent on its bonafides.

(xiii). If it is shown by cogent evidence by the bonafide third party claimant (as aforesaid), staking interest in an alternative attachable property (or deemed tainted property), claiming that it had acquired the same at a time around or after the commission of the proscribed criminal activity, in order to establish a legitimate claim for its release from attachment it must additionally prove that it had taken "due diligence" (e.g. taking reasonable precautions and after due inquiry) to ensure that it was not a tainted asset and the transactions indulged in were legitimate at the time of acquisition of such interest.

(xiv). If it is shown by cogent evidence by the bonafide third party claimant (as aforesaid), staking interest in an alternative attachable property (or deemed tainted property) claiming that it had acquired the same at a time anterior to the commission of the proscribed criminal activity, the property to the extent of such interest of the third party will not be subjected to

confiscation so long as the charge or encumbrance of such third party subsists, the attachment under PMLA being valid or operative subject to satisfaction of the charge or encumbrance of such third party and restricted to such part of the value of the property as is in excess of the claim of the said third party.

(xv). If the bonafide third party claimant (as aforesaid) is a "secured creditor", pursuing enforcement of "security interest" in the property (secured asset) sought to be attached, it being an alternative attachable property (or deemed tainted property), it having acquired such interest from person(s) accused of (or charged with) the offence of money-laundering (or his abettor), or from any other person through such transaction (or interconnected transactions) as involve(s) criminal activity relating to a scheduled offence, such third party (secured creditor) having initiated action in accordance with law for enforcement of such interest prior to the order of attachment under PMLA, the directions of such attachment under PMLA shall be valid and operative subject to satisfaction of the charge or encumbrance of such third party and restricted to such part of the value of the property as is in excess of the claim of the said third party.

(xvi). In the situations covered by the preceding two sub-paragraphs, the bonafide third party claimant shall be accountable to the enforcement authorities for the "excess" value of the property subjected to PMLA attachment.”

The line of enquiry indicated by the Delhi HC is instructive and will serve as an aperçu while framing the rules for the insolvency professional regarding the segregation of assets for recovery of monies held in trust while protecting the interests of bonafide third parties, including secured creditors.

**Petitioning the Adjudicating Authority and trust property:** One of the issues to be dealt with is the *locus standii* to petition the Adjudicating Authority under the IBC. As a corollary to aforesaid discussion, the position of subscribers of securities to whom monies is due for refund, can be that of ‘beneficiaries’ if the assets are traceable



(or their converted or blended assets are available) rather than as ‘creditors’. They cannot be eligible to file an insolvency petition unless the trust assets have been totally dissipated without recourse and the beneficiaries claim is transformed into a financial claim for damages. Such ‘subscribers’ do not have the *de jure* right of a share-holder or debenture holder. If, however, no assets can be determined for the purpose of the trust, then the position of such trust beneficiaries may be reduced to a general creditor. Further, if the allotment of securities has been lawfully made, then and then only can such applicants be considered as holders of securities. In which case, their standing under insolvency and bankruptcy law is to be determined as holder of relevant securities, e.g. equity share-holders will be liable to receive monies as per the waterfall, whereas secured debenture holders will be secured creditors and their standing will be superior and determined as per the nature of the security made available for them. Thus, where the allotment of the securities is not in dispute, the manner of claim will depend on the waterfall. Difficulty will however arise in case where the allotment is invalid and due to a resulting trust the investors could apply as beneficiaries or creditors, depending on whether or not trust assets (or their converted or blended assets are available) exist. However, this investigation into the assets can only be done after the petition is admitted and the same is best left to the insolvency professional under the *Berkeley Applegate* principle. There should be some provision under which a claim can be filed. In civil matters, where property of a third party has been sequestered or a receiver has been appointed, a petition for examination *pro interesse suo* is permitted to prove the title and release of their assets.<sup>265</sup> In the matter of

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<sup>265</sup> See *Naresh Shridhar Mirajkar And Ors vs State Of Maharashtra And Anr*, AIR 1967 SC 1, 1966 (3) SCR 744 wherein the Supreme Court *inter alia* held that,-

“The jurisdiction of the Court does not depend on who the person affected by its order, is. Courts often have to pass orders which affect strangers to the proceedings before them. To take a common case, suppose a court appoints a receiver of a property about which certain persons are litigating but which in fact belongs to another. That person is as much bound by the order appointing the receiver as the parties to it are. His remedy is to move the court by an application *pro interesse suo*. He cannot by force prevent the receiver from taking possession and justify his action on the ground that the order was without jurisdiction and therefore violated his fundamental right to hold property. It would be an intolerable calamity if the law were otherwise.

...

If a stranger to the proceeding feels aggrieved by the order, he may take appropriate steps for setting it aside, but while it lasts, it must be obeyed. Take a case where a Court appoints a receiver over a property in a suit concerning it. If a stranger interested in the property is prejudiced by the order, his proper course is to apply to the Court to enforce his right, and the Court will then examine his claim and give him the relief to which he may be entitled.”

*Weather Makers Pvt. Ltd. v Parabolic Drugs Ltd.*<sup>266</sup>, the application for recovery of assets was filed under sub-section (5) of section 60 of the IBC which permits the National Company Law Tribunal to entertain or dispose of,-

- (a) any application or proceeding by or against the corporate debtor or corporate person;
- (b) any claim made by or against the corporate debtor or corporate person, including claims by or against any of its subsidiaries situated in India; and
- (c) any question of priorities or any question of law or facts, arising out of or in relation to the insolvency resolution or liquidation proceedings of the corporate debtor or corporate person under this Code.

Similar provision exists under Section 179 of the IBC in respect of bankruptcy of individuals and partnership firms. This is similar to Section 280 of the Companies Act, 2013. As on date, a petition for examination *pro interesse suo* would have to be filed under Section 60 of the IBC, for lack of a well-defined procedure under the IBC. A well-defined procedure under the IBC at the outset would help in protecting the trust assets from being dissipated towards any creditor oriented resolution or liquidation. A well-defined procedure will be beneficial for beneficiaries of trusts (private or public), whether or not such trusts are financial trusts regulated by a financial regulator, and may also be helpful to a financial regulator such as SEBI seeking recovery of assets held in trust pursuant to disgorgement or refund or forfeiture obligation under applicable laws.

Thus, in order to deal with the issue of properties held in ‘trust’, there is a need to confirm whether the ‘trust’-based activity was duly registered with the Board or otherwise.

- A. In case of the resolution/liquidation of a person who is duly registered; the lawful claims of various creditors, including secured creditors will have precedence over trust beneficiaries. Such claims being incurred for running the lawful enterprise, the registered person being in the position of a trustee, has the right of indemnification from the assets of the trust for debts incurred in

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<sup>266</sup> Available at <https://nclt.gov.in/sites/default/files/Interim-order-pdf/FINAL%20Orders%20on%20CA%20206%20of%2019%20in%20CP%20102%20of%2018%20-60%285%29-Weather%20Makers.pdf>.

operating the trust. The right of indemnity is comprised of two distinct parts. A right of recoupment (being the right to recoup money from the trust assets in respect of liabilities which the trustee has previously discharged from their own funds) and a right of exoneration (being a right to discharge trust liabilities directly from the assets of the trust).<sup>267</sup> Both the right of recoupment and right of exoneration will pass to the bankruptcy trustee/liquidator as the part of the trustee's estate. In case of any co-mingling the approach indicated in B. would also have to be followed.

- B. If the resolution/liquidation is of a person who is not registered or authorized by the Board, various factors arise and the following need to be considered,-
- a. Whether the assets in 'trust' are traceable (or their converted or blended assets are available) or not;
  - b. If assets are traceable there may exist a proprietary right in respect of such assets which will need to be separated and kept aside; and
  - c. If the assets are not traceable by reason of conversion or blending., the claim in respect of such assets may extend to such converted or blended assets;
  - d. If the assets are not traceable due to dissipation of trust assets, the claim in respect of such assets will be reduced to a claim as a general creditor.
  - e. If there is a secured charge of a third party on certain assets it would need to be seen if the secured charge has lawfully perfected, if not the claim in favor of the trust would prevail. This will also depend on the (i) nature of assets - moveable properties<sup>268</sup> may not require the level of due diligence that immovable properties may require - as well as the (ii) nature of the lender- banks, nbfc's, etc., that are required to follow fixed lending norms to ensure public funds are not jeopardized and (iii) the circumstances in which the transaction was executed.
  - f. In case of perfected secured charge, - (a) if the value of the secured asset is not sufficient to satisfy the secured charge, the secured creditor should not be entitled to dip into the assets charged in favour of the trust or may do so after the claim of the trust has been satisfied; (b) the investors claim against the secured asset will be reduced to a claim as a general creditor.

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<sup>267</sup> See Regulation 37(4) of the SEBI (Collective Investment Schemes) Regulations, 1999 which permit the payment of liabilities incurred for the scheme and scheme winding up costs to be paid ahead of the claims of unit holders.

<sup>268</sup> Moveable properties are freely transferable and *bonafide* purchasers for value with no notice of the underlying violation are protected. See *iTrade Finance Inc. v Bank of Montreal*, [2011] 2 SCR 360, available at <<https://scc-csc.lexum.com/scc-csc/scc-csc/en/item/7940/index.do>>; *MBank-Waco, NA v. L. & J., Inc.*, 754 S.W.2d 245 (Tex. App. 1988), available at <<https://www.courtlistener.com/opinion/1780475/mbank-waco-na-v-l-j-inc/>>.

#### **IV. APPLICATION OF MORATORIUM UNDER IBC TO SECURITIES LAWS PROCEEDINGS.**

Section 14 of the IBC contains a moratorium against suit and proceedings against a company that has been admitted for insolvency. It reads as follows,-

**“Section 14. Moratorium. -**

(1) Subject to provisions of sub-sections (2) and (3), on the insolvency commencement date, the Adjudicating Authority shall by order declare moratorium for prohibiting all of the following, namely: -

(a) the institution of suits or continuation of pending suits or proceedings against the corporate debtor including execution of any judgement, decree or order in any court of law, tribunal, arbitration panel or other authority;

(b) transferring, encumbering, alienating or disposing off by the corporate debtor any of its assets or any legal right or beneficial interest therein;

(c) any action to foreclose, recover or enforce any security interest created by the corporate debtor in respect of its property including any action under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (54 of 2002);

(d) the recovery of any property by an owner or lessor where such property is occupied by or in the possession of the corporate debtor.

(2) The supply of essential goods or services to the corporate debtor as may be specified shall not be terminated or suspended or interrupted during moratorium period.

(3) The provisions of sub-section (1) shall not apply to —

(a) such transaction as may be notified by the Central Government in consultation with any financial regulator;

(b) a surety in a contract of guarantee to a corporate debtor.

(4) The order of moratorium shall have effect from the date of such order till the completion of the corporate insolvency resolution process:

Provided that where at any time during the corporate insolvency resolution process period, if the Adjudicating Authority approves the resolution plan under sub-section (1) of section 31 or passes an order for liquidation of corporate debtor under section 33, the moratorium shall cease to have effect from the date of such approval or liquidation order, as the case may be.”

A bare reading of the moratorium provision u/s 14 of the IBC (and similar provisions in Section 33, 81, 85, 101 and 124 of the IBC) would seem to indicate that bankruptcy process may become a refuge from all and any kind of action against the debtor which can be subject to abuse. It may be noted that similar widely worded moratoriums existed under the liquidation process in case of Companies Act, 1956 (Section 446) and Companies Act, 2013 (Section 279) and also under the resolution process under the Sick Industrial Companies (Special Provisions) Act, 1985. However, courts have interpreted the term 'suit or legal proceedings' in the moratorium provisions as extending only to those cases where the company court (HC/NCLT) can deal and dispose of matter. In all other cases, the action does not stop.

Therefore the following need to be considered in the context of IBC,-

- i. Criminal proceedings against the debtor;
- ii. Civil proceedings which “assess” civil liability under special laws;
- iii. Civil proceedings for recovery of monies due against assets of the debtor;
- iv. Civil proceedings for recovery of “assets held in trust”;
- v. Interim orders;
- vi. Settlement Proceedings;
- vii. Other proceedings under securities laws where the debtor may be a party.

**Institution and continuation of criminal proceedings:** It has been the general determination of courts that criminal proceedings against the debtor are not barred

merely because of commencement of insolvency.<sup>269</sup> However due to recent insertion of Section 32A in the IBC, criminal proceedings against corporate debtor shall cease upon approval of resolution plan by the adjudicating authority in respect of any offence committed prior to the commencement of the Corporate Insolvency Resolution Process if it leads to a change in the management and promoter group of the corporate debtor. The present 32A places the Committee of Creditors in a position of conflict; as creditors they are allowed to approve a resolution plan that may pay off debts due to them under the garb of resolving a company. Section 32A will place a premium on the lack of due diligence required to be conducted by financial creditors, who constitute the Committee of Creditors. Creditors may henceforth fund illegal activities without appropriate due diligence, since they are aware that at the time of resolution they can pay themselves out of the proceeds acquired illegally by the debtor. Though it is possible that certain assets acquired illegally may escheat to the Government, the Government may by law allow the creditors to use such assets for resolution of the debtor company, since the title of such monies vests with the Government, which it can validly give up. However, where there is enforcement authority seeking such monies on behalf of the public or a lawful owner of such monies who may seek restitution, neither the corporate debtor has a right to utilise the assets of another to discharge his debts nor the creditors have the right to apply such assets, their remedy should be restricted to assets lawfully belonging to the creditor.

It may also be noted that the moratorium provision needs to be amended so that it clearly reflects the right of the Board to complete its proceedings and determine the amount of monies to be refunded by the corporate debtor. (Under the SEBI Act, 1992 the Investigation Authority does not determine the amounts to be refunded, thus the safeguards presently provided in Section 32A are insufficient).

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<sup>269</sup> *Kusum Ingots & Alloys Limited v. Penmar Peterson Securities Limited and Others* AIR 200 SC 594; *BSI Limited and Another v Gift Holdings Private Limited and Another* AIR 2000 SC 926; *Shah Brother Ispat Pvt. Ltd. v P Mohanraj & Ors*, NCLAT order dated 31.07.2018, available at <[https://ibbi.gov.in/webadmin/pdf/order/2018/Aug/31st%20Jul%202018%20in%20the%20matter%20of%20Shah%20Brothers%20Ispat%20Pvt.%20Ltd.%20Vs.%20P.%20Mohanraj%20&%20Ors.%20CA%20\(AT\)%20No.%20306-2018\\_2018-08-07%2010:28:16.pdf](https://ibbi.gov.in/webadmin/pdf/order/2018/Aug/31st%20Jul%202018%20in%20the%20matter%20of%20Shah%20Brothers%20Ispat%20Pvt.%20Ltd.%20Vs.%20P.%20Mohanraj%20&%20Ors.%20CA%20(AT)%20No.%20306-2018_2018-08-07%2010:28:16.pdf)>; *Tayal Cotton (P). Ltd. v State of Maharashtra*, Bom HC order dated 06.08.2018, available at <[https://ibbi.gov.in/webadmin/pdf/order/2019/Jan/In%20the%20matter%20of%20Tayal%20Cotton%20Pvt%20Ltd%20Vs%20State%20of%20Maharashtra%20&%20Ors%20Criminal%20Writ%20Petition%20No.%201437-2018\\_2019-01-23%2022:59:30.pdf](https://ibbi.gov.in/webadmin/pdf/order/2019/Jan/In%20the%20matter%20of%20Tayal%20Cotton%20Pvt%20Ltd%20Vs%20State%20of%20Maharashtra%20&%20Ors%20Criminal%20Writ%20Petition%20No.%201437-2018_2019-01-23%2022:59:30.pdf)>.

**Recommendation:** It is advisable for SEBI to write to the Ministry of Corporate Affairs, Government of India that where public monies have been illegally siphoned off into an estate, Section 32A of the IBC should be amended to ensure that the creditors cannot decide to approve a resolution plan to pay themselves or resolve the company using the monies representing public monies illegally acquired, especially where the Board or another enforcement authority is acting as *parens patriae* to recover such monies, as SEBI did before the Australian Courts.

**“Assessment proceedings” under special laws i.e. securities laws:** Insolvency of one person does not and cannot operate as a total restriction on the lawful rights of others, otherwise the default of one person would prejudicially affect even those who are not at fault. It must be noted that proceedings that may become subject to a moratorium under the IBC or the Companies Act, 2013 can be continued before the Adjudicating Authority (u/s 60 and 179 of the IBC) and the NCLT (u/s 280 of the Companies Act, 2013), which have been given wide powers to decide such issues. The purpose of this is to ensure that all claims can be decided in one court i.e. the court dealing with the insolvency.

However, there are certain issues that cannot be decided at all by the Adjudicating Authority because exclusive jurisdiction in certain matters is vested with specialised bodies. Thus determination of guilt and levy of penalty, assessment of tax due, determination of “proceeds of crime”, etc. are left to specialised and exclusive tribunals and quasi-judicial authorities. This point gains strength from the order of the Hon'ble Supreme Court in the matter of *Damji Valji Shah v LIC of India*<sup>270</sup> (AIR 1966 SC 135), that in proceedings before specialised tribunals with exclusive jurisdiction, the provision relating to the moratorium will not be applicable. Section 20A of the SEBI Act provides exclusive jurisdiction to the Board and the Adjudicating Officer in respect of the issues that may be decided by them. Similarly, in *Embassy Property Developers Pvt. Ltd. v State of Karnataka & Ors.*<sup>271</sup>, the Hon'ble Supreme Court dealt with the issue where after the company had been admitted into insolvency the State of Karnataka cancelled the mining lease permission and the judicial review of that was

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<sup>270</sup> AIR 1955 SC 135.

<sup>271</sup> SC judgment dated 03.12.2019 in C.A. No. 9170 of 2019 with C.A. No. 9171 of 2019 and C.A. No. 9172 of 2019.

done by the High Court of Karnataka and not the NCLT, the apex court *inter alia* held that, -

"29. The NCLT is not even a Civil Court, which has jurisdiction by virtue of Section 9 of the Code of Civil Procedure to try all suits of a civil nature excepting suits, of which their cognizance is either expressly or impliedly barred. Therefore NCLT can exercise only such powers within the contours of jurisdiction as prescribed by the statute, the law in respect of which, it is called upon to administer."

In respect of such specialised bodies exercising exclusive jurisdiction, a further finer distinction needs to be made between proceedings that "assess" the liability and those that recover the liability.<sup>272</sup> The Calcutta HC in *Official Liquidator, HC v CIT (WB)*<sup>273</sup> has held as follows,-

"49a. Assessment proceedings and recovery proceedings, although both are proceedings under the Income-tax Act, do not, to my mind, stand on the same footing in so far as leave under Section 446(1) of the Companies Act, 1956 is concerned. So long as the duty of assessment is not performed, the right to recover does not arise at all. Assessment validly done in accordance with the provisions of the Income-tax Act is the only way of creating a debt in favour of the Department and does not affect the assets and properties of the company or the scheme of administration thereof or the winding up of the company in any way. (emphasis supplied) When any debt for payment of taxes arises on an assessment, it is open to the Department to prove the debt in liquidation, claim payment thereof and the debt of the Department will be paid in the same manner as the debt of other creditors of the same class. It may also be open to the Department to seek to enforce its right of recovery of the debt in accordance with the provisions of the Income-tax Act. But the right to enforce recovery by taking recourse to recovery proceeding against the assets of the company in liquidation is and cannot be an unfettered right. This right to recover in enforcement of the recovery proceedings under the Income-tax Act is controlled by Section 446(1) of the Companies Act, 1956 and is subject to necessary leave of Court, not merely because the recovery proceeding may affect the estate and effects of the company and interfere with the scheme of administration thereof, but also because the Department may otherwise get an undue preference over the other creditors of the same class in

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<sup>272</sup> *Kondaskar v ITO (Companies Circle), Bombay*, (1972) 1 SCC 438 : (1972) 42 Comp Cas 168 : AIR 1972 SC 878.

<sup>273</sup> AIR 1970 Cal 349.



violation of the provisions of the Companies Act, 1956.... (emphasis supplied)

This principle of harmonious construction of the two Acts, namely, the Income-tax Act and the Companies Act, indicates, to my mind, that leave of Court is necessary by the Department in respect of any recovery proceeding and no leave of Court is necessary by the Department in respect of any assessment proceeding of the company." (emphasis supplied)

The purpose of this is to ensure the determination of the liability by the specialised bodies and the enabling the filing of the claim by the relevant creditor. The Insolvency Law Committee also debated this and recognised the distinction but did not consider it necessary to expressly provide for this. The Committee *inter alia* noted as follows,-

“5.4 Thus, if a purposive interpretation is given to section 14, a moratorium on the mere determination of the amount (and not its enforcement) may not have been the intent of the Code. However, the same was deliberated in the Committee and in light of absence of concrete empirical evidence of any hardship being faced by any authority or court in this regard, the Committee agreed that it may not be prudent to provide explicit carve-outs from section 14 without on-ground evidence, at this stage. The power of the Central Government under section 14(3) to notify transactions which may be exempt from the moratorium may be explored to address this issue on the basis of demonstrated hardship in the future.”<sup>274</sup>

In contrast to the approach adopted by the Insolvency Law Committee, the US bankruptcy Law contains a clear exception saving any action (other than recovery) by (i) any governmental unit; or (ii) organization established under the Chemical Weapons Convention, from the moratorium which reads as follows,-

“(4) under paragraph (1), (2), (3), or (6) of subsection (a) of this section, of the commencement or continuation of an action or proceeding by a governmental unit or any organization exercising authority under the Convention on the Prohibition of the Development, Production, Stockpiling and Use of Chemical Weapons and on Their Destruction, opened for signature on January 13, 1993, to enforce such governmental unit’s or organization’s police and regulatory power, including the enforcement of a judgment other than a money judgment, obtained in

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<sup>274</sup> Report of the Insolvency Law Committee, pp. 31-32, available at <[http://www.mca.gov.in/Ministry/pdf/ILRReport2603\\_03042018.pdf](http://www.mca.gov.in/Ministry/pdf/ILRReport2603_03042018.pdf)>.

an action or proceeding by the governmental unit to enforce such governmental unit's or organization's police or regulatory power."<sup>275</sup>

The US SEC has exercised its powers several times under this exception to ensure that defaulters do not take the bankruptcy route to defeat the enforcement of securities laws. The Court in *SEC v Brennan*<sup>276</sup> explained the history behind the enactment of this exception and *inter alia* held as follows,-

“As we have explained, the purpose of this exception is to prevent a debtor from "frustrating necessary governmental functions by seeking refuge in bankruptcy court." *City of New York v. Exxon Corp.*, 932 F.2d 1020, 1024 (2d Cir. 1991) (internal quotation marks omitted); see also S.REP. No. 95-989, at 52 (1978), U.S. Code Cong. Admin. News at 5787, 5838; H.R. REP. No. 95-595, at 343 (1977), U.S. Code Cong. Admin. News at 5963, 6299. Thus, "where a governmental unit is suing a debtor to prevent or stop violation of fraud, environmental protection, consumer protection, safety, or similar police or regulatory laws, or attempting to fix damages for violation of such a law, the action or proceeding is not stayed under the automatic stay." H.R. REP. No. 95-595, at 343, U.S. Code Cong. Admin. News at 6299; accord S.REP. No. 95-989, at 52, U.S. Code Cong. Admin. News at 5838.

In the present case, Brennan concedes that the SEC obtained the Repatriation Order in a proceeding to enforce its "police and regulatory power." Cf. *SEC v. Towers Fin. Corp.*, 205 B.R. 27, 29-31 (S.D.N.Y. 1997) (holding that a civil enforcement action by the SEC against the debtor-defendant fit within the "governmental unit" exception of § 362(b)(4)); *Bilzerian v. SEC*, 146 B.R. 871, 872-73 (M.D.Fla. 1992) (same); 3 COLLIER ON BANKRUPTCY § 362.05[5][b][i], at 362-63 (5th ed. 2000) ("The police or regulatory exception has . . . been applied to enforcement actions by the Securities and Exchange Commission, including actions seeking disgorgement of illicit profits.").

Thus, a more explicit exception on the lines of the US bankruptcy law would lessen the litigation around the moratorium provision of the IBC to enable the determination of guilt which cannot be done by the adjudicating authority and determination of the claims which need to be filed under the IBC.

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<sup>275</sup> Title 11-US Code, Chapter 3, Sub-Chapter IV, § 362 (b) (4), available at <<https://www.law.cornell.edu/uscode/text/11/362>>.

<sup>276</sup> 230 F.3d 65 (2d Cir. 2000), available at <<https://casetext.com/case/sec-v-brennan>>.

**RECOMMENDATION:** The following amendment may be considered in Section 14 of the IBC (and in Section 33, 81, 85, 101 and 124 of the IBC),-

“(\*) The order of moratorium shall not affect the commencement or continuation of an action or proceeding by any government or any authority constituted by or under any law or by a recognized stock exchange and the enforcement of such government, authority or stock exchange’s regulatory power, including the enforcement of a judgment or order other than a money decree or recovery of any dues (other than recovery of monies directed to be disgorged or refunded) obtained in such an action or proceeding.”

**Proceedings for recovery of monies due against assets of the debtor and**

**‘assets in trust’:** In view of the fore-going discussion it becomes clear that recovery proceedings against the ‘assets of’ the debtor in bankruptcy cannot lie. In such cases, it is appropriate to file a claim with the resolution professional. Thus, in cases where penalties or fees have to be recovered by the Board, once the claim is assessed in appropriate proceedings, filing a claim is a relatively straight forward process. The problem arises in cases where ‘assets in trust’ have to be recovered. In such cases, the regulator or the beneficiaries may not be aware of any particular asset which would correspond to such description. Complications may also arise where the ‘assets held in trust’ have been commingled with the assets of the debtor. In such cases, either an application may be made before the Adjudicating Authority under the IBC (u/s 60 and 179 of the IBC) or the NCLT under the Companies Act, 2013 (u/s 280 of the Companies Act, 2013) or an application for examination *pro interesse suo* may be appropriate in addition to the *Berkley Applegate* principle so that such monies are identified and handed over by the Insolvency Professional, as directed by the Adjudicating Authority, to the Recovery Officer under securities laws. In respect of third party assets, the non-obstante provision contained in Section 238 of the IBC is of no avail, in this context the Supreme Court in *Municipal Corporation of Greater Mumbai (MCGM) v Abhilash Lal & Ors.*<sup>277</sup> inter alia held as follows,-

"This court is of opinion that Section 238 could be of importance when the properties and assets are of a debtor and not when a third party like the MCGM is involved. Therefore, in the absence of approval in terms of Section 92 and 92A of the MMC Act, the adjudicating authority could

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<sup>277</sup> SC judgment dated 15.11.2019 in C.A. No. 6350 of 2019.

not have overridden MCGM's objections and enabled the creation of a fresh interest in respect of its properties and lands.”

**Interim Orders:** Since the IBC does not have any particular mechanism for identification of ‘assets held in trust’, a situation may arise where the resolution professional or committee of creditors may knowingly (by refusing to recognise an asset as held in trust) or unknowingly authorise its use while the debtor is being managed as a ‘going concern.’ This can severely prejudice the interests of investors whose right to recover may get seriously compromised if the relevant assets are lost or co-mingled. In such cases, approaching the adjudicating authority itself may be a time consuming process. In this respect, the approach of the US SEC and Bankruptcy courts is enlightening. In *SEC v Wyly*<sup>278</sup>, the Court upheld the powers of the US SEC to issue a temporary freeze while the bankruptcy proceedings were ongoing, since such a freeze is meant only to safeguard assets and not meant for recovery. The Court inter alia held as follows,-

“The SEC argues that Brennan is inapplicable here, as no final judgment has been entered. As such, the SEC contends that it cannot be seeking to enforce a money judgment, and is therefore acting in its police and regulatory capacity. Moreover, the SEC argues that an asset freeze is necessary to prevent dissipation of the assets, as no third-party fiduciary has been appointed in the bankruptcy proceeding. The Wyls disagree, and assert that the SEC is seeking to control property of the bankruptcy estate, which falls within the exception to the exception. Further, the Wyls contend that an asset freeze is unnecessary because all property of the bankruptcy estate is under the control and supervision of the bankruptcy judge.

This Court has jurisdiction to determine whether the automatic stay applies. Though the question is close, I conclude that the SEC is acting in its police and regulatory capacity, and thus the automatic stay does not apply. There are many similarities between this case and Brennan;

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<sup>278</sup> 73 F. Supp. 3d 315 (S.D.N.Y. 2014), available at <<https://casetext.com/case/sec-amp-exch-commn-v-wyly-3>>.

however, two primary distinctions allow for the entry of a temporary asset freeze here.

First, there has been no final judgment. Brennan explicitly drew the line at entry of judgment, and explained that all actions taken by the government “up to the moment” when judgment is entered are actions within the government's police or regulatory capacity. The exception to the exception is only implicated after final judgment has been entered and the government is acting to “vindicate its own interest in collecting its judgment.” In Brennan, the SEC was seeking repatriation of offshore assets for the purpose of enforcing a judgment. There is, as yet, no judgment to be enforced here. The SEC is merely seeking an asset freeze in anticipation of a judgment. It is not seeking to repatriate any assets located abroad. Because the SEC is not seeking to enforce a money judgment, it is therefore acting in its police and regulatory capacity.

Second, the SEC is not seeking control over any asset. In Brennan, the SEC sought to repatriate offshore trusts. This involved “the return of assets transferred by Brennan so as to preserve them for the benefit of all potential claimants.” Though the court denied the SEC's request to repatriate—or control—assets, it did so because it concluded that the SEC was acting to preserve its claim in preparation for enforcing a judgment that had been entered. By contrast, no asset here will be modified in any way. The SEC seeks to preserve the status quo in anticipation of a final judgment. Preserving assets in anticipation of a judgment is not equivalent to controlling those assets in an effort to enforce a judgment already entered.

Therefore, I conclude that the automatic stay does not apply to the SEC's request for a temporary asset freeze, expedited discovery, preservation of financial documents, and an accounting.

...

Having determined that the automatic stay does not apply, I conclude that a temporary asset freeze, expedited discovery, preservation of financial documents, and an accounting are warranted. With regard to the property that is part of the bankruptcy estate, no third party has yet

been appointed to ensure that no assets are transferred or otherwise depleted. Therefore, Sam Wyly and Caroline Wyly, as beneficiary of the probate estate of Charles Wyly, remain in control of their assets. Though they are required to act as fiduciaries, this does not ensure that assets will be protected. The Wyllys contend that subjecting domestic property to an asset freeze interferes with the bankruptcy process. However, once these assets are accounted for and under the jurisdiction and control of the Bankruptcy Court, the asset freeze order will be dissolved as to those assets.

Further, the bankruptcy proceeding does not address potential dissipation of offshore assets by third parties. As Sam Wyly appears to contest, contrary to the jury's verdict, that he has control or beneficial ownership of these assets, they may not be included in his bankruptcy estate. Thus, third parties could potentially transfer or deplete these assets without an order in place that compels the Wyllys to direct the protectors and trustees of all IOM trusts to refrain from taking any action to dissipate foreign assets.”

When dealing with specialised jurisdiction matters, the moratorium clauses under the IBC and the Companies Act, 2013 are meant to stay proceedings in the nature of recovery only. The Committee also notes that the application of interim orders against assets should be for a limited time frame and till the filing of appropriate claim/proceedings before the insolvency professional/adjudicating authority. Once appropriate filings have been made, the further dealing in the assets would be subject to the relevant provisions of IBC/Companies Act, 2013.

**Settlement Proceedings:** Section 14 of the IBC bars the initiation and continuation of proceedings ‘against’ the insolvent company. However, a settlement proceeding is initiated by the company itself and continued by the IRP. Further, the settlement is beneficial to a company since it removes the possibility of it being held in breach of law.

In this respect the Delhi High Court vide order dated 11.12.2017 in the matter of *Power Grid Corporation of India v Jyoti Structures Ltd.*<sup>279</sup> *inter alia* held as follows,-

“12. The learned counsel for the respondent has though argued that once the moratorium comes into effect, no proceedings against the corporate debtor may continue. No doubt to the said proposition of law as stated above, but one need to see the nature of the proceedings; if such proceedings is against the corporate debtor or is in its favour. Stay of proceedings against an award in favour of the corporate debtor would rather be stalling the debtor’s effort to recover its money and hence would not fall in the embargo of Section 14 (1) (a) of the Code.

...

14. Hence for following reasons I conclude the present proceeding would not be hit by the embargo of Section 14(1)(a) viz.,

(a) “proceedings” do not mean “all proceedings”;

(b) moratorium under section 14(1)(a) of the code is intended to prohibit debt recovery actions against the assets of corporate debtor;

(c) continuation of proceedings under section 34 of the Arbitration Act which do not result in endangering, diminishing, dissipating or adversely impacting the assets of corporate debtor are not prohibited under section 14(1)(a) of the code;

(d) term “including” is clarificatory of the scope and ambit of the term “proceedings”;

(e) the term “proceeding” would be restricted to the nature of action that follows it i.e. debt recovery action against assets of the corporate debtor;

(f) the use of narrower term “against the corporate debtor” in section 14(1)(a) as opposed to the wider phrase “by or against the corporate debtor” used in section 33(5) of the code further makes it evident that section 14(1)(a) is intended to have restrictive meaning and applicability;

(g) the Arbitration Act draws a distinction between proceedings under section 34( i.e. objections to the award) and under section 36(i.e. the enforceability and execution of the award). The proceedings under section 34 are a step prior to the execution of an award. Only after determination of objections under section 34, the party may move a step forward to execute such award and in case the objections are settled against the corporate debtor, its enforceability against the corporate debtor then certainly shall be covered by moratorium of section 14(1)(a).

...

16. Second limb of objection raised is once the moratorium is declared the decision to continue with the objections need to be taken only by the Resolution Professional, since per Section 17 of the Code from the date

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<sup>279</sup> Available at <http://lobis.nic.in/ddir/dhc/YKH/judgement/11-12-2017/YKH11122017OMPCOMM3972016.pdf>.

<<http://lobis.nic.in/ddir/dhc/YKH/judgement/11-12-2017/YKH11122017OMPCOMM3972016.pdf>>.

of the appointment of the interim resolution professional, the management of the affairs of the corporate debtor shall vests with the interim resolution professional and hence in the peculiar circumstances of this case where a counter claims was preferred by the objector, though rejected, it would be appropriate if the interim resolution profession be made aware of these proceedings and he consents to its continuation.”

Hence the Committee is of the view that the settlement proceedings, being beneficial to the company and instituted by the company, can be proceeded ahead only if the company is represented by the IRP. Further, in view of Regulation 31 of the IBBI (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 the settlement charges arrived at during the insolvency resolution process, must to be approved by the Committee of Creditors.

**Other proceedings:** There may be proceedings against the corporate debtor that do not financially affect any of the assets of the debtor. One such proceedings that may arise is on account of delisting. Where a company has defaulted in complying with the listing conditions, it is liable for delisting by the concerned stock exchange. In such cases, the company is given an opportunity for replying since the listing agreement is entered into between the company and the stock exchange. However, the shares that are being delisted though issued by the company belong to its share-holders and not the exchange. Thus, delisting is not a proceeding against the asset of the debtor company even though it is triggered on account of the default of the company. Recently, the NCLT in *Roofit Industries Ltd. v BSE ltd. & Ors.*<sup>280</sup> has inter alia held as follows, -

“12. ... If at all combined reading is given to the prohibition given under the said subsection, it appears it is a prohibition to proceed against the company in respect to the dues payable by the company, not in respect to other violations under various enactments. All actions envisaged there, are of same kind. There cannot be any omnibus applicability of prohibitions or restrictions given under any enactment, including this Code as well. There are two tests to be looked into, one is strict application of prohibitory law, it can't be liberally and freely applied like

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<sup>280</sup> NCLT order dated 15.11.2017, available at [https://ibbi.gov.in/webadmin/pdf/order/2018/Jun/15th%20Nov%202017%20in%20the%20matter%20of%20Roofit%20Industries%20Ltd.%20MA%20No.%20373-2017%20IN%20CP%20No.%201055-I&BP-2017\\_2018-06-06%2010:55:36.pdf](https://ibbi.gov.in/webadmin/pdf/order/2018/Jun/15th%20Nov%202017%20in%20the%20matter%20of%20Roofit%20Industries%20Ltd.%20MA%20No.%20373-2017%20IN%20CP%20No.%201055-I&BP-2017_2018-06-06%2010:55:36.pdf).



any other beneficiary legislation, two is the doctrine of *ejusdem generis*, which is applicable to understand these prohibitions given in section 14 (1) (a) of the Code, because this Code is basically a Code dealing with debts payable by the company, therefore what all prohibitions and overriding effect speaking of under section 238 is to be conceived as an effect to be given in respect to the laws dealing with dues payable by the Company, but not to arrest the effect of all enactments working under respective domains.

13. Companies are governed by various enactments, they have to run in compliance of laws of this country, and it can't be that companies running under CIRP are free enough to flout all other law. It cannot be the intention of any enactment and it is in fact not so.

14. As to application of section 238 is concerned, that non-obstante clause can be invoked only when any other law, dealing with the core issues this enactment dealt with, is inconsistent with the provisions of I&B Code, since the provisions of Securities Contract Regulations Rules of 1957/provisions in respect to the Listing of shares before Exchanges is nowhere connected to the dues payable by the company, it can't be said that action under Securities Contract Regulations Rules of 1957 is hit by either Moratorium under section 14 or under section 238 of the Code. It is an issue in relation to Investors therefore, such an issue cannot be construed as inconsistent with the provisions of I&B Code, therefore, this Bench is of the opinion that the action of National Stock Exchange or Bombay Stock Exchange is neither connected to the prohibitions given under sec.14 of I&B Code nor inconsistent with the non-obstante clause given under 238 of I&B Code.”

In view of the above, proceedings where the company has no immediate financial interest can continue inspite of the moratorium under the IBC.

#### **V. DISCHARGE FROM CERTAIN DEBTS IN CASE OF INDIVIDUAL INSOLVENCY UNDER THE IBC.**

Unlike corporate insolvency which may result in liquidation in case resolution fails i.e. demise of its separate legal existence, in cases of individual insolvency, where the resolution fails; the debtor is declared bankrupt and discharged from his debts and his legal existence continues. There always exists a possibility that delinquents may use

bankruptcy law as a shelter from their legal responsibility and seek discharge orders to evade their liability under law, including securities laws. Hence, bankruptcy laws usually declare certain debts as “non-dischargeable debts.” Recently, the Ministry of Corporate Affairs re-constituted the Insolvency Law Committee as a Standing Committee,<sup>281</sup> to *inter alia* study the insolvency resolution and bankruptcy framework for individuals and partnership firms and make recommendations for its successful implementation. Thus, Part III of the IBC, dealing with insolvency resolution and bankruptcy for individuals and partnership firms may be brought into operation soon. Hence, this concept assumes great significance under the securities laws, since in a majority of the cases, the recoveries are largely possible due to the personal liability imposed on promoters, directors and other individuals. Corporate assets are usually insufficient on account of being siphoned off. Further, certain violations such as “insider trading” are usually done by individuals.

Under the IBC, “non-dischargeable debts” are referred to as ‘excluded debt’ and defined u/s 79 (15) of the IBC as follows,-

““excluded debt” means –

- (a) liability to pay fine imposed by a court or tribunal;
- (b) liability to pay damages for negligence, nuisance or breach of a statutory, contractual or other legal obligation;
- (c) liability to pay maintenance to any person under any law for the time being in force;
- (d) liability in relation to a student loan;
- (e) any other debt as may be prescribed;”

Since the Board does not impose ‘fines’ or ‘damages’, it is possible that securities laws defaulters may misuse the IBC to evade their liabilities under the securities laws. The Committee notes the provisions of US Code: Section 523 (a) (3) (7)<sup>282</sup> and 523(a) (19)

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<sup>281</sup> See Ministry of Corporate Affairs’ Order dated 06.03.2019 Re-constituting the Insolvency Law Committee as a Standing Committee for review of implementation of the IBC, available at <[http://www.mca.gov.in/Ministry/pdf/ILCOrder\\_11032019.pdf](http://www.mca.gov.in/Ministry/pdf/ILCOrder_11032019.pdf)>.

<sup>282</sup> See *In re Telsey*, 144 B.R. 563, 565 (Bankr. S.D. Fla. 1992), available at <<https://casetext.com/case/in-re-telsey>>, *inter alia* holding that,-

“The district court’s disgorgement order in this case serves the purpose of deterrence. See, e.g., *S.E.C. v. First City Financial Corp.*, 890 F.2d 1215, 1230 (D.C. Cir. 1989); *Rowe v. Maremont Corp.*, 850 F.2d 1226, 1241 (7th Cir. 1988); *S.E.C. v. Blatt*, 583 F.2d 1325, 1335 (5th Cir. 1978); *S.E.C. v. Blavin*, 760

(A) & (B) of sub-chapter II, Chapter 5, Title 11<sup>283</sup> where suitable provisions are made for various non-dischargeable debts, including those in relation to securities laws and court orders and suggests that SEBI seek the benefit of inclusion of the following in 'excluded debt' u/s 79 (15) of the IBC,-

“(\*) Debt due, other than fees due, under any law administered by the Securities and Exchange Board of India;

“(\*) Any debt which results from any court or quasi-judicial order for any damages, fine, penalty, restitutionary payment, including disgorgement or forfeiture, or other payment owed by the debtor;

“(\*) Debt due under any other law relating to fraud, deceit or manipulation in connection with the purchase or sale of any security and the creation or redemption of any deposit.”

**RECOMMENDATION:** To sum up the discussion, this Committee is of the view that in order to protect the interest of securities markets investors, SEBI may take up the issues discussed in this Report with the IBBI and the Ministry of Corporate Affairs to initiate necessary steps including amendments, if any, to the IBC and the regulations issued thereunder to *inter alia* ensure that,-

- a. A well-defined procedure is available for dealing with applications for examination *pro interesse suo* in respect of claims relating to 'assets held in trust';
- b. A well-defined procedure is available for identification of 'assets held in trust' (in specie or in converted or co-mingled form) by the insolvency professional at the time of his appointment, and costs for such identification;

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F.2d 706, 713 (6th Cir. 1985); S.E.C. v. *Manor Nursing Centers*, 458 F.2d 1082, 1104 (2nd Cir. 1972). This Court finds the deterrence purpose of the disgorgement order sufficiently penal to characterize the resulting debt as a "fine, penalty, or forfeiture" within the meaning of § 523(a)(7).”

<sup>283</sup> Available at <<https://www.law.cornell.edu/uscode/text/11/523>>.

- c. A well-defined procedure is available dealing with claims of third parties and determining their bona fides and priority vis-à-vis trust assets;
- d. Adjudicating authorities be explicitly empowered to apply the *Berkeley Applegate principle*;
- e. Exemptions from moratorium may be expressly recognized in respect of ‘assessment’ proceedings, including ‘interim orders’ issued before completion of assessment of liability under any statute;
- f. A well-defined procedure may be provided for distribution of trust assets by the insolvency professional, and costs for such identification; and
- g. The list of non-dischargeable debts under the IBC may be expanded to ensure that defaulters of securities laws do not use individual bankruptcy as a refuge from legal liability.

## **VI. IMPLICATIONS OF INSOLVENCY AND BANKRUPTCY CODE (AMENDMENT) ORDINANCE, 2019.**

Insolvency and Bankruptcy Code (Amendment) Ordinance, 2019 (‘IBC Ordinance’) was promulgated by the President of India on December 28, 2019 to amend the Insolvency and Bankruptcy Code, 2016. Section 32A has been inserted in IBC to provide immunity against prosecution to a corporate debtor and prevent action against the property of such corporate debtor subject to certain conditions mentioned therein. This provision may have wide ranging impact on various enforcement proceedings undertaken by SEBI, hence it merits a detailed analysis.

Section 32A (1) is a non-obstante provision under which a corporate debtor may seek immunity from prosecution for an offence committed prior to the commencement of the corporate insolvency resolution process only if it meets following criteria:

- i. resolution plan for such corporate debtor has been approved by the Adjudicating Authority under section 31;
- ii. such resolution plan results in the change in the management or control of the corporate debtor to a person who was not:

- a. a promoter or in the management or control of the corporate debtor or a related party of such a person; or
  - b. a person with regard to whom the relevant investigating authority has, on the basis of material in its possession, reason to believe that he had abetted or conspired for the commission of the offence, and has submitted or filed a report or a complaint to the relevant statutory authority or Court;
- iii. prosecution instituted during the corporate insolvency resolution process against such corporate debtor stands discharged from the date of approval of the resolution plan;
- iv. such immunity will not extend to any person, including a designated partner or an officer in default,
  - a. who was in any manner in charge of, or responsible to the corporate debtor for the conduct of its business or associated with the corporate debtor in any manner, and
  - b. who was directly or indirectly involved in the commission of such offence as per the report submitted or complaint filed by the investigating authority

Section 32A (2) bars action against the property of a corporate debtor in relation to an offence committed prior to the commencement of the corporate insolvency resolution process of the corporate debtor if it meets the following criteria:

- i. such property must be covered under a resolution plan approved by the Adjudicating Authority under section 31;
- ii. such resolution must result in:
  - a. change in control of the corporate debtor to a person, or
  - b. sale of liquidation assets under the provisions of Chapter III of Part II of IBC to a person,

who was not:

- a. a promoter or in the management or control of the corporate debtor or a related party of such a person; or

- b. a person with regard to whom the relevant investigating authority has, on the basis of material in its possession, reason to believe that he had abetted or conspired for the commission of the offence, and has submitted or filed a report or a complaint to the relevant statutory authority or Court;
- iii. an action against the property includes the attachment, seizure, retention or confiscation of such property under such law as may be applicable to the corporate debtor;
- iv. such bar on action against the property shall not extend to any person:
  - a. other than the corporate debtor or
  - b. a person who has acquired such property through corporate insolvency resolution process or liquidation process.

Section 32A (3) states that subject to subsection (1) and (2) of Section 32A, any person including a corporate debtor shall extend all assistance and co-operation to any authority investigating an offence committed prior to the commencement of the corporate insolvency resolution process.

### **Implications on SEBI Proceedings**

Section 32A which provides immunity to the corporate debtor refers to the term 'offence' but does not define its scope and extent. The term 'offence' has been defined in the General Clauses Act (No. 10 of 1897) as meaning "any act or omission made punishable by any law for the time being in force". However, in the case of *Standard Chartered Bank vs. Directorate of Enforcement* (Appeal (civil) 1748 of 1999 of Supreme Court), the Supreme court gave a wider interpretation to meaning of the term 'offence' and held that the expression 'offence' is not indicative of the expression 'being confined to a criminal offence alone'. Para 30 of the said judgement is quoted below for reference:

*“30. It is true that the entire penalty that may be imposed on adjudication, is capable of being recovered from the company itself. But that does not mean that it cannot be recovered from the officer incharge of the company or those who connived at or were*

*instrumental in the contravention of the provisions of the Act by the company. Once the ingredient of the offence is contravention of the provisions of the Act and the consequences flowing from the contravention is to make that person including a company liable for penalty as well as for prosecution, there does not appear to be any justification in confining the scope of the Section 68 only to prosecutions under Section 56 of the [FERA] Act. We have earlier indicated that use of the expression 'offence' in the marginal heading of Section 68 [of FERA] is not indicative of the expression 'being confined to a criminal offence alone' because an offence in the context of the Act is really a contravention of any of the provisions of the [FERA] Act referred to in Section 50 and in Section 56 of the [FERA] Act.”*

Section 24 of the SEBI Act deals with offences and states as follows:

*“Offences.*

*24. (1) Without prejudice to any award of penalty by the adjudicating officer or the Board under this Act, if any person contravenes or attempts to contravene or abets the contravention of the provisions of this Act or of any rules or regulations made thereunder, he shall be punishable with imprisonment for a term which may extend to ten years, or with fine, which may extend to twenty-five crore rupees or with both.”*

Thus, SEBI Act, 1992 explicitly makes it an offence to contravene any of the provisions of the Act. In light of the interpretation of the term 'offence' by the Supreme Court in Standard Chartered judgment (referred above), any contravention of SEBI Act by a corporate debtor may be treated as an offence regardless of whether any prosecution has been initiated by SEBI against the violator or not. Hence any violation of securities laws committed by a corporate debtor prior to CIRP stands absolved and SEBI may be unable to take necessary actions against any property of such corporate debtor that forms part of the resolution plan, subject to conditions of section 32A being fulfilled.

It is also seen that due to lack of specificity in Section 32A (2) of the IBC, it is not clear whether the bar on action against property of corporate debtor is applicable in criminal proceedings only or both civil and criminal proceedings. If the latter view is taken, it implies that SEBI will be unable to recover even penalty for violation of securities laws which it can otherwise recover after moratorium is revoked.

**Recommendation:** The Committee recommends insertion of the following provision after sub-section (3) of section 32A of IBC,

*“(4) Nothing in this section shall apply to an action for disgorgement or refund under securities laws.”*

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**भारतीय प्रतिभूति और विनियम बोर्ड**  
**Securities and Exchange Board of India**

**Notice inviting comments on the recommendation made by High Level Committee under the Chairmanship of Justice A. R. Dave, Retired Judge, Supreme Court of India, on the Measures for Strengthening the Enforcement Mechanism of the Board and Incidental Issues.**

Dated the 16<sup>th</sup> June, 2020

1. The High Level Committee under the Chairmanship of Justice A. R. Dave, Retired Judge, Supreme Court of India has submitted the Report on the Measures for Strengthening the Enforcement Mechanism of the Board and Incidental Issues.

2. Suggestions/comments if any, on the following recommendations of the High-level Committee, are invited:

- 2.1 Amendment to the Securities and Exchange Board of India (Intermediaries) Regulations, 2008;
- 2.2 Comprehensive Regulations for Recovery, to clarify issues relating to recovery in the context of the securities laws;
- 2.3 Use of financial economics by the Board, as used in similar disclosure based market regimes and proposal for a method of quantification of profit(s) made by the defaulter and loss(s) caused to the investors;

3. Details of the recommendations are in the Annexure.

4. Suggestions/comments if any, on the said recommendations along with justification in brief may be sent, latest by July 07, 2020 through email at [publiccommentsdop1@sebi.gov.in](mailto:publiccommentsdop1@sebi.gov.in). The name, telephone number and address of the sender should be clearly indicated at the time of sending suggestions/comments.

Name, Address, Contact No. of Stakeholder \_\_\_\_\_

SL. No.	Para No.	Suggestion	Justification

GLOSSARY

<b>Sr. No.</b>	<b>Terms Used</b>	<b>Meaning</b>
1.	AO	Adjudicating Officer
2.	Board	The Securities and Exchange Board of India
3.	Depositories Act	Depositories Act, 1996
4.	DA	Designated Authority
5.	DM	Designated Member
6.	FCA	Financial Conduct Authority
7.	IBBI	The Insolvency and Bankruptcy Board of India
8.	IBC	Insolvency and Bankruptcy Code, 2016
9.	SAT	Securities Appellate Tribunal
10.	Settlement Regulations	Securities and Exchange Board of India (Settlement Proceedings) Regulations, 2018
11.	Intermediaries Regulations	Securities and Exchange Board of India (Intermediaries) Regulations, 2008
12.	SCRA	Securities Contracts (Regulation) Act, 1956
13.	SEBI	Securities and Exchange Board of India
14.	SEBI Act	The Securities and Exchange Board of India Act, 1992
15.	SEC	US Securities and Exchange Commission
16.	WTM	Whole Time Member

**PART-A**

**REVIEW OF THE INTERMEDIARIES REGULATIONS**

## I. INTRODUCTION

Intermediaries operate as the bridge between capital providers and capital seekers in the securities market. The capital providers i.e. the investors, especially retail investors, do not have adequate information, knowledge or expertise and the capital seekers i.e. the issuers do not have adequate resources to reach out to individual investors spread across the world. Therefore, intermediaries play a very crucial role in making the market matrix, and ensuring smooth working of anonymous order-driven trading platforms.

### DEFINING INTERMEDIARIES

The Committee notes that although only Chapters V, V-A and VI of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008 ("Intermediaries Regulations") have been notified and are in force, the definition of an intermediary under regulation 2(1)(g) is not yet operative. For the purpose of the Report, it may be referred to in order to understand the concept from a regulatory perspective since the other statutes do not offer any principle based definition of the term "intermediary". The Intermediaries Regulations has defined the term "intermediary" as follows:

**“Regulation 2 (1) (g) - “intermediary” means a person mentioned in clauses (b) and (ba) of sub-section (2) of section 11 and sub-section (1) and (1A) of section 12 of the [SEBI] (supplied) Act and includes an asset management company in relation to the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, a clearing member of a clearing corporation or clearing house, foreign portfolio investors and a trading member of a derivative segment or currency derivatives segment of a stock exchange but does not include foreign venture capital investor, mutual fund, collective investment scheme and venture capital fund;”**

The intermediaries mentioned in clauses (b) and (ba) of sub-section (2) of section 11 and sub-section (1) and (1A) of section 12 of the SEBI Act are given below:

- i) stock brokers;
- ii) sub-brokers (this category has since ceased to exist);
- iii) share transfer agents;
- iv) bankers to an issue;
- v) trustees of trust deeds;
- vi) registrars to an issue;
- vii) merchant bankers;
- viii) underwriters;
- ix) portfolio managers;
- x) investment advisers;
- xi) depositories and their participants;
- xii) custodians of securities;
- xiii) foreign institutional investors;
- xiv) credit rating agencies
- xv) such other intermediaries who may be associated with the securities markets in any manner or such other intermediaries as the Board may, by notification, specify in this behalf.

The definition of “intermediary” is inclusive although the term “intermediary” as defined in the Intermediaries Regulations, specifically includes and excludes certain types of persons associated with the securities markets. Thus, even other market participants, which provide services akin to that of an intermediary, albeit not specifically included in the definition, would come under the purview of Intermediaries Regulations.

Several other players in the securities market are required to register under the specific regulations governing them and their activities such as, -

- (a) The Securities and Exchange Board of India (Mutual Funds) Regulations, 1996;

- (b) The Securities and Exchange Board of India (Collective Investment Schemes) Regulations, 1999;
- (c) The Securities and Exchange Board of India (Public Offer and Listing of Securitised Debt Instruments) Regulations, 2008;
- (d) The Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012;
- (e) The Securities and Exchange Board of India (Infrastructure Investment Trusts) Regulations, 2014;
- (f) The Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014.

#### **LEGISLATIVE HISTORY OF THE INTERMEDIARIES REGULATIONS**

Between 1992 and 2002, separate regulations dealing with each intermediary were framed which provided for the process of registration, laid down obligations and responsibilities of the intermediary, specified the procedure for inspection and stipulated action in case of default by the intermediary.

In 2002, the Securities and Exchange Board of India (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002 ("Enquiry Regulations") were notified. These regulations consolidated the procedure for action to be taken in case of default by any of the intermediaries. The remaining provisions pertaining to registration, procedure for inspection and those pertaining to obligation and responsibilities of the intermediaries were retained in the respective Regulations.

Thereafter in 2008, the Securities and Exchange Board of India (Intermediaries) Regulations, 2008 were framed, which provided for a consolidated approach while dealing with registration of intermediaries, their general obligations, inspection and disciplinary proceedings and action in case of default as well as the manner of the suspension or cancellation of certificate of all intermediaries. However, only Chapter V

dealing with action in case of default and manner of suspension or cancellation of the certificate of all intermediaries, Chapter VA dealing with the summary procedure and Chapter VI dealing with miscellaneous issues of the Intermediaries Regulations were brought into effect after due notification.

## **REGISTRATION OF INTERMEDIARIES**

Section 12 of the SEBI Act prohibits a stock broker, sub-broker, share transfer agent, banker to an issue, trustee of trust deed, registrar to an issue, merchant banker, underwriter, portfolio manager, investment adviser and such other intermediary who may be associated with the securities market, from buying, selling or dealing in securities, except under, and in accordance with, the conditions of a certificate of registration obtained from the Board under the regulations made under the SEBI Act. Therefore, any intermediary which is required to obtain a certificate of registration, for acting as an intermediary in the securities market may be referred to as an “Intermediary” for the purpose of this Report and the proposed amendment to the Intermediaries Regulations.

## **II. NEED FOR PRESENT REVISION**

### **Historical Perspective**

In the past three decades, SEBI has notified more than a dozen regulations, each with the objective of regulating a different category of intermediary. The current two tier process of enquiry proceedings against intermediaries in the Intermediaries Regulations traces its origin to the procedure contemplated in the Securities and Exchange Board of India (Stock Brokers and Sub-Brokers) Regulations, 1992 (“Stock Broker Regulations”). In 2002, provisions similar to those contained in Stock Brokers Regulations and other respective Regulations pertaining to other intermediaries were amended by the Securities and Exchange Board of India (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002, to enable SEBI to take action on the basis of investigation and inspection report.

However, later in 2008, it was decided that since there is a considerable overlap in the regulations pertaining to intermediaries, a consolidated regulation could be enacted. Eventually, when SEBI published Intermediaries Regulation in 2008, due various practical difficulties, only the process for holding enquiry against intermediaries by the Board was notified. Even though 12 years have elapsed since the publication of Intermediaries regulations, most of its provisions have not come into effect. Thus, the Committee feels that Intermediaries Regulations need to be examined from the viewpoint of their practical applicability.

### **Pendency of Enquiry Proceedings**

The SEBI Annual Report details the data pertaining to actions initiated by the Board including initiation of enquiries and adjudication proceedings against various intermediaries. As per the latest data available with SEBI, almost 408 enquiry proceedings are pending with the Board.



**Two Tier Enquiry Proceedings:**

Enquiry proceedings are initiated against the registered intermediaries and involve a two-step process under the Intermediaries Regulations. The two tier enquiry system has been borrowed from the Enquiry Regulations which in turn was borrowed from the respective regulations pertaining to various intermediaries. In the first step, the fact-finding proceedings are conducted by the DA, and in the second step, quasi-judicial proceedings are conducted before the DM of the Board on the basis of the recommendation of the DA. A two stage process adds to the time required in disposing off the proceedings.

**Time Taken for disposal of enquiry cases**

The analysis of the time taken between the date of action approved for each proceeding to the date of the final order passed in an enquiry case during the financial year 2018-19 and the current financial year, indicates that considerable amount of time is taken for completion of a case which hampers the regulatory effectiveness of the enquiry proceedings.

In light of the above, it becomes imperative to examine options to ensure that the time consumed in the enquiry proceedings be reduced and that the same may be effected by simple and necessary amendments to the applicable provisions.

### **III. REGULATION OF INTERMEDIARIES – GLOBAL SCENARIO**

#### **UNITED STATES OF AMERICA**

In the United States, the US Securities and Exchange Commission (US-SEC) is required to register broker dealers under section 15 of the Securities Exchange Act, 1934. The primary regulation of broker dealers is done through the Financial Industry Regulatory Authority, Inc. (FINRA), a private corporation, acting as a self-regulatory organization (SRO) for intermediaries. It is a non-governmental organization that regulates member brokerage firms and exchange markets. The government agency which acts as the ultimate regulator of the securities industry, including FINRA, is the US-SEC. Other intermediaries such as Investment Advisers are required to be registered with the USA SEC under the Investment Advisers Act, 1940 and Investment companies under the Investment Company Act of 1940. FINRA provides the first line of oversight for broker-dealers and the first line of defense for investors by virtue of its comprehensive oversight program. FINRA regulates both the firms and professionals selling securities in the United States and the U.S. securities markets. In this capacity, FINRA writes and enforces its own rules, as well as enforces federal securities rules and laws.<sup>1</sup>

FINRA has the authority to fine, suspend or bar brokers and firms from the industry. FINRA may also take disciplinary action through two separate procedures: a settlement or a formal complaint. With a settlement, a firm or broker may opt to settle with FINRA through a Letter of Acceptance, Waiver and Consent (AWC).<sup>2</sup>

When FINRA determines that a violation of the securities rules has occurred and formal disciplinary action is necessary, the Enforcement Department or the Market Regulation Department files a complaint with the Office of Hearing Officers (OHO).

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<sup>1</sup> <<http://www.finra.org/industry/oversight>>

<sup>2</sup> <<http://www.finra.org/industry/enforcement>>

The OHO is an office of impartial adjudicators of disciplinary cases brought by FINRA's Department of Enforcement against FINRA members. The OHO maintains strict independence from FINRA's regulatory programs and is physically separated from other FINRA departments.

The OHO arranges a three-person Panel to hear the case. The Panel is chaired by a hearing officer who is an employee of the OHO. The Chief Hearing Officer appoints two industry panellists, drawn primarily from a pool of current and former securities industry members of FINRA's District Committees, as well as its Market Regulation Committee, former members of FINRA's National Adjudicatory Council (NAC) and former FINRA Governors.

Hearing officers are not involved in the investigative process. Employment protection exist for hearing officers to further ensure their independence. They may not be terminated except by the FINRA Chief Executive Officer, with a right to appeal to the Audit Committee of FINRA's Board of Governors.<sup>3</sup> At the hearing, the parties present evidence for the panel to determine whether a firm or individual has engaged in conduct that violates FINRA rules, SEC regulations or federal securities laws. In reaching its decision, the hearing panel also considers previous decisions of the court, the SEC, and the National Adjudicatory Council (NAC) to determine if violations occurred. The NAC is the national committee which reviews initial decisions rendered in FINRA disciplinary and membership proceedings.

For each case, the hearing panel issues a written decision explaining the reasons for its ruling and consults the FINRA Sanction Guidelines to determine the appropriate sanctions if violations have occurred. FINRA may also, when feasible and appropriate, order firms and individuals to provide restitution to harmed customers.

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<sup>3</sup> *Ibid.*

## **Appeal Process**

Under FINRA's disciplinary procedures, a firm or individual has the right to appeal a hearing panel decision to the NAC or the NAC may on its own initiate a review of a decision.

While a decision is on appeal, the sanction is not actively enforced against the firm or individual. The NAC may affirm, dismiss, modify, or reverse any finding, or remand for further proceedings. The NAC may affirm, modify, reverse, increase, or reduce any sanction or impose any other fitting sanction.<sup>4</sup>

On appeal, the NAC will determine if a hearing panel's findings were legally correct, factually supported and consistent with the Sanction Guidelines of FINRA. Unless the Board of Governors of FINRA decides to review the NAC's appellate decision, that decision represents FINRA's final action. A firm or individual can appeal FINRA's decision to the SEC and then to federal court.<sup>5</sup>

The amount of fines in 2018 that the FINRA Enforcement Division ordered against its member firms increased slightly to \$74 million from \$68 million in 2017. While the amount increased nearly nine percent, the total number of fines decreased to 209 in 2018, compared to 318 in 2017.<sup>6</sup>

## **THE UNITED KINGDOM**

The Financial Services and Markets Act, 2000 of the United Kingdom created the Financial Conduct Authority (FCA) as a regulator for insurance, investment business and banking, and the Financial Ombudsman Service. The FCA operates independently of the UK Government, and is financed by charging fees to the members of the financial services industry. The FCA regulates financial firms providing services to consumers

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<sup>4</sup> <<http://www.finra.org/industry/nac>>

<sup>5</sup> <<http://www.finra.org/industry/decisions>>

<sup>6</sup> <<https://www.acacompliancegroup.com/blog/summary-finra-regulatory-actions-2018>>

and maintains the integrity of the financial markets in the United Kingdom. It focuses on the regulation of conduct by both retail and wholesale financial services firms. Like its predecessor (the FSA), the FCA is structured as a company limited by guarantee.

Section 42 of the Financial Services and Markets Act, 2000 provides that the FCA may grant permission to the applicant to carry on regulated activities. Granting permission in UK is akin to providing registration under section 12 of the SEBI Act, 1992.

Section 42 of the Financial Services and Markets Act, 2000 reads as follows:

***“Permission Giving***

**S. 42.**—(1) *“The applicant” means an applicant for permission under permission section 40.*

(2) *The Authority may give permission for the applicant to carry on the regulated activity or activities to which his application relates or such of them as may be specified in the permission.*

(3) *If the applicant—*

(a) *in relation to a particular regulated activity, is exempt from the general prohibition as a result of section 39(1) or an order made under section 38(1), but*

(b) *has applied for permission in relation to another regulated activity, the application is to be treated as relating to all the regulated activities which, if permission is given, he will carry on.*

(4) *If the applicant—*

(a) *in relation to a particular regulated activity, is exempt from the general prohibition as a result of section 285(2) or (3), but*

(b) *has applied for permission in relation to another regulated activity, the application is to be treated as relating only to that other regulated activity.*

(5) *If the applicant—*

(a) *is a person to whom, in relation to a particular regulated activity, the general prohibition does not apply as a result of Part XIX, but*

- (b) has applied for permission in relation to another regulated activity, the application is to be treated as relating only to that other regulated activity.*
- (6) If it gives permission, the Authority must specify the permitted regulated activity or activities, described in such manner as the Authority considers appropriate.*
- (7) The Authority may—*
- (a) incorporate in the description of a regulated activity such limitations (for example as to circumstances in which the activity may, or may not, be carried on) as it considers appropriate;*
  - (b) specify a narrower or wider description of regulated activity than that to which the application relates;*
  - (c) give permission for the carrying on of a regulated activity which is not included among those to which the application relates.”*

Section 40 of the Financial Services and Markets Act, 2000 provides that an application for permission to carry on one or more regulated activities may be made to the FCA by—

- (i) an individual;
- (ii) a body corporate;
- (iii) a partnership; or
- (iv) an unincorporated association.

Further section 45 of the Financial Services and Markets Act, 2000 provides that if the authorised person is failing or is likely to fail to satisfy the condition of permission, the Authority may vary or cancel the permission. Furthermore, section 56 specifies that if the Authority is satisfied that an individual is not a fit and proper person to perform functions in relation to a regulated activity carried on by an authorised person, the Authority may prohibit any individual from performing as a specified function.

## **Hearings and Appeals**

The order passed by the Authority may be referred to the Financial Service and Markets Tribunal (the Tribunal). During the period that the reference is pending before the Tribunal, the Authority cannot take the action specified in the decision notice. On determining a reference, the Tribunal is required to remit the matter to the Authority with such directions (if any) as the Tribunal considers appropriate for giving effect to its determination. Further, a party to a reference to the Tribunal may appeal to the Court of Appeal or in Scotland, to the Court of Sessions. After taking a leave from the Court of Appeal or House of Lord (now UK Supreme Court) the decision of the Court of Sessions or Court of Appeal may be appealed.

## **IV. KEY RECOMMENDATIONS AND RATIONALE**

### **PROPOSED PROCESS FOR ENQUIRY PROCEEDINGS**

#### **Current provisions**

In the present system, the first tier of enquiry is conducted by the DA. As per regulation 24(1) of the Intermediaries Regulations, when the DM (Chairman or a WTM of the Board designated for the purpose) is satisfied that an intermediary has failed to comply with the conditions subject to which a certificate of registration was issued to him or has contravened any of the provisions of the securities laws, or any directions or circular issued thereunder, the DM may appoint an officer not below the rank of a Division Chief, as a DA. The regulations further provide that pursuant to the appointment, the DA shall issue a notice to the concerned intermediary requiring it to show cause as to why the certificate of registration granted to it should not be suspended or cancelled or why any other action provided in the Intermediaries Regulations should not be taken against the noticee. Upon conclusion of the enquiry the DA, submits a recommendation to the DM on the basis of material available before him.

On receipt of the recommendation from the DA, the DM considers these recommendations and issues a show cause notice to the noticee enclosing a copy of the report submitted by the DA calling upon him to submit its reply as to why an order as deemed appropriate should not be issued. After considering the report of the DA, the reply of the noticee and other material available before it, and providing the person with an opportunity of being heard, the DM passes the final order.

The two tier proceedings in the Intermediaries Regulations traces its origin to the procedure contemplated in the Securities and Exchange Board of India (Stock Brokers and Sub-Brokers) Regulations, 1992 (“Stock Broker Regulations”). It is also worth mentioning that the provision dealing with investigation under section 11C was inserted in the SEBI Act w.e.f. October 29, 2002 vide the Securities and Exchange Board of India (Amendment) Act, 2002.



The Stock Broker Regulations in its original form, even before its amendment vide the Enquiry Regulations, 2002, provided for inspection of Stock Brokers. Further, regulation 23 of Stock Broker Regulations provided that after considering the explanation of the stock broker on the findings of inspection report, the Board may call upon the stock-broker to take such measures as the Board may deem fit in the interest of the securities market<sup>7</sup>. After the amendment of these regulations in 2002, regulation 23 provided that the Board shall, after considering the inspection or investigation report, take such action as it may deem fit and appropriate, including action under the Enquiry Regulations (now chapter V of the Intermediaries Regulations). Similar amendments were also carried out in the other regulations dealing with the respective intermediaries.

Accordingly, it may be inferred that before the year 2002, when investigation and inspection reports may not necessarily have been the basis for action in case of default by the intermediaries, it was logical to have in place the two tier enquiry for taking action in case of default by the intermediaries where, the first tier enquiry served as a primary fact finding authority collecting documents and evidence, as well as for analysis of all the relevant facts of the case and submissions made by the Intermediaries.<sup>8</sup> It is also noteworthy that the notice issued by the enquiry officer under regulation 28 (since repealed) of the Stock Broker Regulations to call for explanation, reply, information, documents or evidences, was not a show cause notice. Instead the report of the enquiry was used to form the basis of the show-cause notice issued by the Board which constituted the first step of the second tier enquiry process. After considering the reply

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<sup>7</sup> Regulation 23 of the Stock Broker Regulations before September 27, 2002 read as follows:

***Communication of findings etc.***

23. (1) *The Board shall after consideration of the inspection report communicate the findings of the stock-broker to give in an opportunity of being heard before the action is taken by the Board on the findings of the inspecting authority.*

(2) *On the receipt of the explanations, if any, from the stock – broker, the Board may call upon the stock-broker to take such measure as the Board may deem fit in the interest of the securities market and for due compliance with the provisions of the Act, rules and regulations.*

<sup>8</sup> Read now repealed regulation 28 and 29 of the Securities and Exchange Board of India (Stock Broker and Sub-Broker) Regulations, 1992.

to the show-cause notice, if received, the Board was mandated to pass such orders as it deemed fit in the second tier process.

It is observed that although provisions similar to those contained in regulation 23 of Stock Brokers Regulations and other respective Regulations pertaining to other intermediaries, were amended by the Enquiry Regulations, enabling SEBI to take action on the basis of investigation and inspection report, the same two tier enquiry process as originally contained in the regulations pertaining to the respective intermediaries was carried forward to the Enquiry Regulations.

However, when in 2008, the Intermediaries Regulations replaced the Enquiry Regulations, the two tier enquiry procedure was once again adopted, albeit with certain modifications such that regulation 25 of the Intermediaries Regulations mandates both the DA and the DM to issue show-cause notices. That is even after submission of the report by the DA, the DM was once again required to issue a show cause notice to the entity, granting personal hearing during which time the DM is required to consider the submissions made by the intermediary.

Given the time consumed in the duplication of the process even without a cost benefit analysis of the process, the Committee is of the opinion that such a two tier enquiry process does not add much value and in fact causes further delays in the completion of the enquiry proceedings.

Most of the enquiry matters originate post the inspection or investigation processes. Only after analysis of the facts and laws, does the Board determine if it is a fit case to initiate enquiry proceedings.

The present two-stage inquiry envisages a process similar to that followed in a 'domestic inquiry' by an employer against an employee. Such long winding procedures are acceptable in employment matters since the employer may like to grant the employee maximum opportunities to explain the alleged misconduct.

In the context of the securities markets, an enquiry proceeding against the intermediary is recommended after a first-level investigation or inspection has already been carried out. Hence, adopting a long winding process as in a domestic inquiry to enquiry against market intermediaries may unduly work against public interest with the enquiry losing relevance over the period of time in which it is conducted and finally concluded.

However, a two tier enquiry does have certain advantages such that it entails a deeper examination of facts and applicable laws which may presumably lead to better dispensation of justice. The Committee examined the possibility of proposing continuing with a two tier enquiry system for the intermediaries which handle funds of clients, and a single tier enquiry system for the intermediaries which do not handle funds of clients. However, with the increase in various categories of intermediaries recognised by the Board (such as research analysts and investment advisers) it may not be advisable to clog the enforcement mechanism by continuing with the two tier enquiry mechanism only for a certain class of intermediaries. The Committee considered the proposal that the two tier mechanism for intermediaries which do not handle funds of the clients namely, share transfer agent, registrars to an issue, merchant bankers, underwriters, investment advisors and credit rating agencies may be moved to the one tier enquiry process. However, the Committee is of the view that such a classification may not be a reasonable classification and provide a potential ground for challenge before a Court of Law.

Therefore, the Committee then considered the proposal for a two tier enquiry process of registration for intermediaries to be replaced with an enquiry process, as is the case in Adjudication or section 11/11B proceedings such that the person authorized to conduct such single tier enquiry be called “Enquiry Authority”. The Board may appoint any officer not below the rank of Division Chief to be an “Enquiry Authority” who would be equal or senior in rank to the officer, to whom the power to grant registration to such intermediary, has been delegated by the Board. In case of multiplicity of proceedings, a single stage inquiry would also enable the same authority to be appointed for various

single-stage proceedings which would allow simultaneous and expeditious disposal of such cases since the grounds of inquiry in multiple proceedings would remain the same, but the sanction to be imposed would be different.

After considerable debate on the merits of the processes discussed above, the Committee arrived at the view that the process may be simply reworked by reducing the time taken in concluding the proceedings without compromising application of the principles of natural justice or any of the process envisaged therein. This could be enabled by completion of all processes at one level followed by the submission of the report to the DM. Thereafter, the DM may grant opportunity of written representation to the noticee, pursuant to which he may pass the final order.

#### **RECOMMENDATION No. 1**

The Committee noted that the Intermediaries Regulations do not mandate the DA to grant personal hearing to the noticee. As per the present scheme in the Intermediaries Regulations, after the show cause notice is issued by the DA, if the noticee does not reply to the show cause notice, the DA may proceed with the matter ex-parte after recording the reasons for doing so and make suitable recommendations. On the other hand, on receipt of the report recommending measures from the DA, the DM is required to issue a show cause notice to the noticee and only after providing them with an opportunity of being heard, does the DM pass an appropriate order.

Since the opportunity of personal hearing is granted by the DM, issues relating to inspection of documents and/or cross-examination increases at this stage of the enquiry proceeding. Currently only four WTMs (who also function as the DM) have been appointed to the Board by the Central Government. Due to such work getting concentrated before the WTMs, the chances of more time being consumed at the second tier of enquiry becomes high. On the other hand, the Board is not constrained by the number of officers who may be appointed as a DA.

In light of these constraints, it is proposed to provide for the opportunity of personal hearing to be given by the DA and not by the DM.

The Committee also notes that judicial processes differ from the administrative adjudicatory process in an important aspect. While the judicial/quasi-judicial authority is exclusively engaged in adjudication, the administrator–adjudicator discharges adjudicatory functions along with other administrative duties. Similarly, in the case of WTMs who apart from adjudicating as the DM also discharge other administrative functions.

It has however been experienced that pure institutional decisions give rise to two main issues.<sup>9</sup> Firstly, the authorship of such a decision may not be known as it is reached through several officers in the concerned department. Secondly, there may be divisions in the decision-making process in that while one person may hear, another may decide.

The Hon'ble Supreme Court in the matter of *Travancore Rayons Vs India*<sup>10</sup> held that the procedural safeguards in case of an institutional decision should be such that the party affected is informed of the official who has considered the matter. The Committee notes that this requirement is fulfilled by the Intermediaries Regulations and hence keeping the same in mind, the Committee recommends similar amendments to the Intermediaries Regulations.

The decision of the Hon'ble Supreme Court in *Gullapalli Nagewara Rao vs. A. P. State Road Transport Corporation*<sup>11</sup> that personal hearing enables the authority concerned to watch the demeanour of the witnesses and clear up any doubts during the course of the argument and of the party appearing to persuade the authority by reasoned argument to accept their point of view is also noted by the

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<sup>9</sup> M P Jain & S N Jain, Principles of Administrative Law, Fourth Edition, p . 273

<sup>10</sup> A.I.R. 1971 S.C. 862

<sup>11</sup> A.I.R. 1959 S.C. 308

Committee. If one person hears and another decides, then a personal hearing would become a mere formality. Therefore, it has to be ensured that the opportunity of personal hearing by the DM entails a reasonable must grant an effective opportunity to the noticee to defend his case and the same may be effected by way of a written representation, which is to be considered before passing of the final order in the case.

Such a proposal emanates from the principle that oral hearing is not essential to comply with the principles of natural justice which do not necessarily predicate an oral hearing to be provided unless the context requires otherwise.<sup>12</sup> The only requirement of natural justice in such cases is that the quasi-judicial bodies do not arrive at adverse finding without giving the noticee an effective opportunity of defending any allegations. Such an opportunity may be effected even through a written representation. The opportunity of making a written representation is equally efficacious and also amounts to a hearing. The Hon'ble Supreme Court in several judgements has reiterated its view that in quasi-judicial proceedings, an opportunity to make representation need not necessarily be provided by way of personal hearing; it can also be done by granting an opportunity to make written representation.<sup>13</sup>

The right of oral or personal hearing is, however, often demanded by affected persons since it is believed that they are in a position to effectively persuade the authorities to countenance their point of view. Occasionally, not affording oral hearing could itself prejudice the proceedings and render the order invalid or ineffective.<sup>14</sup> Yet oral hearing is not mandatory, except in cases where a provision of law or a rule specifically provides for an opportunity of oral hearing. Under those circumstances the oral hearing is required to be provided in strict compliance of the law.

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<sup>12</sup> *Gopalan Vs. Madras*. AIR., 1960 S.C.

<sup>13</sup> *Madya Pradesh Industries Ltd. Vs Union of India and others* 1966 AIR 671, 1966 SCR (1) 466

<sup>14</sup> *M. Sadasiva Sekhar vs District Collector and Ors.* 203 (2) ALD843, 2003 (3) ALT 68

After considering all the above and the various judgments of the Hon'ble Supreme Court, the Committee is of the view that in a two tier process as specified in the Intermediaries Regulations, the requirement of natural justice stands adequately complied with if the DA grants an opportunity to make written representation and grant an oral hearing to the noticee and the DM grants an opportunity to the noticee to only submit written representation after providing the copy of the Report of the DA.

The Committee is also cognizant of the fact that a WTM, in the course of institutional decision-making process also discharges duties as a DM. Due to the change in WTMs, who are appointed by Central Government from time to time, a fresh oral hearing needs to be granted to the noticee by the new DM in case the erstwhile DM was unable to pass the order before demitting office. The aforesaid proposal would, thus, enable SEBI to conclude enquiry proceedings in a timely manner by avoiding grant of multiple oral hearings. A written representation would enable the other DM to pass final orders without delaying the enquiry proceedings on account of granting fresh oral hearing to the Noticee.

Considering the above factors, the Committee recommends the following process to be adopted in all enquiry proceedings before the Board, which would entail suitable amendments to the Intermediaries Regulations:

- I. The process related to granting of an opportunity of personal hearing, inspection of documents, cross-examination etc., shall be granted by the DA. After conducting a detailed enquiry and after considering all the representation(s) and the facts and circumstances of the case, the DA may submit a report recommending appropriate action as contemplated in the Intermediaries Regulations.
- II. Upon receipt of the report of the DA, the DM may issue a show cause notice calling upon the noticee to submit within 21 days, a suitable response as to why action as recommended by the DA or any other action

as contemplated in the Intermediaries Regulations may not be initiated. The show cause notice may also clearly specify that no opportunity of personal hearing would be granted and all the submission, if any, may be made only in a written form.

## **FACTORS TO BE TAKEN INTO ACCOUNT BY THE DESIGNATED AUTHORITY**

### **Current provisions**

Section 15J of the SEBI Act, provides for relevant factors to be taken into account by the adjudicating officer while adjudging quantum of penalty under section 15-I of the SEBI Act. Such a provision acts as a pole star while deciding the quantum of penalty and guides the officer in prudently exercising the discretion vested upon him by the statute. The Intermediaries Regulations do not have any provision similar to that of section 15J of the SEBI Act to guide the DA and DM while exercising discretion to determine issuance of suitable direction as contemplated in the Intermediaries Regulations.

### **RECOMMENDATION No. 2:**

In view of the above discussion, the Committee also recommends the incorporation of a provisions similar to section 15J of the SEBI Act in the Intermediaries Regulations. The DA and the DM, as the case may be, while making the recommendation and passing the order under the Intermediaries Regulations, shall have due regard to the following factors, namely, –

- the amount of disproportionate gain or unfair advantage, wherever quantifiable, made as a result of the default;
- the amount of loss caused to an investor or group of investors as a result of the default;
- the repetitive nature of the default; and
- any other relevant and just factors.



## **V. DRAFT OF REGULATIONS**

The Committee recommends that regulation 25, 26, 27 and 28 of Chapter V of the Intermediaries Regulations may be substituted with the following regulations, which may be made applicable upon the notification of the proposed amendments, -

### **CHAPTER V**

#### **Holding of enquiry.**

25. (1) The Designated Authority shall issue a notice to a person against whom an enquiry has been initiated, to show cause as to why the action, as contemplated against such person should not be recommended.

(2) The noticee shall be called upon to submit, within a period to be specified in the notice, not exceeding twenty-one days from the date of service thereof, a written reply to the notice, along with documentary evidence, if any, in support of such written reply:

Provided that the Designated Authority may extend the time specified in the notice for sufficient grounds shown by the noticee and after recording reasons in writing.

(3) Every notice under sub-regulation (1) shall specify the contravention alleged to have been committed by the noticee by indicating the provisions of the securities laws or the direction or the order of the Board alleged to have been contravened.

(4) There shall be annexed to the notice issued under sub- regulation (1), copies of documents relied upon by the Board along with the extracts of relevant portions of the reports containing the findings arrived at in an inquiry, investigation or inspection, if any.

(5) If the noticee demands inspection of such documents within the period specified in sub-regulation (2) and the designated authority is of the opinion that the same may be granted, then the DA may issue a notice fixing a date of inspection of documents for the same within thirty days from the date of receipt of such request.

(6) If the Designated Authority is satisfied that there is a need to grant an opportunity of personal hearing, then the DA may issue or cause to issue a notice scheduling a date for hearing the noticee or authorised representative:

Provided that no opportunity of oral hearing may be granted in the cases where the noticee is alleged to have failed to pay the registration fee or any other applicable fees to the Board as per the provisions of the relevant regulations or the noticee has been declared a wilful defaulter or a fugitive economic offender.

(7) If the noticee does not reply to the notice or fails to appear on the scheduled hearing date and the designated authority is satisfied that sufficient opportunity has been given to the noticee, the designated authority may conclude the proceedings after, recording the reasons for doing so, on the basis of the material available on record.

#### **Recommendation of action**

26. (1) After considering the reply, if any, and other material available on record, the Designated Authority may by way of a report, where the facts so warrant, recommend –

- (i) cancellation of the certificate of registration;
- (ii) suspension of the certificate of registration for a specified period;
- (iii) prohibition of the noticee from taking up any new assignment or contract or launching a new scheme for the period specified in the order;
- (iv) debarment of an officer of the noticee from being employed or associated with any registered intermediary or other person associated with the securities market for the period specified in the order;
- (v) debarment of a branch or an office of the noticee from carrying out activities for the specified period;
- (vi) issuance of a regulatory censure to the noticee:

Provided that in respect of the same certificate of registration, not more than five regulatory censures under these regulations may be recommended to be issued to any intermediary, thereafter, the action as detailed in clause (i) to

(v) of this sub-regulation may be considered.

(2) The designated authority shall endeavour to submit the report within one hundred and twenty days from the date of receipt of reply to the notice or date of last personal hearing, whichever is later.

### **Order**

27. (1) On receipt of the report containing the measures recommended by the designated authority, the designated member shall issue notice to the noticee enclosing therein a copy of the report submitted by the designated authority and call upon the noticee to reply to the notice, in writing, as to why the action recommended by the designated authority considers appropriate, should not be taken.

(2) The noticee shall submit, within a period as specified in the notice, but not exceeding twenty-one days from the date of service thereof, a written reply to the notice, along with documentary evidence, if any, in support of such written reply.

Provided that upon the request of the noticee the designated member may extend the time specified in the notice, after recording reasons in writing.

Provided further that the noticee shall not have any right to seek opportunity of oral hearing before the designated member.

(3) The designated member shall after considering the written submission, if any and other facts and circumstances of the matter, pass an appropriate order within one hundred and twenty days from the date of receipt of the written reply to the notice.

### **Factors to be taken into account.**

28. While making a recommendation or passing an order as under this chapter, the designated authority or designated member, as the case may be, shall have due regard to the following factors, namely, -

- (a) the amount of disproportionate gain or unfair advantage, wherever quantifiable, made as a result of the default;
- (b) the amount of loss caused to an investor or group of investors as a result of the default;

- (c) the repetitive nature of the default;
- (d) any other relevant and just factors.

The Committee also notes that only Chapter V, V-A and VI of the Intermediaries Regulations have been notified till date. Hence the Committee recommends that the Intermediaries Regulations may be replaced by new regulations which may only contain provisions with respect to manner of actions in case of defaults by Intermediaries, as proposed below:

**THE GAZETTE OF INDIA  
EXTRA-ORDINARY  
PART –III – SECTION 4  
PUBLISHED BY AUTHORITY  
SECURITIES AND EXCHANGE BOARD OF INDIA**

**NOTIFICATION**

**Mumbai, the ..... day of ....., 2020**

**SECURITIES AND EXCHANGE BOARD OF INDIA (PROCEDURE FOR  
HOLDING ENQUIRY) REGULATIONS, 2020**

*No. .... In exercise of the powers conferred by section 30 read with sub-section (3) of section 12 of the Securities and Exchange Board of India Act, 1992 (15 of 1992), the Board hereby makes the following regulations, namely: -*

**CHAPTER I**  
**PRELIMINARY**

**Short title and commencement**

1. (1) These regulations may be called the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020.
- (2) They shall come into force on the date of their publication in the Official Gazette.

**Definitions**

2. (1) In these regulations, unless the context otherwise requires, -
  - (a) "Act" means the Securities and Exchange Board of India Act, 1992 (15 of 1992);
  - (b) "Board" means the Securities and Exchange Board of India constituted under section 3 of the Act;
  - (c) "Certificate" means a certificate of registration granted to an intermediary under the relevant Regulations;
  - (d) "Designated Authority" means an officer of the Board and includes a bench of such officers;
  - (e) "Designated Member" means the Chairman or a Whole Time Member of the Board designated for the purpose;
  - (f) "Executive Director" means an officer of the Board who is appointed as such by the Board;
  - (g) "Intermediary" means a person who is required to obtain a certificate of registration from the Board and includes an asset management company in relation to the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, an investment

manager in relation to the Securities and Exchange Board of India (Infrastructure Investment Trusts) Regulations, 2014, a manager in relation to the Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014, a manager in relation to the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, a clearing member of a clearing corporation or clearing house, a foreign portfolio investor and a trading member of a derivative segment or currency derivatives segment of a stock exchange.

- (h) “Noticee” means the person to whom a notice has been issued under these Regulations;
- (i) “Securities Laws” includes the Act, the Securities Contracts (Regulation) Act, 1956 (42 of 1956), the Depositories Act, 1996 (22 of 1996), and the rules or regulations or circulars or guidelines made thereunder and includes the provisions of the Companies Act, 2013 (18 of 2013) and the rules made thereunder to the extent administered by the Board.

(2) Words and expressions used and not defined in these regulations, but defined in the securities laws shall have the meanings respectively assigned to them thereunder, as the case may be.

## **CHAPTER II**

### **ACTION IN CASE OF DEFAULT**

#### **Cancellation or suspension of registration and other actions**

3. Where any registered intermediary or its sponsor, trustee, partners, directors or

officers, as the case may be,

- (a) fails to comply with any conditions subject to which a certificate of registration has been granted;
- (b) contravenes or attempts to contravene or abet the contravention of any of the provisions of the securities laws or fails to comply with any of the directions or orders of the Board;

the Board may, without prejudice to any action under the securities laws, by an order, take action in the manner specified under these regulations.

#### **Appointment of the Designated Authority**

4. (1) Where it appears to the Designated Member that any person has committed any default as specified in regulation 3, the Designated Member may approve the initiation of proceedings under these regulations against such person.

(2) The relevant Executive Director shall thereafter appoint an officer not below the rank of a Division Chief, as a Designated Authority:

Provided that the Executive Director may appoint a bench of three officers, each of whom shall not be below the rank of a Division Chief:

Provided further that such bench shall be presided by the senior most amongst them and all the decisions or recommendations of such bench shall be by way of majority.

#### **Holding of enquiry.**

5. (1) The Designated Authority shall issue a notice to a person against whom an enquiry has been initiated, to show cause as to why the action as contemplated against such a person should not be recommended.

(2) The noticee shall be called upon to submit, a written reply to the notice, along with documentary evidence, if any, in support of such written reply within a period to be specified in the notice, not exceeding twenty-one days from the date of service thereof:

Provided that the Designated Authority may extend the time specified in the notice for sufficient grounds shown by the noticee and after recording reasons in writing.

(3) Every notice under sub-regulation (1) shall specify the contravention alleged to have been committed by the noticee by indicating the provisions of the securities laws or the direction or the order of the Board alleged to have been contravened.

(4) There shall be annexed to the notice issued under sub- regulation (1), copies of documents relied upon by the Board along with the extracts of relevant portion of the reports containing the findings arrived at in the inquiry, investigation or inspection, if any.

(5) If the noticee seeks inspection of such documents within the period specified in sub-regulation (2) and the designated authority is of the opinion that the same may be granted, then the Designated Authority may issue a notice fixing a date for inspection of documents for the same within thirty days from the date of receipt of such request.

(6) If the Designated Authority is satisfied that there is a need to grant an opportunity of personal hearing, then the Designated Authority may issue or cause to issue a notice scheduling a date for hearing to the noticee or authorised representative:

Provided that no opportunity of oral hearing may be granted in the cases arising out of a failure of the noticee to pay the registration fee or any other applicable



fees to the Board as per the provisions of the relevant regulations or where he noticee has been declared a wilful defaulter or a fugitive economic offender.

(7) If the noticee does not reply to the notice or fails to appear on the scheduled hearing date and the Designated Authority is satisfied that sufficient opportunity has been given to the noticee, the Designated Authority may conclude the proceedings, after recording the reasons for doing so, on the basis of the material available on record.

### **Recommendation of action**

6. (1) After considering the reply if any and other material available on record, the Designated Authority may by way of a report, where the facts so warrant, recommend –

- (i) cancellation of the certificate of registration;
- (ii) suspension of the certificate of registration for a specified period;
- (iii) prohibition of the noticee from taking up any new assignment or contract or launching a new scheme for the period specified in the order;
- (iv) prohibition of a branch or an office of the noticee from carrying out activities for the specified period;
- (v) issuance of a censure to the noticee:

(2) The Designated Authority shall endeavour to submit the report within one hundred and twenty days from the date of receipt of reply to the notice or date of last personal hearing, whichever is later.

### **Order**

7. (1) Upon the receipt of the report containing the measures recommended by

the Designated Authority, the Designated Member shall issue a notice to the noticee enclosing therein a copy of the report submitted by the Designated Authority and call upon the noticee to reply to the notice, in writing, as to why the action recommended by the Designated Authority or any action as considered appropriate, should not be taken.

(2) The noticee shall submit, within a period as specified in the notice, but not exceeding twenty-one days from the date of service thereof, a written reply to the notice, along with documentary evidence, if any, in support of such a written reply.

Provided that upon the request of the noticee, the Designated Member may extend the time specified in the notice, after recording the reasons in writing.

Provided further that the noticee shall not have any right to seek an opportunity of oral hearing before the Designated Member.

(3) After considering the written submission, if any and the other facts and circumstances of the matter, the Designated Member shall endeavour, within one hundred and twenty days from the date of receipt of the written reply to the notice, to pass an appropriate order.

#### **Factors to be taken into account**

8. While making a recommendation or passing the order, the Designated Authority or Designated Member, as the case may be, shall have due regard to the following factors, namely, -

(a) the amount of disproportionate gain or unfair advantage, wherever quantifiable, made as a result of the default;

(b) the amount of loss caused to an investor or group of investors as a result of the default;

- (c) the repetitive nature of the default;
- (d) any other relevant and just factors.

**Surrender of any certificate of registration.**

9. (1) Any person, who has been granted a certificate of registration under the Act or the regulations made thereunder, desirous of giving up its activity and surrendering the certificate, may make a request for such surrender to the Board and while disposing such a request, the Board shall not be bound by the procedure specified in the foregoing provisions of these regulations.

(2) While disposing of a request under this regulation, the Board may require the concerned person to satisfy the Board with such factors as it deems fit, including but not limited to the following-

- (a) the arrangements made for maintenance and preservation of records and other documents required to be maintained under the relevant regulations;
- (b) redressal of investor grievances;
- (c) transfer of records, funds or securities of clients;
- (d) the arrangements made for ensuring continuity of service to clients;
- (e) completion of pending proceedings or addressing the defaults if any.

(3) While accepting surrender, the Board may impose upon the person such conditions as it deems fit for the protection of the investors or clients or the securities market and such person shall comply with such conditions.

**Effect of suspension or cancellation or surrender**

10. (1) On and from the date of cancellation or suspension or surrender of the certificate, the concerned person shall -

(i) not represent that he is an intermediary while such suspension is in force;

(ii) not undertake any new assignment or contract or launch any new scheme and during the period of such suspension, it shall cease to carry on any activity in respect of which certificate had been granted;

(2) On and from the date of cancellation or surrender of the certificate, the concerned person shall-

(a) return the certificate of registration so cancelled or surrendered to the Board and shall not represent itself to be a holder of certificate for carrying out the activity for which such certificate had been granted;

(b) cease to carry on any activity in respect of which the certificate had been granted;

(c) transfer its activities to another person holding a valid certificate of registration to carry on such activity and allow its clients or investors to withdraw or transfer their securities or funds held in its custody or to withdraw any assignment given to it, without any additional cost to such client or investor;

(d) make provisions as regards liability incurred or assumed by it;

(e) take such other action including the action relating to any records or documents and securities or money of the investors that may be in custody or control of such person, within the time period and in the manner, as may be required under the relevant regulations or as may be directed by the Board while passing order under these Regulations or otherwise.

**CHAPTER III**  
**MISCELLANEOUS**

**Intimation of the order.**

11. (1) A copy of the order passed under these Regulations shall be sent to the noticee and shall be uploaded on the website of the Board.

(2) A copy of the order shall also be sent to the concerned stock exchange, clearing corporation, depository or self-regulatory organization where the noticee is a member.

**Manner of service of notice and order and publication of order**

12. Any notice issued or order passed under these regulations may be served -

(a) by hand delivery to the concerned person or the duly authorized agent;  
or

(b) by delivery, at the address available on the records of the Board and addressed to that person or the duly authorized agent, by registered post acknowledgement due or by speed post or by such courier service or by fax or electronic mail service or by any other means of transmission which affords a record of delivery;

Provided that a notice sent through electronic mail shall be digitally signed by the competent authority.

Provided further that bouncing of the electronic mail shall not constitute valid service;

(c) in case of a stock broker or a sub-broker or a depository participant through the concerned stock exchange or the depository respectively;  
and

(d) if it cannot be served as per clause (a) or (b) or (c), by affixing it on the

door or some other conspicuous part of the premises in which such person resides or is known to have last resided or carries on business or is known to have last carried on business or personally works for gain or is known to have last personally worked for gain.

- (e) if it cannot be affixed on the outer door as per clause (d), by publishing the notice in at least two newspapers, one in an English daily newspaper having nationwide circulation and another in a newspaper having wide circulation published in the language of the region where the intermediary was last known to have resided or carried on business or personally worked for gain.

**Power of the Board to issue clarifications.**

13. In order to remove any difficulties in the application or interpretation of these regulations, the Board may issue clarifications and guidelines in the form of circulars.

**Amendments to other regulations.**

14. The regulations specified in the Schedule I shall be amended in the manner and to the extent stated therein.

**Repeal and savings**

15. (1) With effect from the publication of these regulations in the Official Gazette, the Securities and Exchange Board of India (Intermediaries) Regulations, 2008 shall be repealed.

(2) Notwithstanding such repeal, anything done or any action taken under the Securities and Exchange Board of India (Intermediaries) Regulations, 2008,

including an inquiry commenced or notice issued under the Securities and Exchange Board of India (Intermediaries) Regulations, 2008, before the notification of these regulations in the Official Gazette, shall be deemed to have been done or taken or commenced under the corresponding provisions of these regulations.

(3) After the repeal of the regulations referred to in sub-regulation (1), any reference thereto in any other regulation, guideline or circular shall be deemed to be a reference to the corresponding provisions of these Regulations.

## **SCHEDULE I**

**[See regulation 14]**

### **Amendments to other regulations**

#### **1. Amendment of Securities and Exchange Board of India (Bankers to an Issue) Regulations, 1994.**

(i) For regulation 6A, the following regulation shall be substituted, namely: -

##### **“Criteria for fit and proper person**

6A. For the purpose of determining whether an applicant or the banker to an issue is a fit and proper person, the Board may take into account the criteria specified in Schedule IV of these regulations.”

- (ii) In regulation 22, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.
- (iii) In regulation 23, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.
- (iv) After Schedule III, the following Schedule shall be inserted, namely: -

#### **“SCHEDULE IV**

**(See regulations 6A)**

#### **Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant or the intermediary is a ‘fit and proper person’ the Board may take into account such consideration as it deems fit, including but not limited to the following criteria in relation to the applicant or the intermediary or its sponsor, trustee, partners, the principal officer, director, promoter or the key management persons by whatever name called—

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;



(d) absence of categorization as a wilful defaulter.”

(e) absence of declaration as a fugitive offender

## **2. Amendment of Securities and Exchange Board of India (Collective Investment Schemes) Regulations, 1999**

(i) For regulation 9A, the following regulation shall be substituted, namely: -

### **“Criteria for fit and proper person**

9A. For the purpose of determining whether an applicant or the collective investment management company is a fit and proper person, the Board may take into account the criteria specified in Schedule X of these regulations.”

(ii) In regulation 56, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iii) In regulation 59, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iv) After Schedule IX, the following Schedule shall be inserted, namely: -

## **“SCHEDULE X**

**(See regulations 9A)**

### **Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant or the intermediary is a ‘fit and proper person’ the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation to the applicant or the intermediary, its sponsor, trustee, partners, the principal officer, the director, the promoter and the key management persons by whatever name called–

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

### **3. Amendment of Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999.**

(i) For regulation 5A, the following regulation shall be substituted, namely: -

**“Criteria for fit and proper person**

5A. For the purpose of determining whether an applicant or the credit rating agency is a fit and proper person the Board may take into account the criteria specified in Schedule IV of these regulations.”

(ii) In regulation 33, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iii) In regulation 34, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iv) After Schedule III, the following Schedule shall be inserted, namely: -

#### **“SCHEDULE IV**

**(See regulations 5A)**

#### **Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant or the intermediary is a ‘fit and proper person’ the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation to the applicant or the intermediary, its sponsor, trustee, partners, principal officer, the director, the promoter and

the key management persons by whatever name called—

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

**4. Amendment of Securities and Exchange Board of India (Custodian of Securities) Regulations, 1996.**

(i) For regulation 6A, the following regulation shall be substituted, namely: -

**“Criteria for fit and proper person**

6A. For the purpose of determining whether an applicant or the custodian of securities is a fit and proper person the Board may take into account the criteria specified in Schedule IV of these regulations.”

(ii) In regulation 25, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iii) In regulation 26, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the

words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iv) After Schedule III, the following Schedule shall be inserted, namely: -

**“SCHEDULE IV**

**(See regulations 6A)**

**Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant or the intermediary is a ‘fit and proper person’ the Board may take into account such consideration as it deems fit, including but not limited to the following criteria in relation to the applicant or the intermediary, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever name called—

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

**5. Amendment of Securities and Exchange Board of India (Debenture Trustees) Regulations, 1993.**

(i) For regulation 6A, the following regulation shall be substituted,

namely: -

**“Criteria for fit and proper person**

6A. For the purpose of determining whether an applicant or the debenture trustee is a fit and proper person the Board may take into account the criteria specified in Schedule V of these regulations.”

(ii) In regulation 23, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iii) In regulation 25, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iv) After Schedule IV, the following Schedule shall be inserted, namely: -

**“SCHEDULE V**

**(See regulations 6A)**

**Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant or the intermediary is a ‘fit and proper person’ the Board may take into account such consideration as it deems fit, including but not limited to the following criteria in relation to the applicant or the intermediary, its sponsor, trustee, partners, principal officer, the director, the promoter and

the key management persons by whatever name called—

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

**6. Amendment of Securities and Exchange Board of India (Depositories and Participants) Regulations, 2018.**

- (i) In regulation 88, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.
- (ii) In regulation 92, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

**7. Amendment of Securities and Exchange Board of India (Foreign Venture Capital Investors) Regulations, 2000.**

- (i) For regulation 4A, the following regulation shall be substituted, namely: -  
**“Criteria for fit and proper person**

4A. For the purpose of determining whether an applicant or the foreign venture capital investor is a fit and proper person the Board may take into account the criteria specified in Schedule III of these regulations.”

(ii) In regulation 23, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iii) After Schedule II, the following Schedule shall be inserted, namely: -

### **“SCHEDULE III**

**(See regulations 4A)**

#### **Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant or the intermediary is a ‘fit and proper person’ the Board may take into account such consideration as it deems fit, including but not limited to the following criteria in relation to the applicant or the intermediary, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever name called—

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender



**8. Amendment to Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012.**

(i) For sub-regulation (f) of regulation 4, the following sub-regulation shall be substituted, namely: -

**“(f) the applicant, Sponsor and Manager are fit and proper persons based on the criteria specified in Schedule IV of these Regulations.”**

(ii) In regulation 35, for the words “the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iii) In clause 7 of Form A of First Schedule, for the words “the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “these Regulations” shall be substituted.

(iv) After Schedule III, the following Schedule shall be inserted, namely: -

**“SCHEDULE IV**

**(See regulations 4 (f))**

**Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant is a ‘fit

and proper person' the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation to the applicant, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever name called –

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

**9. Amendment of Securities and Exchange Board of India (Merchant Bankers) Regulations, 1992.**

- (i) For regulation 6A, the following regulation shall be substituted, namely: -

**“Criteria for fit and proper person**

6A. For the purpose of determining whether an applicant or the merchant banker is a fit and proper person the Board may take into account the criteria specified in Schedule IV of these Regulations.”

- (ii) In regulation 33, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iii) For regulation 35, the following regulation shall be substituted, namely: -

**“Liability for action in case of default**

35. A merchant banker who contravenes any of the provisions of the Act, Rules or Regulations framed thereunder shall be liable for one or more actions specified therein including the action under Chapter V of the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020.”

(iv) After Schedule III, the following Schedule shall be inserted, namely: -

**“SCHEDULE IV**

**(See regulations 6A)**

**Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant is a ‘fit and proper person’ the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation to the applicant, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever name called –

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

**10. Amendment of Securities and Exchange Board of India (Mutual Funds) Regulations, 1996.**

(i) For regulation 7A, the following regulation shall be substituted, namely: -

**“Criteria for fit and proper person**

7A. For the purpose of determining whether an applicant or the mutual fund is a fit and proper person the Board may take into account the criteria specified in Schedule XIII of these Regulations.”

(ii) In regulation 65, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iii) In regulation 68, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iv) After Schedule XII, the following Schedule shall be inserted, namely: -

**“SCHEDULE XIII**

**(See regulations 7A)**

**Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant is a ‘fit and proper person’ the Board may take account of any consideration

as it deems fit, including but not limited to the following criteria in relation to the applicant, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever name called –

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

**11. Amendment of Securities and Exchange Board of India (Portfolio Managers) Regulations, 2020.**

(i) For regulation 8, the following regulation shall be substituted, namely: -

**“Criteria for fit and proper person**

8. For the purpose of determining whether an applicant or the portfolio manager is a fit and proper person the Board may take into account the criteria specified in Schedule VII of these Regulations.”

(ii) In regulation 39, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iii) In regulation 41, for the words “Chapter V of the Securities and Exchange

Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iv) In clause 10.2 of Form A of First Schedule, for the words “SEBI (Intermediaries) Regulations, 2008” the words “these Regulations” shall be substituted

(v) After Schedule VI, the following Schedule shall be inserted, namely:

-

#### **“SCHEDULE VII**

**(See regulations 8)**

#### **Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant is a ‘fit and proper person’ the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation to the applicant, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever name called –

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”

(e) absence of declaration as a fugitive offender

**12. Amendment of Securities and Exchange Board of India (Registrars to an Issue and Share Transfer Agents) Regulations, 1993.**

(i) For regulation 6A, the following regulation shall be substituted, namely: -

“Criteria for fit and proper person

6A. For the purpose of determining whether an applicant or the registrar to an issue and share transfer agent is a fit and proper person the Board may take into account the criteria specified in Schedule IV of these Regulations.”

(ii) In regulation 20, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iii) In regulation 22, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iv) After Schedule III, the following Schedule shall be inserted, namely: -

**“SCHEDULE IV**

**(See regulations 6A)**

**Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant is a ‘fit and proper person’ the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation to the applicant, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever name called –

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

**13. Amendment of Securities and Exchange Board of India (Stock Brokers and Sub-Brokers) Regulations, 1992.**

(i) For regulation 5A, the following regulation shall be substituted, namely: -

**“Criteria for fit and proper person**

5A. For the purpose of determining whether an applicant or the stock broker, sub-broker, trading member and clearing member is a fit and proper person the Board may take into account the criteria specified in Schedule VII of these Regulations.”



- (ii) In regulation 23, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.
- (iii) In sub-regulation (ii) of regulation 25, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.
- (iv) In regulation 27, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.
- (v) After Schedule VI, the following Schedule shall be inserted, namely:

-

## **“SCHEDULE VII**

**(See regulations 5A)**

### **Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant is a ‘fit and proper person’ the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation to the applicant, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever name called –

- (a) integrity, reputation and character;

- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

**14. Amendment of Securities and Exchange Board of India (Underwriters) Regulations, 1993.**

- (i) For regulation 6A, the following regulation shall be substituted, namely: -

**“Criteria for fit and proper person**

6A. For the purpose of determining whether an applicant or the underwriter is a fit and proper person the Board may take into account the criteria specified in Schedule IV of these Regulations.”

- (ii) In regulation 23, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

- (iii) For regulation 25, the following regulation shall be substituted, namely:-

**“Liability for action in case of default.**

25. An underwriter who contravenes any of the provisions of the Act, Rules or Regulations framed thereunder shall be liable for one or more actions specified therein including the action under the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020.”

(iv) After Schedule III, the following Schedule shall be inserted, namely: -

**“SCHEDULE IV**

**(See regulations 6A)**

**Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant is a ‘fit and proper person’ the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation to the applicant, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever name called

- (a) integrity, reputation and character;
- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

**15. Amendment of Securities and Exchange Board of India (Investment Advisers) Regulations, 2013.**

- (i) In sub-regulation (f) of regulation 6, for the words “Schedule II of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “Schedule IV of these Regulations” shall be substituted
- (ii) In regulation 28, for the words “the Securities and Exchange Board of

India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iii) In sub-clause (f) of clause (6) of Form A of First Schedule, for the words “Schedule II of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “these Regulations” shall be substituted.

(iv) After Schedule III, the following Schedule shall be inserted, namely: -

#### **“SCHEDULE IV**

**(See regulations 6)**

#### **Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant is a ‘fit and proper person’ the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation to the applicant, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever name called –

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

**16. Amendment of Securities and Exchange Board of India (Research Analysts) Regulations, 2014.**

(i) clause (c) of sub-regulation (1) of regulation (2) shall be substituted as follows, namely,-

“associate” means any person controlled, directly or indirectly, by the intermediary, or any person who controls, directly or indirectly, the intermediary, or any entity or person under common control with such intermediary, and where such intermediary is a natural person will include any relative of such intermediary and where such intermediary is a body corporate will include its group companies (as defined in the Monopolies and Restrictive Trade Practices Act, 1969 (Act No. 54 of 1969) or any re-enactment thereof) or companies under the same management;”

(ii) In sub-regulation (vii) of regulation 6, for the words “Schedule II of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “Schedule IV of these Regulations” shall be substituted.

(iii) In regulation 32, for the words “the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iv) In sub-clause (e) of clause (5) of Form A of First Schedule, for the words “Schedule II of the Securities and Exchange Board of India

(Intermediaries) Regulations, 2008” the words “these Regulations” shall be substituted.

(v) After Schedule III, the following Schedule shall be inserted, namely: -

**“SCHEDULE IV**

**(See regulations 6)**

**Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant is a ‘fit and proper person’ the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation to the applicant, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever name called –

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

**17. Amendment of Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2019.**

(i) In sub-regulation (g) of regulation 4, for the words “Schedule II of the

Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “Schedule IV of these Regulations” shall be substituted.

(ii) In clause (f) of sub-regulation (1) of regulation 11, for the words “Schedule II of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “Schedule IV of these Regulations” shall be substituted.

(iii) In clause (h) of sub-regulation (1) of regulation 22, for the words “Schedule II of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “these Regulations” shall be substituted.

(iv) In regulation 40, for the words “Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(v) In regulation 43, for the words “the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(vi) After Schedule III, the following Schedule shall be inserted, namely: -

## **“SCHEDULE IV**

**(See regulation 4(g) and regulation 11(f))**

### **Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant is a ‘fit and proper person’ the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation to the applicant, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever name called

- (a) integrity, reputation and character;
- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

### **18. Amendment of Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014.**

- (i) In clause (j) of sub-regulation (2) of regulation 4, for the words “Schedule II of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “Schedule VIII of these Regulations” shall be substituted.



(ii) In regulation 32, for the words “the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.

(iii) In sub-clause (b) of clause 8 of Form A of Schedule I, for the words “the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “these Regulations” shall be substituted.

(iv) After Schedule VII, the following Schedule shall be inserted, namely:

-

### **“SCHEDULE VIII**

**(See regulation 4(2)(j))**

#### **Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant is a ‘fit and proper person’ the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation to the applicant, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever name called –

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”

(e) absence of declaration as a fugitive offender

**19. Amendment of Securities and Exchange Board of India (Infrastructure Investment Trusts) Regulations, 2014.**

- (i) In clause (k) of sub-regulation (2) of regulation 4, for the words “Schedule II of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “Schedule VII of these Regulations” shall be substituted.
- (ii) In regulation 32, for the words “the Securities and Exchange Board of India (Intermediaries) Regulations, 2008”, the words “the Securities and Exchange Board of India (Procedure for Holding Enquiry) Regulations, 2020” shall be substituted.
- (iii) In clause 9 of Form A of Schedule I, for the words “the Securities and Exchange Board of India (Intermediaries) Regulations, 2008” the words “these Regulations” shall be substituted.
- (iv) After Schedule VI, the following Schedule shall be inserted, namely: -

**“SCHEDULE VII**

**(See regulation 4(2)(k))**

**Criteria for determining a ‘fit and proper person’**

For the purpose of determining as to whether an applicant is a ‘fit

and proper person' the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation to the applicant, its sponsor, trustee, partners, principal officer, the director, the promoter and the key management persons by whatever name called –

- (a) integrity, reputation and character;
- (b) absence of convictions and extent of restraint orders;
- (c) competence including financial solvency and net worth;
- (d) absence of categorization as a wilful defaulter.”
- (e) absence of declaration as a fugitive offender

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**PART-B**

**RECOVERY OF MONIES DUE UNDER SECURITIES LAWS**

## I. GENERAL

The Securities and Exchange Board of India (“SEBI” or “the Board”) is empowered to impose monetary penalties on violators, issue directions for refund to investors of monies raised in deemed public issues and unregistered collective investment schemes and order disgorgements. SEBI is also empowered to levy fees on market intermediaries under various regulations.

In case of default in the payment of such amounts, the SEBI Act, the SCRA and the Depositories Act (collectively referred to as the securities laws) empower SEBI to recover such amounts in the mode and manner as derived from the provisions of the Income-tax Act, 1961 and the Rules made thereunder, with suitable modifications as may be necessary.

However, there remain several challenges in the enforcement of such powers conferred upon SEBI.

An enforcement system without an efficient mechanism for recovering dues may render an agency ineffective. In this backdrop, the reference made to the Committee to suggest suitable changes, if any, to the securities laws and to consider the aggregation of a comprehensive set of rules or regulations that would lay down the procedure for recovery and for matters incidental and connected thereto, in light of the provisions pertaining to recovery of dues under the Income-tax laws and other laws, in the domestic and international space, prompted the Committee to examine a few of the domestic laws that pertain to employees’ provident funds, municipal corporation, insurance and competition laws as well as laws prevalent in certain foreign jurisdictions in the context of recovery of monies due under their securities laws.

The Committee also held extensive deliberations with the officers of the Legal Affairs Department and the Recovery and Refund Department. After considering the concerns raised during the deliberations and suggestions made during such meetings, the Committee has formulated its recommendations for improving the present system of recovery.

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## II. RECOVERY PROVISIONS UNDER VARIOUS LAWS

### INDIAN SCENARIO:

1. The Committee examined the following enactments with provisions for recovery mechanism, as summarized below, -
  - (a) Under the **Employees' Provident Funds and Miscellaneous Provisions Act, 1952**, the arrears of amount mentioned in section 8 (recovery of moneys due from employers) of the said Act shall be recovered in terms of the provisions of the Second and Third Schedules to the Income-tax Act, 1961 (43 of 1961). The Income-tax Certificate Proceedings Rules, 1962, as in force from time to time, is also applicable with necessary modifications. Thus like the SEBI Act, the aforesaid Act also directs the application of the provisions of Income-tax Act and the Rules for recovery of moneys due from employers.
  - (b) Under the state municipal laws such as the **Chennai City Municipal Corporation Act, 1919**, if any tax due from any person in India remains unpaid in whole or in part and if such a person leaves the country or cannot be found, the said tax or such part thereof that remains unpaid together with all sums payable in connection therewith, is recoverable as if it were an arrear of land revenue.
  - (c) Under section 33 of the **Insurance Act, 1938**, all expenses of, and incidental to, any investigation made under the said section shall be defrayed by the insurer, shall have priority over that debts due from the insurer and shall be recoverable as an arrear of land revenue.

In the context of the aforesaid Acts providing for amounts due to be recoverable as arrears of land revenue, the following deserve to be noted:

2. The Revenue Recovery Act<sup>15</sup>, 1890, in section 5 thereof states ‘*Where any sum is recoverable as an arrear of land-Revenue of any public officer other than a Collector or by local authority, the Collector of the district in which the office of that officer or authority is situate shall, on the request of the officer or authority, proceed to recover the sum as if it were an arrear of land-revenue which had accrued in his own district, and may send a certificate of the amount to be recovered to the Collector of another district under the foregoing provisions of this Act, as if the sum were payable to himself.*
3. There are also State enactments for each of the States in India that provide for recovery of arrears of revenue due to the Government.

In the matter of *State Bank of Indore v. Regional Provident Fund*<sup>16</sup>, the Hon’ble High Court of Madhya Pradesh brought out the difference between the terms “arrears of land revenue” and “amount recoverable as an arrear of land revenue” -

“5. In our judgment, the contentions advanced on behalf of the petitioner must be given effect to. Section 8 of the Act provides, inter alia, that any amount due from the employer in relation to an establishment to which a Scheme under the Act applies, may, if the amount is in arrear, be recovered by the appropriate Government in the same manner as an arrear of land revenue. It does not say that the amount may be recovered as an arrear of land revenue. It merely provides the manner of the recovery of the amount mentioned in Section 8. The manner prescribed for the recovery of the amount as an arrear of land revenue does not convert the amount into an arrear of land revenue; nor does it create any charge on any property of the employer for the payment of the amount or give a priority in the manner of payment of the amount. There is no provision in the Act in regard to the creation of any such charge or priority for the payment of the employer's contribution.”

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<sup>15</sup> An Act to make better provision for recovering certain public demands.

<sup>16</sup> AIR 1965 MP 40 (DB), (1965) IILLJ 662 MP; case before the provisions of Income-tax Act and Rules could be applied for recovery under the EPF Act.



4. Competition Act, 2002 read with the Competition Commission of India (Manner of recovery of Monetary Penalty) Regulations, 2011:
- A. The Competition Act, 2002 aims to prevent practices that have an adverse effect on competition, promote and sustain competition in markets, protect the interests of consumers and ensure freedom of trade carried on by other participants in the markets in India, and for matters connected therewith or incidental thereto.
  - B. Chapter VI contains sections 42-48 that provide for the imposition of monetary ‘penalties’ for various contravention.
  - C. Section 64 empowers the Commission to make regulations to carry out the purposes of the Competition Act. Under clause (g) of sub-section (2) of section 64, the Commission is empowered to make regulations for the manner in which penalty shall be recovered under sub-section (1) of section 39<sup>17</sup>.

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<sup>17</sup> **“Execution of orders of Commission imposing monetary penalty.**

**39. (1) If a person fails to pay any monetary penalty imposed on him under this Act, the Commission shall proceed to recover such penalty, in such manner as may be specified by the regulations.**

*(2) In a case where the Commission is of the opinion that it would be expedient to recover the penalty imposed under this Act in accordance with the provisions of the Income-tax Act, 1961 (43 of 1961), it may make a reference to this effect to the concerned income-tax authority under that Act for recovery of the penalty as tax due under the said Act.*

*(3) Where a reference has been made by the Commission under sub-section (2) for recovery of penalty, the person upon whom the penalty has been imposed shall be deemed to be the assessee in default under the Income Tax Act, 1961 (43 of 1961) and the provisions contained in sections 221 to 227, 228A, 229, 231 and 232 of the said Act and the Second Schedule to that Act and any rules made there under shall, in so far as may be, apply as if the said provisions were the provisions of this Act and referred to sums by way of penalty imposed under this Act instead of to income-tax and sums imposed by way of penalty, fine, and interest under the Income-tax Act, 1961 (43 of 1961) and to the Commission instead of the Assessing Officer.*

*Explanation 1 – Any reference to sub-section (2) or sub-section (6) of section 220 of the income-tax Act, 1961 (43 of 1961), in the said provisions of that Act or the rules made thereunder shall be construed as references to sections 43 to 45 of this Act.*

*Explanation 2 – The Tax Recovery Commissioner and the Tax Recovery Officer referred to in the Income-tax Act, 1961 (43 of 1961) shall be deemed to be the Tax Recovery Commissioner and the Tax Recovery Officer for the*

- D. The Commission is empowered to recover monetary penalty from a defaulter in the manner specified by the regulations or in accordance with the provisions of the Income-tax Act, 1961. It may make a reference to the concerned Income-tax Authority under that Act for recovery of the penalty as tax due under the said Act.
- E. On a reference made to the Income-tax Authority, the person upon whom the penalty has been imposed shall be deemed to be the assessee in default under the income tax laws and recovery shall be initiated accordingly.
- F. Salient features of the Competition Commission of India (Manner of recovery of Monetary Penalty) Regulations, 2011:
- a. Regulation 4: provides for extension of time for payment of dues or allow payment in instalments subject to such conditions as deemed fit by the Commission;
  - b. Regulation 5: If the amount specified in the demand notice is not paid within the period specified by the Commission, the enterprise/defaulters shall be liable to pay simple interest at one and one half per cent. for every month or part of a month comprised in the period commencing from the day immediately after the expiry

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*purposes of recovery of sums imposed by way of penalty under this Act and reference made by the Commission under sub-section (2) would amount to drawing of a certificate by the Tax Recovery Officer as far as demand relating to penalty under this Act.*

*Explanation 3 – Any reference to appeal in Chapter XVIII and the Second Schedule to the Income-tax Act, 1961 (43 of 1961), shall be construed as a reference to appeal before the Competition Appellate Tribunal under section 53B of this Act.”*

of the period mentioned in demand notice and ending with the day on which the penalty is paid.

c. Regulation 9 (Modes of recovery):

i. RA person who holds or may subsequently hold money for or on account of the defaulter is required to pay the Commission and in case of failure of such person to pay the money, he shall also be treated in the same manner as an enterprise in default.

ii. An application is required to be made to the court which is holding the custody of the defaulter's money.

iii. If the defaulter is in a country outside India (being a country with which the Central Government has entered into an agreement for the recovery of penalty under the Act and the corresponding law in force in that country), the Commission may propose to that country to take such action thereon as the Commission may deem appropriate and remit any sum so received to the Commission.

d. Regulation 10 (Other modes of recovery): Recovery may also be done in accordance with the Rules laid down in the Second Schedule of Income-tax Act, 1961 by attachment and sale of movable/immovable properties of the defaulting enterprise.

e. Regulations 10 and 11 - Require reference by the Commission to the Income-tax Authority for recovery of penalty.

- f. Regulation 14 – Refund of excess penalty: In case the Competition Appellate Tribunal or the High Court or the Supreme Court of India holds that the enterprise is not liable to pay any penalty or liable to pay penalty less than the amount mentioned in any order or notice, the demand notice or the recovery certificate shall be withdrawn or modified and the amount of penalty, if paid, shall be refunded.
  
- g. Regulation 15: The Commission is empowered to determine the procedure in case a situation is not provided for in the regulations.

From the referred provisions of different enactments, it can be seen that under certain laws, the arrears or dues are recovered as if such arrears were arrears of land revenue. In some areas like in the securities markets and the employees' provident fund, the arrears or dues are recovered by resorting to the procedure under the Income-tax laws. However, under the laws administered by the Competition Commission, the said Commission is empowered to frame regulations for the purposes of recovering unpaid penalties imposed under the Competition Act, 2002. Thus, there is a diversity in the manner in which dues are recovered under different laws.

## **INTERNATIONAL SCENARIO:**

In certain advanced jurisdictions, the arrears due to the securities markets regulator of that jurisdiction is recovered as if such dues were a ‘civil debt’, as can be seen from the following examples:

### **A. United States of America**

The US SEC<sup>18</sup>, being a federal agency, is empowered to collect a claim from a defaulter in terms of the **Debt Collection Act** (codified at 31 U.S.C.3716). The said Act requires notice procedures TO be observed by the agency. The claim is recovered against “administrative offset”, “salary offset”, tax refund offset” and “wage garnishment order”.

The Commission may report delinquent debts to consumer reporting agencies (See 31 U.S.C. 3701(a)(3), 3711). Section 13 of the Debt Collection Act (31 U.S.C. 3718) authorizes agencies to enter into contracts for collection services to recover debts owed to the United States of America.

### **B. Australia**

In Australia, the ASIC may pursue<sup>19</sup> actions in the courts to punish a person or entity in response to a misconduct. Actions include –

- a. Criminal penalties (such as imprisonment, fines, community service orders, etc.).

Matters giving rise to criminal penalties are prosecuted by the Commonwealth Director of Public Prosecutions (CDPP), with the

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<sup>18</sup> See Code of Federal Regulations, Title 17, Chapter II, Part 204, Rules relating to Debt collection, available at <[https://www.ecfr.gov/cgi-bin/text-idx?node=17:3.0.1.1.5&rgn=div5#se17.3.204\\_15](https://www.ecfr.gov/cgi-bin/text-idx?node=17:3.0.1.1.5&rgn=div5#se17.3.204_15)>; U. S Code, Title 31, Sub-title III, Chapter 37, Sub-chapter II, Section 3716, available at <<https://www.law.cornell.edu/uscode/text/31/3716>>; U. S. Code, Title 26, Sub-title F., Chapter 65, Sub-chapter A., Section 6402, available at <<https://www.law.cornell.edu/uscode/text/26/6402#g>>; Code of Federal Regulations, Title 31, Sub-title B., Chapter II, Sub-chapter A., Part 285, Sub-part A., Section 285.2, available at <<https://www.law.cornell.edu/cfr/text/31/285.2>>; Code of Federal regulations, Title 31, Sub-title B., Chapter IX, Part 901, Section 901.3, available at <<https://www.law.cornell.edu/cfr/text/31/901.3>>.

<sup>19</sup> See ASIC Enforcement Review: Position Paper 7 Strengthening Penalties for Corporate and Financial Sector Misconduct, available at <<https://static.treasury.gov.au/uploads/sites/1/2017/10/c2017-t232150.pdf>>.

exception of a number of minor regulatory offences which are prosecuted by the ASIC; and

b. Civil monetary penalties.

All monetary penalties in these types of actions are payable to the Commonwealth of Australia. Under section 91 of the Australian Securities and Investments Commission Act 2001 (“**ASIC Act**”), the ASIC has the power to pass an order to recover the investigation expenses and costs, if as a result of the investigation, -

- i. a person is convicted of an offence, or
- ii. judgment is awarded, or a declaration or other order is made against a person in a proceeding in a court.

The AISC may pass an order that the person pay or reimburse ASIC, -

- i. for the whole or a specified part, of the expenses of the investigation;
- ii. for the whole or a specified part, of the costs to ASIC of making the investigation, including the remuneration of ASIC staff concerned in the investigation.

ASIC has similar powers under section 319 of the *National Consumer Credit Protection Act 2009* which allows ASIC to pass an order to recover investigation expenses and costs, including, -

- a. salary costs for ASIC staff who have worked on the investigation
- b. travel expenses when required to interview witnesses
- c. costs of external legal counsel, and
- d. costs of employing an expert to perform an analysis.

In terms of sub-section (4) of section 91 of the AISC Act, if the amount payable under an Order made under the said section is not paid, ASIC may then recover the same through a court of competent jurisdiction as a debt due to ASIC.

### C. Singapore

In Singapore, under sections 27C<sup>20</sup>, 148(10)<sup>21</sup> and 177<sup>22</sup> of the Monetary Authority of Singapore Act (“**MAS Act**”), the Monetary Authority of Singapore (“**MAS**”) recovers remuneration, expenses, financial penalty and fees as a civil debt. ‘Debt’ due to MAS is recoverable in terms of the Civil Law Act.

The Committee notes that recovery of penalty or fees in the aforesaid jurisdictions is effected as recovery of a ‘civil debt’ and the general law is invoked to recover the same through a civil court.

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<sup>20</sup> **Inspection of financial institutions for compliance with directions and regulations under sections 27A and 27B. 27C.**—(1) The Authority may, from time to time, inspect under conditions of secrecy the books of —

- (a) a financial institution; or
- (b) any subsidiary, branch, agency or office outside Singapore of a financial institution incorporated or established in Singapore,

for the purpose of determining the extent of compliance by the financial institution with the directions issued and the regulations made under sections 27A and 27B.

(2) The Authority may appoint any person, including an auditor (not being an auditor of the financial institution), to carry out an inspection under this section.

(3) If the inspection is carried out on the ground that the Authority has reason to believe that the financial institution has contravened or is contravening any direction issued or regulation made under section 27A or 27B, and if the Authority so directs, then the financial institution is liable to pay for the remuneration and expenses of any person appointed under subsection (2) for the inspection.

(4) The Authority may recover from the financial institution the remuneration and expenses referred to in subsection (3) as a civil debt due to the Authority.

.....

<sup>21</sup> **Cancellation, etc., of appointment as primary dealer**

**148.** .....

(3) In the case of a failure by a primary dealer to comply with any direction issued by the Authority under section 147, the Authority may, in addition to any order that may be made under subsection (2), order the primary dealer to pay to the Authority, for every day or part thereof of such failure, a financial penalty in accordance with such formula as the Minister may, by notification published in the Gazette, prescribe.

(4) A financial penalty collected by the Authority under subsection (3) shall be paid into the Consolidated Fund.

....

(10) The Authority may recover on behalf of the Government any financial penalty ordered under subsection (3) as though the financial penalty were a civil debt due to the Authority.

<sup>22</sup> **Recovery of fees, expenses, etc.**

**177.** There shall be recoverable as a civil debt due to the Authority from the financial institution concerned —

(a) the amount of any fees payable to the Authority under section 29 or under any rules issued under section 29A; and

(b) any remuneration and expenses payable by the financial institution to —

- (i) a statutory adviser appointed under section 33(2);
- (ii) a statutory manager appointed under section 33(2);
- (iii) the Authority or any person appointed by the Authority under section 13B in relation to the Authority’s assumption of control of any business of the financial institution under section 33; and
- (iv) any person appointed to perform any independent assessment under Part IVA or IVB.

## **RECOVERY UNDER THE INDIAN SECURITIES LAWS**

### **GENESIS OF SECTION 28A OF SEBI ACT, 1992:**

Prior to July 2013, SEBI did not have the power to recover amounts due. The absence of recovery power severely jeopardized its ability to recover unpaid penalties. The Committee is given to understand that many orders directing disgorgement in the IPO scam unearthed in 2005 and 2006 were not complied with. The options available to the regulator was to impose debarment for a longer period or file for prosecution in a criminal court. Such provisions though meant to act as a deterrent, did not enable SEBI to recover the unpaid amounts from the violators. Instead, huge costs were incurred by the regulator in such proceedings including manpower to oversee such action.

Realizing the lacunae in its enforcement tools, SEBI deliberated the issue with the Central Government and sought an amendment to the SEBI Act to empower it to recover unpaid monies due in line with the provisions of the Income-tax Act, 1961.

Finally, through an Ordinance in 2013 i.e., the Securities Laws (Amendment) Ordinance, 2013, with effect from July 18, 2013, an important amendment was brought about by the insertion of a new section 28A in the SEBI Act and in the analogous provisions in the SCRA and the Depositories Act to provide SEBI with the power to recover the amounts due.

An Ordinance route was necessitated since the Parliament was not in session. When the Amendment Ordinance, 2013 lapsed, a Second Ordinance was promulgated on September 16, 2013 and upon the lapse of this Second Ordinance, a third Ordinance was promulgated on March 28, 2014. Subsequently, the Securities Laws (Amendment) Act, 2014<sup>23</sup> was notified on August 25, 2014.

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<sup>23</sup> This included reference to section 220 of the Income Tax Act, 1961 which otherwise was not present in the previous three amendment Ordinances.



The avowed 'Statement of Objects and Reasons' in respect of the power to recover monies due in the Securities Laws (Amendment) Bill, 2014 is as follows, -

*“...to insert a new section 28A so as to empower the Recovery Officer to recover the amount, against the persons who fail to comply with any direction of the Board for refund of monies or fail to comply with a direction of disgorgement issued under section 11B or fail to pay any fees due to the Board.”*

Further, the Notes on Clauses provided as under, -

*“Clause 21.—This clause seeks to insert a new section 28A in the SEBI Act, 1992 relating to recovery of amounts. This clause empowers the Board, inter alia, to attach and sell movable and immovable property of the defaulters without recourse to any court of law and attach bank accounts of defaulters, in case a person fails to pay the penalty imposed by the adjudicating officer or fails to comply with any direction of the Board for refund of monies or fails to comply with a direction of disgorgement order issued under section 11B or fails to pay any fees due to the Board.”*

#### **POWER TO RECOVER:**

Section 28A of the SEBI Act empowers a Recovery Officer appointed by SEBI to recover unpaid monetary penalties, unpaid monies directed to be refunded to investors, disgorgement amounts and unpaid fees due to SEBI. The provisions of section 28A is reproduced below:

##### **“Recovery of amounts.**

**28A.** (1) If a person fails to pay the penalty imposed [under the Act]<sup>24</sup> or fails to comply with any direction of the Board for refund of monies or fails to comply with a direction of disgorgement order issued under section 11B or fails to pay any fees due to the Board, the Recovery Officer may draw up under his signature a statement in the specified form specifying the amount due from the person

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<sup>24</sup> Substituted for the words “by the adjudicating officer” by the Finance Act, 2018. This amendment is not yet brought into force.

(such statement being hereafter in this Chapter referred to as certificate) and shall proceed to recover from such person the amount specified in the certificate by one or more of the following modes, namely:—

- (a) attachment and sale of the person's movable property;
- (b) attachment of the person's bank accounts;
- (c) attachment and sale of the person's immovable property;
- (d) arrest of the person and his detention in prison;
- (e) appointing a receiver for the management of the person's movable and immovable properties,

and for this purpose, the provisions of sections 220 to 227, 228A, 229, 232, the Second and Third Schedules to the Income-tax Act, 1961 (43 of 1961) and the Income-tax (Certificate Proceedings) Rules, 1962, as in force from time to time, insofar as may be, apply with necessary modifications as if the said provisions and the rules made thereunder were the provisions of this Act and referred to the amount due under this Act instead of to income-tax under the Income-tax Act, 1961.

Explanation 1.—For the purposes of this sub-section, the person's movable or immovable property or monies held in bank accounts shall include any property or monies held in bank accounts which has been transferred directly or indirectly on or after the date when the amount specified in certificate had become due, by the person to his spouse or minor child or son's wife or son's minor child, otherwise than for adequate consideration, and which is held by, or stands in the name of, any of the persons aforesaid; and so far as the movable or immovable property or monies held in bank accounts so transferred to his minor child or his son's minor child is concerned, it shall, even after the date of attainment of majority by such minor child or son's minor child, as the case may be, continue to be included in the person's movable or immovable property or monies held in bank accounts for recovering any amount due from the person under this Act.

Explanation 2.—Any reference under the provisions of the Second and Third Schedules to the Income-tax Act, 1961 (43 of 1961) and the Income-tax (Certificate Proceedings) Rules, 1962 to the assessee shall be construed as a reference to the person specified in the certificate.

Explanation 3.— Any reference to appeal in Chapter XVIID and the Second Schedule to the Income-tax Act, 1961 (43 of 1961), shall be construed as a reference to appeal before the Securities Appellate Tribunal under section 15T of this Act.

Explanation 4.— The interest referred to in section 220 of the Income-tax Act, 1961 shall commence from the date the amount became payable by the person.

(2) The Recovery Officer shall be empowered to seek the assistance of the local district administration while exercising the powers under sub-section (1).

(3) Notwithstanding anything contained in any other law for the time being in force, the recovery of amounts by a Recovery Officer under sub-section (1), pursuant to non-compliance with any direction issued by the Board under section 11B, shall have precedence over any other claim against such person.

(4) For the purposes of sub-sections (1), (2) and (3), the expression "Recovery Officer" means any officer of the Board who may be authorised, by general or special order in writing, to exercise the powers of a Recovery Officer.”

[Emphasis supplied]

Analogous<sup>25</sup> provisions are also seen in the SCRA and the Depositories Act.

On a clear reading of section 28A(1)<sup>26</sup>, the following is noted,-

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<sup>25</sup> 23JB of the SCRA and section 19-IB of the Depositories Act.

<sup>26</sup> Read with analogous provisions i.e. 23JB of the SCRA and section 19-IB of the Depositories Act.

- a. Action for “recovery” under section 28A gets triggered when there is a failure to -
- i. pay a **penalty** imposed under the Act;
  - ii. comply with a direction of the Board for **refund** of monies;
  - iii. comply with a direction of **disgorgement**; or
  - iv. pay **fees** due to the Board.
- b. In case of defaults mentioned above, the Recovery Officer<sup>27</sup> draws up a **certificate**<sup>28</sup> specifying the amount due from the person (called the “defaulter”) and proceeds to recover the amount specified in his certificate by one or more of the following modes -
- i. attachment and sale of the defaulter’s movable property;
  - ii. attachment of the defaulter’s bank accounts;
  - iii. attachment and sale of the defaulter’s immovable property;
  - iv. arrest of the defaulter and his detention in prison;
  - v. appointing a receiver for the management of the defaulter’s movable and immovable properties.
- c. For the aforesaid purpose, the provisions of sections 220 to 227, 228A, 229, 231, 232, the Second and Third Schedules to the Income-tax Act, 1961 and the Income-tax (Certificate Proceedings) Rules, 1962, as in force from time to time, shall be applied with necessary modifications as if the said provisions and the rules thereunder were the provisions of the Act.
- d. In terms of sub-section (3) thereof, the recovery of amounts by a Recovery Officer pursuant to non-compliance with any direction issued by the Board under section 11B shall have **precedence** over any other claim against such person.

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<sup>27</sup> Any officer of the Board who is authorized to exercise the powers of a Recovery Officer.

<sup>28</sup> Statement in a specified form under the signature of the Recovery Officer.

## **Procedure for effecting recovery.**

Sub-section (1) of section 28A provides that for the purpose of recovering amounts under the said section, the provisions of the Income-tax Act and the Rules framed thereunder, as mentioned in sub-section (1) of section 28A, shall be applied with necessary modifications.

Accordingly, SEBI has been following the provisions of –

- a. section 220 (*when tax is payable and when an assessee is deemed in default*);
- b. section 221 (*penalty payable when tax is in default*);
- c. section 222 (*certificate to Tax Recovery Officer*);
- d. section 223 (*Tax Recovery Officer by whom recovery is to be effected*);
- e. section 224 (*validity of certificate and cancellation or amendment thereof*);
- f. section 225 (*stay of proceedings in pursuance of certificate and amendment or cancellation thereof*);
- g. section 226 (*other modes of recovery*);
- h. section 227 (*Recovery through State Government*);
- i. section 228A (*Recovery of tax in pursuance of agreements with foreign countries*);
- j. section 229 (*recovery of penalties, fine, interest and other sums*);
- k. section 231 (*period for commencing recovery proceedings*);
- l. section 232 (*recovery by suit or under other law not affected*);
- m. the Second Schedule (*Procedure for recovery of Tax – sections 222 and 276*);
- n. the Third Schedule (*Procedure for distraint by Assessing Officer or Tax Recovery Officer*);

of the Income-tax Act, 1961; and

o. the Income-tax (Certificate Proceedings) Rules, 1962<sup>29</sup>, as in force, with necessary modifications, while initiating recovery proceedings under section 28A of the Act.

#### **LEGISLATIVE CHANGES:**

The Finance Act, 2018 inserted a new section (section 28B<sup>30</sup>) in the SEBI Act (similar to the provisions for Legal Representatives found in the Income Tax Act, 1961) to enable the Board to continue with the recovery proceedings against a legal representative in the event the person (i.e. defaulter) dies.

Section 28B reads as follows,-

#### ***“Continuance of proceedings.***

**28B.** (1) *Where a person dies, his legal representative shall be liable to pay any sum which the deceased would have been liable to pay, if he had not died, in the like manner and to the same extent as the deceased:*

*Provided that, in case of any penalty payable under this Act, a legal representative shall be liable only in case the penalty has been imposed before the death of the deceased person.*

(2) *For the purposes of sub-section (1),—*

*(a) any proceeding for disgorgement, refund or an action for recovery before the Recovery Officer under this Act, except a proceeding for levy of penalty, initiated against the deceased before his death, shall be deemed to have been initiated against the legal representative, and may be continued against the legal representative from the stage at which it*

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<sup>29</sup> In exercise of powers under section 295(1) of the Income-tax Act, 1961 and rules 91 and 92 of the Second Schedule to the Income-tax Act, 1961

<sup>30</sup> Also see Part-D of this Report for discussion on this provision.

*stood on the date of the death of the deceased and all the provisions of this Act shall apply accordingly;*

*(b) any proceeding for disgorgement, refund or an action for recovery before the Recovery Officer under this Act, except a proceeding for levy of penalty, which could have been initiated against the deceased if he had survived, may be initiated against the legal representative and all the provisions of this Act shall apply accordingly.*

*(3) Every legal representative shall be personally liable for any sum payable by him in his capacity as legal representative if, while his liability for such sum remains undischarged, he creates a charge on or disposes of or parts with any assets of the estate of the deceased, which are in, or may come into, his possession, but such liability shall be limited to the value of the asset so charged, disposed of or parted with.*

*(4) The liability of a legal representative under this section shall be limited to the extent to which the estate of the deceased is capable of meeting the liability.*

*Explanation. —For the purposes of this section “legal representative” means a person who in law represents the estate of a deceased person, and includes any person who intermeddles with the estate of the deceased and where a party sues or is sued in a representative character, the person on whom the estate devolves on the death of the party so suing or sued.”*

Analogous provisions are made in the SCRA (new section 23JC) and the Depositories Act (new section 19-IC).

By virtue of the insertion of such legislation, the legal representative is now liable to pay the penalty, had the person (original defaulter) not deceased, to the extent of the estate of the deceased that is capable of meeting the liability.

### III. CONCERNS IN THE PRESENT LAW

The Committee examined the existing laws, including the provisions relating to recovery of Income Tax as applicable to the Indian securities markets and notes that adoption of the mechanism designed for recovery of income tax for recovery of dues under the securities laws has brought to the surface certain difficulties.

#### A. CHALLENGES IN THE EXISTING LAW FOR RECOVERY OF SIPHONED OFF MONIES

One of the commonly practiced securities laws violations involves monies raised through public issue of securities being siphoned off by the issuer/promoters to various sister concerns and individuals. Difficulties arise when the aspects of siphoning of the amounts comes to the notice of SEBI after the passing of the final order but during the pendency of the recovery proceedings.

The Income Tax Act, 1961 has provisions relating to the clubbing of income. Adopting the provisions of recovery under that law to securities markets has led to a unique limitation in the context of SEBI. Explanation-I to Section 28A of the SEBI Act allows the Recovery Officer to deal with transfers made to certain dependent relatives i.e. spouse, son's wife, minor child and son's minor wife- i.e. *persons with whom clubbing of income is allowed under the Income-tax Act*. This provision, however, does not extend to corporate entities, other individuals and sons or grandsons who have already attained the age of majority who may have benefitted from the default. Thus, if one promoter entity transfers the assets to another promoter entity to avoid recovery (and such entity is not one of the enumerated individuals), it becomes difficult for the Recovery Officer to deal with such transfers.



In matters which have invited judicial attention such as those of Arrow Global, Sahara group, etc., the Courts/Tribunal have specifically permitted the sale of assets belonging to third parties *inter alia* to whom monies had been allegedly siphoned off. However, it is doubtful if in the absence of directions from the Court or Tribunal, the Recovery Officer of SEBI could sell off the assets of third parties and draw up a certificate of sale in respect of assets for recovery of the siphoned off monies.

In contrast, the Committee notes that in the USA, SEC *inter alia* does disgorgement of unlawful gains against “*relief defendants*”- i.e. *any persons to whom unlawful proceeds were transferred and who have no legitimate claim to the funds or other assets*. Relief defendants are so-named because their presence in the suit is necessary in order to provide full relief. E.g. in *SEC v George and Ors*,<sup>31</sup> the court *inter alia* explained the concept and liability of relief defendants as follows -

*“57. A relief defendant (sometimes referred to as a nominal defendant) may be joined to aid the recovery of relief” and “has no ownership interest in the property which is the subject of litigation.” (emphasis supplied) SEC v. Cherif, 933 F.2d 403, 414 (7th Cir.1991); see also SEC v. Cavanagh, 155 F.3d 129, 136 (2d Cir.1998). “Federal courts may order equitable relief against [such] a person who is not accused of wrongdoing in a securities enforcement action where that person: (1) has received ill-gotten funds; and (2) does not have a legitimate claim to those funds.” Cavanagh, 155 F.3d at 136; see also Commodity Futures Trading Comm'n v. Kimberlynn Creek Ranch, Inc., 276 F.3d 187, 192 (4th Cir.2002); SEC v. Colello, 139 F.3d 674, 677 (9th Cir.1998).*

*58. Each of the relief defendants in this instance received ill-gotten funds and had no legitimate claim to those funds. (emphasis supplied) The pricey diamond ring and the \$32,000 that Dzorney received from Thorn came from funds Thorn received from investors. Because Thorn obtained the*

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<sup>31</sup> 426 F.3d 786, available at <https://openjurist.org/426/f3d/786/securities-and-exchange-commission-v-george-e-d-r-e>.

money through fraud, then gave it to Dzierney as a gift, she has no legitimate claim to the funds. To hold otherwise "would allow almost any defendant to circumvent the SEC's power to recapture fraud proceeds by the simple procedure of giving [the proceeds] to friends and relatives, without even their knowledge." (emphasis supplied) *Cavanagh*, 155 F.3d at 137.

59. Jackson, Harris and George also received ill-gotten funds from the defendants. While each of the three invested his own money in Thorn's investment scheme, the SEC showed that the money they received from the scheme came not from profits on their investments but from the investments of others. (emphasis supplied) Each of these relief defendants fails to rebut this evidence. Before the district court, Jackson came "forward with no evidence to refute the SEC's evidence that the amount Jackson received as purported profits came from other investors." D. Ct. Op. at 39-40. Jackson now claims in his briefs that the money he received back was "clearly traceable to him," Jackson Br. at 13, but he fails to identify anything in the record that supports this assertion. Matters are worse for Harris: Not only does he fail to present any evidence rebutting the SEC's proof of tracing, but he also has "concede[d] that he does not know the source of the funds" he received from Thorn. D. Ct. Op. at 38. And George, who received back more money than he contributed to the investment pool and so cannot claim he received only his own funds back, has also failed to come forward with any evidence rebutting the SEC's tracing evidence. To survive summary judgment in the face of the SEC's evidence, the relief defendants needed to present affirmative evidence, not just affirmative assertions, demonstrating a disputed issue of material fact. *Betkerur v. Aultman Hosp. Ass'n*, 78 F.3d 1079, 1087 (6th Cir.1996). They did not do so."

**Recommendation:** In view of the above, the following suggestions are made for amendments to securities laws -

- a. after the existing Explanation I to Section 11B of the SEBI Act and related provisions in Depositories Act and SCRA, the following may be inserted,-

*“Explanation II. - For the removal of doubts, it is hereby declared that the power to issue directions under this section shall include and always be deemed to have been included, the power to direct any person to whom proceeds involved in violation, of any of the provisions of this Act, or the rules or the regulations, have been transferred to and who has no legitimate claim to such proceeds.”*

- b. the existing Explanation I to Section 28A of the SEBI Act and analogous provisions in the Depositories Act and SCRA may be substituted with the following, namely, -

*“Explanation 1. — For the purposes of this section, the person's movable or immovable property or monies held in bank accounts shall include any property or monies held in bank accounts which has been transferred without adequate consideration, directly or indirectly, on or after the date when the amount specified in certificate had become due, by such person to any other person.”*

#### **B. INTERIM ATTACHMENT THROUGH THE JUDICIAL BRANCH**

The SEBI Act, 1992 has an interesting, extremely potent but seldom used power. It is the power of attachment through the judicial branch to attach any bank account or other property found in Section 11(4) (e). The recent Banning of Unregulated Deposit Schemes Act, 2019 has linked the assets attached under this provision with the

mechanism to recover monies due under section 28A of the SEBI Act, 1992. The provision reads as follows,-

“(4) Without prejudice to the provisions contained in sub-sections (1), (2), (2A) and (3) and section 11B, the Board may, by an order, for reasons to be recorded in writing, in the interests of investors or securities market, take any of the following measures, either pending investigation or inquiry or on completion of such investigation or inquiry, namely:—

(d) impound and retain the proceeds or securities in respect of any transaction which is under investigation;

(e) <sup>32</sup> [attach, for a period not exceeding ninety days, bank accounts or other property of any intermediary or any person associated with the securities market in any manner involved in violation of any of the provisions of this Act, or the rules or the regulations made thereunder:

Provided that the Board shall, within ninety days of the said attachment, obtain confirmation of the said attachment from the Special Court, established under section 26A, having jurisdiction and on such confirmation, such attachment shall continue during the pendency of the aforesaid proceedings and on conclusion of the said proceedings, the provisions of section 28A shall apply:

Provided further that only property, bank account or accounts or any transaction entered therein, so far as it relates to the proceeds actually involved in violation of any of the provisions of this Act, or

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<sup>32</sup> Substituted by the Banning of Unregulated Deposit Schemes Act, 2019 [No. 21 of 2019] w.e.f 21-2-2019. Prior to its substitution, clause (e) read as follows,-

"(e) attach, after passing of an order on an application made for approval by the Judicial Magistrate of the first class having jurisdiction, for a period not exceeding one month, one or more bank account or accounts of any intermediary or any person associated with the securities market in any manner involved in violation of any of the provisions of this Act, or the rules or the regulations made thereunder:

Provided that only the bank account or accounts or any transaction entered therein, so far as it relates to the proceeds actually involved in violation of any of the provisions of this Act, or the rules or the regulations made thereunder shall be allowed to be attached;"

the rules or the regulations made thereunder shall be allowed to be attached];”

The difficulty in utilizing this power lies in the pre-condition that only ‘proceeds in respect of a transaction under investigation’ or ‘*only property, bank account or accounts or any transaction entered therein, so far as it relates to the proceeds actually involved in violation of any of the provisions of this Act, or the rules or the regulations made thereunder shall be allowed to be attached.*’

This pre-condition of proving at the interim stage itself that the monies and assets involved in the violation be *traced and identified* makes the use of interim attachment quite limited and self-defeating. Comparatively the Recovery Officer has no such limitation and can order the attachment and sale of all or any property for the purpose of recovering the monies due, whether or not such property relates to the violation of securities laws. However, this is too little too late. By the time recovery begins, the defaulting entity would have by then ensured that his assets are beyond the reach of the enforcement agencies. This prejudicially affects the actual amount of money that can be recovered.

In comparison, the US SEC has no such limitation on its powers. In *Federal Trade Commission v. Bronson Partners, LLC*<sup>33</sup>, the court *inter alia* held that:

“But when a public entity seeks disgorgement it does not claim any entitlement to particular property; it seeks only to “deter violations of the laws by depriving violators of their ill-gotten gains.” *Fischbach*, 133 F.3d at 175....In light of this distinction, it is unsurprising that Bronson can point to no case in which a public agency seeking to obtain equitable monetary relief has been required to satisfy the tracing rules. To the contrary, the Federal Reporter is replete with instances in which judges of this Court deeply familiar with equity practice have permitted the SEC to obtain disgorgement without any mention of tracing.”

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<sup>33</sup> 654 F.3d 359 (2d Cir. 2011), available at <<https://www.courtlistener.com/opinion/223605/ftc-v-bronson-partners-llc/>>.

Though initially US Federal Courts had placed such a limitation on the US SEC; subsequently they realised the inequitable result that such a limitation would place on the SEC and the requirement that funds should be traceable to the violation for granting a temporary asset freeze was removed. The Court in *SEC v Lauer & Ors.*<sup>34</sup>, *inter alia* explained the development of law in this respect as follows,-

“Lauer cites, among other cases, *S.E.C. v. First City Financial Corp., Ltd.*, 890 F.2d 1215, 1230 (D.C.Cir.1989) ("First City") which states that because "disgorgement primarily serves to prevent unjust enrichment, the court may exercise its equitable power only over property causally related to the wrongdoing." Several cases have cited First City for this proposition, most notably for our purposes, *CFTC v. Sidoti*, 178 F.3d 1132, 1138 (11th Cir.1999), and *SEC v. Gane*, 2005 WL 90154, \*19 (S.D.Fla. 2005) (Gonzales, J.). The Eleventh Circuit, relying upon First City, held that "the district court may not disgorge profits obtained without the aid of any wrongdoing." *Sidoti*, 178 F.3d at 1138. The Sidoti Court went on to find that the district court had abused its discretion for ordering disgorgement of profits for a period during which there was no record evidence of fraud.

Subsequent to First City, the Court of Appeals for the District of Columbia reviewed the narrow interpretation Lauer proposes for the holding in First City and held to do so conflicts with longstanding precedent and would lead to a monstrous doctrine that would perpetuate rather than correct an inequity. In *SEC v. Banner Fund Int'l, et al.*, 211 F.3d 602, 617 (D.C.Cir.2000), the Court of Appeals explained: (emphasis supplied)

“Because disgorgement is an equitable obligation to return a sum equal to the amount wrongfully obtained, rather than a requirement to replevy a specific asset, we reject Blackwell's challenge and affirm the district court.

. . . As the SEC points out, the requirement of a causal relationship between a wrongful act and the property to be disgorged does not imply that a court may order a malefactor to disgorge only the actual property obtained by means of his wrongful act. Rather, the causal connection required is between the amount by which the defendant was unjustly enriched and the amount he can be required to disgorge. To hold, as Blackwell maintains, that a court may order a defendant to disgorge only the actual assets unjustly received would lead to absurd results. Under Blackwell's approach, for example, a defendant who was careful

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<sup>34</sup> 445 F. Supp. 2d 1362 (S.D. Fla. 2006), available at <<https://www.courtlistener.com/opinion/2499896/sec-v-lauer/>>.

to spend all the proceeds of his fraudulent scheme, while husbanding his other assets, would be immune from an order of disgorgement. Blackwell's would be a monstrous doctrine for it would perpetuate rather than correct an inequity. (emphasis supplied)”

Many district courts faced with this argument agree that "[t]here is no requirement that frozen assets be traceable to the fraudulent activity underlying a lawsuit." *SEC v. Dennis Crowley*, Case No. 0480354-Civ-Middlebrooks, Slip. Op. (S.D.Fla.2004) (order by consent by Magistrate Judge Johnson) [DE 1368, Ex. I]; see also *SEC v. A.B. Financing and Inv., Inc.*, Case No. 02-23487-Civ-Ungaro-Benages, Slip. Op. at 2-3. (S.D.Fla.2003) ("a district court may freeze assets not specifically traced to illegal activity" quoting *Levi Strauss & Co. v. Sunrise Int'l Trading Inc.*, 51 F.3d 982 (11th Cir.1995)) [DE 1368, Ex. J]; *SEC v. Belmonte*, No. 88 6557, 1991 WL 214252 (S.D.Fla.1991) (Roettger, J.) (refusing to release funds from sale of home, even though home had been acquired prior to alleged fraud, because there had been no showing that ill-gotten funds had not been used to subsidize mortgage payments or improve home); *SEC v. Current Financial Svcs.*, 62 F. Supp. 2d 66, 68 (D.D.Cir.1999) (refusing to release personal funds not traceable to the fraud because defendant's liability exceeded total funds frozen); *SEC v. Grossman*, 887 F. Supp. 649, 661 (S.D.N.Y.1995) ("it is irrelevant whether the funds affected by the Asset Freeze are traceable to the illegal activity") (aff'd, 101 F.3d 109 (2d Cir. 1996)); *SEC v. Roor*, No. 99-3372, 1999 WL 553823 at \*2 (S.D.N.Y.1999) (denying motion to release so-called "untainted" funds from mortgage of property that pre-existed alleged fraud); *SEC v. Glauberman*, No. 90-5205, 1992 WL 175270 at \*1 (S.D.N.Y.1992) (rejecting defendant's argument that funds subject to disgorgement must be traced "dollar for dollar" to the illegal activity). (emphasis supplied)

....The amount of assets to be frozen, prior to the finding of liability, is determined not by whether the funds themselves are traceable to the fraudulent activity underlying the lawsuit, but by showing a reasonable approximation of the amount, with interest, the defendant was unjustly enriched. *Id.*; *SEC v. Blatt* 583 F.2d 1325, 1335 (5th Cir.1978). (emphasis supplied)”

**Recommendation:** It may be appropriate to seek amendment to the following provisions of the SEBI Act, 1992, -

- i. Clause (d) of Section 11(4) may be amended as follows,-

“impound and retain ~~the proceeds or securities~~ **or monies not exceeding the value of the proceeds, inclusive of suitable interest thereon**, in respect of any transaction which is under investigation;”

- ii. The second proviso to clause (e) of Section 11(4) may be amended as follows,-

“Provided further that only property, bank account or accounts or any transaction entered therein, ~~so far as it relates to~~ **not exceeding the value of the proceeds actually** involved in violation of any of the provisions of this Act, or the rules or the regulations made thereunder, **inclusive of suitable interest thereon**, shall be allowed to be attached.”

#### C. ‘MODIFICATIONS’ TO THE FRAMEWORK OF RECOVERY UNDER THE INCOME TAX ACT, 1961

While sub-section (1) of section 28A of the SEBI Act (and analogous provisions in the SCRA and Depositories Act) provides leeway for modification, no guidance is provided as to how such “**modification**” is to be effected. The relevant recovery provisions of the Income-tax Act, 1961 and the Income-tax (Certificate Proceedings) Rules, 1962 with necessary modifications are considered to be part of the SEBI Act, the SCRA and Depositories Act. i.e. sections 220 to 227, 228A, 229, 232, the Second and Third Schedules to the Income-tax Act, 1961 and the Income-tax (Certificate Proceedings) Rules, 1962, as in force from time to time, in so far as may be, apply with necessary modifications as if the said provisions and the rules made thereunder were the provisions of the SEBI Act.

It is common for enactments to have provisions which expressly provide that delegated legislation shall have effect as ‘if enacted in this Act.’ It is also common for the enactments to declare how the modifications in such cases are to be made. e.g. Section



35 of the Hampi World Heritage Area Management Authority Act, 2002 provides as follows:-

“(1) If any difficulty arises in giving effect to the provisions of this Act, the State Government may by order published in the Official Gazette, as the occasion may require do anything which appears to it to be necessary to remove the difficulty.

(2) Every order made under sub-section (1) shall as soon as may be after it is published, be laid before both Houses of the State Legislature and shall, subject to any modification which the State Legislature may make, have effect as if enacted in this Act.”

However, Section 28A of the SEBI Act is silent in respect of the various modifications to sections 220 to 227, 228A, 229, 232, the Second and Third Schedules to the Income-tax Act, 1961 and the Income-tax (Certificate Proceedings) Rules, 1962 when applied in the securities markets context. Hence, the Committee is of the view that the delegated legislation made in the ordinary way so as to carry out the purposes of the Act is the mode through which such modifications may be made.

No rules have been prescribed under the SEBI Act in relation to Section 28A and the modifications to the provisions of Income-tax Act, 1961 and the Income-tax (Certificate Proceedings) Rules, 1962 which are deemed to be part of the SEBI Act.

Considering that modifications are to be done while applying the provisions of the Income-tax Act, 1961 and the Certificate Rules, it would be appropriate if such modifications are clarified through regulations since section 30 of the SEBI Act (and analogous provisions in the SCRA and Depositories Act) permits the Board to make regulations consistent with the SEBI Act and the rules made thereunder to carry out the purposes of the Act.

Hence, the Committee is of the view that since the relevant provisions of the Income-tax Act, 1961 and the Income-tax (Certificate Proceedings) Rules, 1962 are deemed to be part of the statute itself, it is possible to frame regulations under the SEBI Act *inter alia* clarifying the modifications in such provisions as well as any enhancements in process within the basic framework relating to a Recovery officer.

**IV. SUITABLE APPLICATION BY MODIFICATION OF CERTAIN PROVISIONS OF THE INCOME-TAX ACT, 1961**

Section 28A of the SEBI Act and the analogous provisions of the SCRA and the Depositories Act refers to the provisions of sections 220-227, 228A, 229 and 232 of the Income-tax Act, 1961. These provisions are substantive in nature. Therefore, the Committee is of the view that in the light of the suggestions made to have comprehensive regulations for the purposes of “recovery” under the securities laws, the aforesaid provisions of the Income-tax Act, 1961 be suitably modified in the securities laws in the context of recovery proceedings intended by the Board.

The Committee suggests the following modifications: -

<b>Sr. No.</b>	<b>Provisions of the Income-tax Act, 1961</b>	<b>Suggested modification for SEBI</b>
<b>I.</b>	<p><b>When tax payable and when assessee deemed in default.</b></p> <p><b>220.</b> (1) Any amount, otherwise than by way of advance tax, specified as payable in a notice of demand under section 156 shall be paid within thirty days of the service of the notice at the place and to the person</p>	<p><b>Amounts when payable.</b></p> <p>(1) Any penalty or refund of monies or disbursement of amounts or fees due to the Board, under the Act<sup>35</sup> or the Securities Contracts (Regulation) Act, 1956 or the Depositories Act, 1996, shall be paid within thirty days of service of notice or in terms of the</p>

<sup>35</sup> ‘Act’ in these suggested modifications means the SEBI Act, 1992.

<p>mentioned in the notice :</p> <p><b>Provided</b> that, where the Assessing Officer has any reason to believe that it will be detrimental to revenue if the full period of thirty days aforesaid is allowed, he may, with the previous approval of the Joint Commissioner, direct that the sum specified in the notice of demand shall be paid within such period being a period less than the period of thirty days aforesaid, as may be specified by him in the notice of demand.</p> <p>(1A) Where any notice of demand has been served upon an assessee and any appeal or other proceeding, as the case may be, is filed or initiated in respect of the amount specified in the said notice of demand, then, such demand shall be deemed to be valid till the disposal of the appeal by the last appellate authority or disposal of the proceedings, as the case may be, and any such notice of demand shall have the effect as specified in section 3 of the Taxation Laws (Continuation and Validation of Recovery Proceedings) Act, 1964 (11 of 1964).</p> <p>(2) If the amount specified in any notice of demand under section 156 is</p>	<p>regulations issued or an order passed by the Board:</p> <p>Provided that where the Recovery Officer has reason to believe that it will be detrimental if the full period of thirty days as aforesaid is allowed, he may, with the previous approval of the Board, direct that the sum specified in the notice of demand be paid within such period being a period less than the period of thirty days, as may be specified by him in the notice of demand.</p> <p>Explanation. – The order imposing penalty, directing refund or directing disgorgement shall be deemed to be a notice of demand.</p> <p>(2) Where any notice of demand has been served upon any person and any appeal or other proceeding, as the case may be, is filed or initiated in respect of the amount specified in the said notice of demand, either by the person or the Board, then such a demand shall be deemed to be valid till the disposal of the proceedings, as the case may be, and any such notice of demand shall have the following effect:</p> <p>(a) where the dues are enhanced</p>
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<p>not paid within the period limited under sub-section (1), the assessee shall be liable to pay simple interest at one per cent for every month or part of a month comprised in the period commencing from the day immediately following the end of the period mentioned in sub-section (1) and ending with the day on which the amount is paid :</p> <p><b>Provided</b> that, where as a result of an order under section 154, or section 155, or section 250, or section 254, or section 260, or section 262, or section 264 or an order of the Settlement Commission under sub-section (4) of section 245D, the amount on which interest was payable under this section had been reduced, the interest shall be reduced accordingly and the excess interest paid, if any, shall be refunded :</p> <p><b>Provided further</b> that where as a result of an order under sections specified in the first proviso, the amount on which interest was payable under this section had been reduced and subsequently as a result of an order under said sections or section 263, the amount on which interest was</p>	<p>in such appeal or proceedings or interest accrues on such monies due to the passage of time; another notice of demand only in respect of the amount by which such dues are enhanced, without the service of any fresh notice of demand, shall be continued from the stage at which such proceedings stood immediately prior to such disposal;</p> <p>(b) where the dues are reduced in such appeal or proceedings, an intimation of the fact of such reduction shall be issued to the person;</p> <p>(c) no proceedings in relation to such dues (including the imposition of penalty or charging of interest) shall be invalid by reason only that no fresh notice of demand was served upon the person after the disposal of such appeal or proceeding or that such dues have been enhanced or reduced in such appeal or proceeding:</p>
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<p>payable under this section is increased, the assessee shall be liable to pay interest under sub-section (2) from the day immediately following the end of the period mentioned in the first notice of demand, referred to in sub-section (1) and ending with the day on which the amount is paid:</p> <p><b>Provided also</b> that in respect of any period commencing on or before the 31st day of March, 1989 and ending after that date, such interest shall, in respect of so much of such period as falls after that date, be calculated at the rate of one and one-half per cent for every month or part of a month.</p> <p>(2A) Notwithstanding anything contained in sub-section (2), the Principal Chief Commissioner or Chief Commissioner or Principal Commissioner or Commissioner may reduce or waive the amount of interest paid or payable by an assessee under the said sub-section if he is satisfied that—</p> <p>(i) payment of such amount has caused or would cause genuine hardship to the assessee;</p> <p>(ii) default in the payment of the amount on which interest has</p>	<p>Provided that where any dues are reduced in such appeal or proceeding and the person is entitled to any refund thereof, such refund shall be made in accordance with the provisions of these regulations.</p> <p>(3) For the removal of doubts, it is hereby declared that no fresh notice of demand shall be necessary in any case where the amount of dues is not varied as a result of any order passed in any appeal or other proceeding.</p> <p>(4) The person who is liable to pay the dues as specified in sub-regulation (1), shall be liable to pay simple interest at the rate of 18% per annum on amounts in default from the date such amounts became due or from the date of passing of the original order by the Board or the Adjudicating Officer till the date of actual payment or realization of such dues, whichever is earlier:</p> <p>Provided that where the amount of dues has been enhanced or reduced by virtue of any order passed in appeal or proceedings, the interest thereon shall be reduced accordingly.</p> <p>(5) While drawing up any notice of demand or a certificate, the Recovery</p>
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<p>been paid or was payable under the said sub-section was due to circumstances beyond the control of the assessee; and</p> <p>(iii) the assessee has co-operated in any inquiry relating to the assessment or any proceeding for the recovery of any amount due from him:</p> <p><b>Provided</b> that the order accepting or rejecting the application of the assessee, either in full or in part, shall be passed within a period of twelve months from the end of the month in which the application is received:</p> <p><b>Provided further</b> that no order rejecting the application, either in full or in part, shall be passed unless the assessee has been given an opportunity of being heard:</p> <p><b>Provided also</b> that where any application is pending as on the 1st day of June, 2016, the order shall be passed on or before the 31st day of May, 2017.</p> <p>(2B) Notwithstanding anything contained in sub-section (2), where interest is charged under sub-section (1A) of section 201 on the amount of tax specified in the intimation issued under sub-section (1) of section</p>	<p>Officer shall include therein the interest as specified above.</p> <p>(6) Without prejudice to the provisions contained in this regulation, on an application made by the person before the expiry of the due date under sub-regulation (1), the Board or the Recovery Officer on approval of the Board, for reasons to be recorded in writing, may extend the time for payment or allow payment by instalments, subject to such conditions as may be imposed considering the facts and circumstances of the case:</p> <p>Provided that extension of time or payment by instalments shall not be granted beyond a period of twenty-four months from the date of expiry of the period specified in sub-regulation (1).</p> <p>(7) Where the amount is not paid within the time specified in sub-regulation (1) or extended under sub-regulation (6), as the case may be, the person shall be deemed to be in default.</p> <p>(8) Where payment by instalments is allowed under sub-regulation (6), the person who commits a default in</p>
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<p>200A for any period, then, no interest shall be charged under sub-section (2) on the same amount for the same period.</p> <p>(2C) Notwithstanding anything contained in sub-section (2), where interest is charged under sub-section (7) of section 206C on the amount of tax specified in the intimation issued under sub-section (1) of section 206CB for any period, then, no interest shall be charged under sub-section (2) on the same amount for the same period.</p> <p>(3) Without prejudice to the provisions contained in sub-section (2), on an application made by the assessee before the expiry of the due date under sub-section (1), the Assessing Officer may extend the time for payment or allow payment by instalments, subject to such conditions as he may think fit to impose in the circumstances of the case.</p> <p>(4) If the amount is not paid within the time limited under sub-section (1) or extended under sub-section (3), as the case may be, at the place and to the person mentioned in the said notice the assessee shall be deemed to be in</p>	<p>paying any one of the instalments within the time fixed under that sub-section, shall be deemed to be in default as to the whole of the amount then outstanding, and the other instalment or instalments shall be deemed to have been due on the same date as the instalment which is actually in default.</p> <p>(9) Where the persons has preferred an appeal before the Securities Appellate Tribunal, the Board or the Recovery Officer subject to such conditions as he may think fit to impose in the circumstances of the case and for reasons to be recorded in writing, treat the person as not being in default in respect of the amount due, even though the time for payment has expired, as long as such appeal remains undisposed of.</p>
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<p>default.</p> <p>(5) If, in a case where payment by instalments is allowed under sub-section (3), the assessee commits defaults in paying any one of the instalments within the time fixed under that sub-section, the assessee shall be deemed to be in default as to the whole of the amount then outstanding, and the other instalment or instalments shall be deemed to have been due on the same date as the instalment actually in default.</p> <p>(6) Where an assessee has presented an appeal under section 246 or section 246A the Assessing Officer may, in his discretion and subject to such conditions as he may think fit to impose in the circumstances of the case, treat the assessee as not being in default in respect of the amount in dispute in the appeal, even though the time for payment has expired, as long as such appeal remains undisposed of.</p> <p>(7) Where an assessee has been assessed in respect of income arising outside India in a country the laws of which prohibit or restrict the remittance of money to India, the Assessing Officer shall not treat the</p>	
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	<p>assessee as in default in respect of that part of the tax which is due in respect of that amount of his income which, by reason of such prohibition or restriction, cannot be brought into India, and shall continue to treat the assessee as not in default in respect of such part of the tax until the prohibition or restriction is removed.</p> <p><i>Explanation.</i>—For the purposes of this section, income shall be deemed to have been brought into India if it has been utilised or could have been utilised for the purposes of any expenditure actually incurred by the assessee outside India or if the income, whether capitalised or not, has been brought into India in any form.</p>	
<p><b>II.</b></p>	<p><b>Penalty payable when tax in default.</b></p> <p><b>221.</b> (1) When an assessee is in default or is deemed to be in default in making a payment of tax, he shall, in addition to the amount of the arrears and the amount of interest payable under subsection (2) of <u>section 220</u>, be liable, by way of penalty, to pay such amount as the Assessing Officer may direct, and in the case of a continuing default, such further amount or amounts as the</p>	<p><b>Liability for other action.</b></p> <p>A person in default or deemed to be in default in making payment of dues, in addition to the amount which is due and the amount of interest payable on such dues, may be liable for any other action under the Act or the Securities Contracts (Regulation) Act, 1956 or the Depositories Act, 1996, as the case may be.</p>

	<p>Assessing Officer may, from time to time, direct, so, however, that the total amount of penalty does not exceed the amount of tax in arrears :</p> <p><b>Provided</b> that before levying any such penalty, the assessee shall be given a reasonable opportunity of being heard:</p> <p><b>Provided further</b> that where the assessee proves to the satisfaction of the Assessing Officer that the default was for good and sufficient reasons, no penalty shall be levied under this section.</p> <p><i>Explanation.</i>—For the removal of doubt, it is hereby declared that an assessee shall not cease to be liable to any penalty under this sub-section merely by reason of the fact that before the levy of such penalty he has paid the tax.</p> <p>(2) Where as a result of any final order the amount of tax, with respect to the default in the payment of which the penalty was levied, has been wholly reduced, the penalty levied shall be cancelled and the amount of penalty paid shall be refunded.</p>	
<p><b>III.</b></p>	<p><b>Certificate to Tax Recovery Officer.</b></p>	<p><b>Certificate.</b> (1) When a person is in default or is</p>

<p><b>222.</b> (1) When an assessee is in default or is deemed to be in default in making a payment of tax, the Tax Recovery Officer may draw up under his signature a statement in the prescribed form specifying the amount of arrears due from the assessee (such statement being hereafter in this Chapter and in the Second Schedule referred to as "certificate") and shall proceed to recover from such assessee the amount specified in the certificate by one or more of the modes mentioned below, in accordance with the rules laid down in the Second Schedule—</p> <ul style="list-style-type: none"> <li>(a) attachment and sale of the assessee's movable property;</li> <li>(b) attachment and sale of the assessee's immovable property;</li> <li>(c) arrest of the assessee and his detention in prison;</li> <li>(d) appointing a receiver for the management of the assessee's movable and immovable properties.</li> </ul> <p><i>Explanation.</i>—For the purposes of this sub-section, the assessee's movable or immovable property shall include any property which has been transferred, directly or indirectly on or after the 1st</p>	<p>deemed to be in default in making a payment of dues, namely, -</p> <ul style="list-style-type: none"> <li>(a) a penalty imposed under the Act, the Securities Contracts (Regulations) Act, 1956 or the Depositories Act, 1996; or</li> <li>(b) any amount payable on failure of any person to refund any monies as directed by the Board; or</li> <li>(c) any amount payable on failure of any person to disgorge monies as directed by the Board; or</li> <li>(d) any fees due to the Board,</li> </ul> <p>the Recovery Officer shall draw up under his signature, a written statement in the form mentioning the amount due from the person (such statement being hereafter referred to as "certificate") and shall proceed to recover from such person, the amount specified in the certificate by one or more of the modes specified in these regulations and in accordance with these regulations.</p> <p>(2) The Recovery Officer may take action under sub-regulation (1), notwithstanding that proceedings for</p>
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	<p>day of June, 1973, by the assessee to his spouse or minor child or son's wife or son's minor child, otherwise than for adequate consideration, and which is held by, or stands in the name of, any of the persons aforesaid; and so far as the movable or immovable property so transferred to his minor child or his son's minor child is concerned, it shall, even after the date of attainment of majority by such minor child or son's minor child, as the case may be, continue to be included in the assessee's movable or immovable property for recovering any arrears due from the assessee in respect of any period prior to such date.</p> <p>(2) The Tax Recovery Officer may take action under sub-section (1), notwithstanding that proceedings for recovery of the arrears by any other mode have been taken.</p>	<p>recovery of the arrears by any other mode have been taken.</p>
<p><b>IV.</b></p>	<p><b>Tax Recovery Officer by whom recovery is to be effected.</b></p> <p><b>223.</b> (1) The Tax Recovery Officer competent to take action under <u>section 222</u> shall be—</p> <p>(a) the Tax Recovery Officer within whose jurisdiction the assessee carries on his business or</p>	<p><b>Recovery Officer by whom recovery is to be effected.</b></p> <p>(1) The Recovery Officer competent to take action shall be—</p> <p>(a) the Recovery Officer within whose jurisdiction the defaulter carries on his business or profession or</p>

<p>profession or within whose jurisdiction the principal place of his business or profession is situate, or</p> <p>(b) the Tax Recovery Officer within whose jurisdiction the assessee resides or any movable or immovable property of the assessee is situate,</p> <p>the jurisdiction for this purpose being the jurisdiction assigned to the Tax Recovery Officer under the orders or directions issued by the Board, or by the Principal Chief Commissioner or Chief Commissioner or Principal Commissioner or Commissioner who is authorised in this behalf by the Board in pursuance of <u>section 120</u>.</p> <p>(2) Where an assessee has property within the jurisdiction of more than one Tax Recovery Officer and the Tax Recovery Officer by whom the certificate is drawn up—</p> <p>(a) is not able to recover the entire amount by sale of the property, movable or immovable, within his jurisdiction, or</p> <p>(b) is of the opinion that, for the purpose of expediting or securing the recovery of the</p>	<p>within whose jurisdiction the principal place of his business or profession is situate, or</p> <p>(b) the Recovery Officer within whose jurisdiction the defaulter resides or any movable or immovable property of the person is situate,</p> <p>the jurisdiction for this purpose being the jurisdiction assigned to the Recovery Officers under the orders or directions issued by the Board.</p> <p>(2) Where a person has property within the jurisdiction of more than one Recovery Officer and the Recovery Officer by whom the certificate is drawn up—</p> <p>(a) is not able to recover the entire amount by sale of the property, movable or immovable, within his jurisdiction, or</p> <p>(b) is of the opinion that, for the purpose of expediting or securing the recovery of the whole or any part of the amount under this Chapter, it is necessary so to do,</p> <p>he may send the certificate or, where</p>
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	<p>whole or any part of the amount under this Chapter, it is necessary so to do, he may send the certificate or, where only a part of the amount is to be recovered, a copy of the certificate certified in the prescribed manner<sup>5Z</sup> and specifying the amount to be recovered to a Tax Recovery Officer within whose jurisdiction the assessee resides or has property and, thereupon, that Tax Recovery Officer shall also proceed to recover the amount under this Chapter as if the certificate or copy thereof had been drawn up by him.</p>	<p>only a part of the amount is to be recovered, a copy of the certificate certified in the specified manner and specifying the amount to be recovered to a Recovery Officer within whose jurisdiction the person resides or has property and, thereupon, that Recovery Officer shall also proceed to recover the amount under these regulations as if the certificate or a copy thereof had been drawn up by him.</p>
<b>V.</b>	<p><b>Validity of certificate and cancellation or amendment thereof.</b></p> <p><b>224.</b> It shall not be open to the assessee to dispute the correctness of any certificate drawn up by the Tax Recovery Officer on any ground whatsoever, but it shall be lawful for the Tax Recovery Officer to cancel the certificate if, for any reason, he thinks it necessary so to do, or to correct any clerical or arithmetical mistake therein.</p>	<p><b>Validity of certificate and cancellation or amendment thereof.</b></p> <p>No person shall be allowed to dispute the correctness of any certificate drawn up by the Recovery Officer on any ground whatsoever, but it shall be lawful for the Recovery Officer to cancel the certificate if, for any reason, he thinks it necessary so to do, or to correct any clerical or mathematical error therein.</p>
<b>V.</b>	<b>Stay of proceedings in pursuance</b>	<b>Stay of proceedings in</b>

<p><b>of certificate and amendment or cancellation thereof.</b></p> <p><b>225.</b> (1) It shall be lawful for the Tax Recovery Officer to grant time for the payment of any tax and when he does so, he shall stay the proceedings for the recovery of such tax until the expiry of the time so granted.</p> <p>(2) Where the order giving rise to a demand of tax for which a certificate has been drawn up is modified in appeal or other proceeding under this Act, and, as a consequence thereof, the demand is reduced but the order is the subject-matter of further proceeding under this Act, the Tax Recovery Officer shall stay the recovery of such part of the amount specified in the certificate as pertains to the said reduction for the period for which the appeal or other proceeding remains pending.</p> <p>(3) Where a certificate has been drawn up and subsequently the amount of the outstanding demand is reduced as a result of an appeal or other proceeding under this Act, the Tax Recovery Officer shall, when the order which was the subject-matter of such appeal or other proceeding has become final and</p>	<p><b>pursuance of certificate and amendment or cancellation thereof.</b></p> <p>(1) It shall be lawful for the Recovery Officer to grant time for the payment of any dues and when he does so, he shall stay the proceedings for the recovery of such dues until the expiry of the time so granted.</p> <p>(2) Where the order giving rise to a demand of dues for which a certificate has been drawn up is modified in appeal or other proceeding under the Act or the Securities Contracts (Regulation) Act, 1956 or the Depositories Act, 1996, and, as a consequence thereof, the demand is reduced but the order is the subject-matter of further proceeding under the aforesaid Acts, the Recovery Officer shall stay the recovery of such part of the amount specified in the certificate that pertains to the said reduction for the period for which the appeal or other proceeding remains pending.</p> <p>(3) Where a certificate has been drawn up and subsequently the amount of the outstanding demand is reduced as a result of an appeal or</p>
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	<p>conclusive, amend the certificate, or cancel it, as the case may be.</p>	<p>other proceeding under the Acts mentioned in sub-regulation (2), the Recovery Officer shall, when the order which was the subject-matter of such appeal or other proceeding has become final and conclusive, amend the certificate, or cancel it, as the case may be.</p>
<p><b>VI.</b></p>	<p><b>Other modes of recovery.</b></p> <p><b>226.</b> (1) Where no certificate has been drawn up under <u>section 222</u>, the Assessing Officer may recover the tax by any one or more of the modes provided in this section.</p> <p>(1A) Where a certificate has been drawn up under <u>section 222</u>, the Tax Recovery Officer may, without prejudice to the modes of recovery specified in that section, recover the tax by any one or more of the modes provided in this section.</p> <p>(2) If any assessee is in receipt of any income chargeable under the head "Salaries", the Assessing Officer or Tax Recovery Officer may require any person paying the same to deduct from any payment subsequent to the date of such requisition any arrears of tax due from such assessee, and such person shall comply with any such requisition</p>	<p><b>Other modes of recovery.</b></p> <p>(1) Where a certificate has been drawn up, the Recovery Officer may, without prejudice to the modes of recovery specified in that section (s), recover the dues by any one or more of the other modes provided in these regulation.</p> <p>(2) If any person is in receipt of any income in the nature of salary, the Recovery Officer may require any person paying the same to deduct from any payment subsequent to the date of such requisition any dues from such person, and such person shall comply with any such requisition and shall pay the sum so deducted to the credit of the Board or as directed by the Recovery Officer: Provided that any part of the salary exempt from attachment in execution of a decree of a civil court under</p>



<p>and shall pay the sum so deducted to the credit of the Central Government or as the Board directs:</p> <p><b>Provided</b> that any part of the salary exempt from attachment in execution of a decree of a civil court under section 60 of the Code of Civil Procedure, 1908 (5 of 1908), shall be exempt from any requisition made under this sub-section.</p> <p>(3) (i) The Assessing Officer or Tax Recovery Officer may, at any time or from time to time, by notice in writing require any person from whom money is due or may become due to the assessee or any person who holds or may subsequently hold money for or on account of the assessee to pay to the Assessing Officer or Tax Recovery Officer either forthwith upon the money becoming due or being held or at or within the time specified in the notice (not being before the money becomes due or is held) so much of the money as is sufficient to pay the amount due by the assessee in respect of arrears or the whole of the money when it is equal to or less than that amount.</p> <p>(ii) A notice under this sub-section may</p>	<p>section 60 of the Code of Civil Procedure, 1908 (5 of 1908), shall be exempt from any requisition made under this sub-regulation.</p> <p>(3) (i) The Recovery Officer may, at any time or from time to time, by notice in writing require any person from whom money is due or may become due to the defaulter or any person who holds or may subsequently hold money for or on account of the defaulter to pay to the Recovery Officer either forthwith upon the money becoming due or being held or at or within the time specified in the notice (not being before the money becomes due or is held) so much of the money as is sufficient to pay the amount due by the defaulter in respect of dues or the whole of the money when it is equal to or less than that amount.</p> <p>Provided that wherever the defaulter has a right to demand payment of any amount before such amount becomes payable under any contract, certificate or instrument, it shall be lawful for the Recovery Officer to demand payment of the amount forthwith.</p>
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<p>be issued to any person who holds or may subsequently hold any money for or on account of the assessee jointly with any other person and for the purposes of this sub-section, the shares of the joint holders in such account shall be presumed, until the contrary is proved, to be equal.</p> <p>(iii) A copy of the notice shall be forwarded to the assessee at his last address known to the Assessing Officer or Tax Recovery Officer, and in the case of a joint account to all the joint holders at their last addresses known to the Assessing Officer or Tax Recovery Officer.</p> <p>(iv) Save as otherwise provided in this sub-section, every person to whom a notice is issued under this sub-section shall be bound to comply with such notice, and, in particular, where any such notice is issued to a post office, banking company or an insurer, it shall not be necessary for any pass book, deposit receipt, policy or any other document to be produced for the purpose of any entry, endorsement or the like being made before payment is made, notwithstanding any rule, practice or requirement to the</p>	<p>(ii) A notice under this sub-regulation may be issued to any person who holds or may subsequently hold any money for or on account of the defaulter jointly with any other person and for the purposes of this sub-regulation, the shares of the joint holders in such account shall be presumed, until the contrary is proved, to be equal.</p> <p>(iii) A copy of the notice shall be forwarded to the defaulter at his last address known to the Recovery Officer, and in the case of a joint account to all the joint holders at their last addresses known to the Recovery Officer.</p> <p>(iv) Save as otherwise provided in this sub-regulation, every person to whom a notice is issued under this sub-regulation shall be bound to comply with such notice, and, where any such notice is issued to a post office, banking company or an insurer, in particular, it shall not be necessary that the pass book, deposit receipt, policy or any other document be produced for the purpose of any entry, endorsement or the like being made before payment is made,</p>
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<p>contrary.</p> <p>(v) Any claim respecting any property in relation to which a notice under this sub-section has been issued arising after the date of the notice shall be void as against any demand contained in the notice.</p> <p>(vi) Where a person to whom a notice under this sub-section is sent objects to it by a statement on oath that the sum demanded or any part thereof is not due to the assessee or that he does not hold any money for or on account of the assessee, then nothing contained in this sub-section shall be deemed to require such person to pay any such sum or part thereof, as the case may be, but if it is discovered that such statement was false in any material particular, such person shall be personally liable to the Assessing Officer or Tax Recovery Officer to the extent of his own liability to the assessee on the date of the notice, or to the extent of the assessee's liability for any sum due under this Act, whichever is less.</p> <p>(vii) The Assessing Officer or Tax Recovery Officer may, at any time or from time to time, amend or revoke</p>	<p>notwithstanding any rule, practice or requirement to the contrary.</p> <p>(v) Any claim in respect of any property in relation to which a notice under these regulations has been issued arising after the date of the notice shall be void as against any demand contained in the notice.</p> <p>(vi) Where a person to whom a notice under this sub-regulation is sent objects to it by a statement on oath that the sum demanded or any part thereof is not due to the defaulter or that he does not hold any money for or on account of the defaulter, then nothing contained in this sub-regulation shall be deemed to require such person to pay any such sum or part thereof, as the case may be, but if it is discovered that such statement was false in any material particular, such person shall be personally liable to the Recovery Officer to the extent of his own liability to the defaulter, or to the extent of the defaulter's liability for any sum due under these regulations, whichever is less.</p> <p>(vii) The Recovery Officer may, at any time or from time to time, amend or revoke any notice issued under this</p>
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<p>any notice issued under this sub-section or extend the time for making any payment in pursuance of such notice.</p> <p>(viii) The Assessing Officer or Tax Recovery Officer shall grant a receipt for any amount paid in compliance with a notice issued under this sub-section, and the person so paying shall be fully discharged from his liability to the assessee to the extent of the amount so paid.</p> <p>(ix) Any person discharging any liability to the assessee after receipt of a notice under this sub-section shall be personally liable to the Assessing Officer or Tax Recovery Officer to the extent of his own liability to the assessee so discharged or to the extent of the assessee's liability for any sum due under this Act, whichever is less.</p> <p>(x) If the person to whom a notice under this sub-section is sent fails to make payment in pursuance thereof to the Assessing Officer or Tax Recovery Officer, he shall be deemed to be an assessee in default in respect of the amount specified in the notice and further proceedings may be taken against him for the realisation of the</p>	<p>sub-regulation or extend the time for making any payment in pursuance of such notice.</p> <p>(viii) The Recovery Officer shall grant a receipt for any amount paid in compliance with a notice issued under this sub-regulation, and the person so paying shall be fully discharged from his liability to the defaulter to the extent of the amount so paid.</p> <p>(ix) Any person discharging any liability to the defaulter after receipt of a notice under this sub-regulation shall be personally liable to the Recovery Officer to the extent of his own liability to the defaulter so discharged or to the extent of the defaulter's liability for any sum due under these regulations, whichever is less.</p> <p>(x) Where the person to whom a notice under this sub-regulation is sent, fails to make payment in pursuance thereof to the Recovery Officer, he shall be deemed to be a person in default in respect of the amount specified in the notice and further proceedings may be continued against him for the</p>
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	<p>amount as if it were an arrear of tax due from him, in the manner provided in <u>sections 222 to 225</u> and the notice shall have the same effect as an attachment of a debt by the Tax Recovery Officer in exercise of his powers under <u>section 222</u>.</p> <p>(4) The Assessing Officer or Tax Recovery Officer may apply to the court in whose custody there is money belonging to the assessee for payment to him of the entire amount of such money, or, if it is more than the tax due, an amount sufficient to discharge the tax.</p> <p>(5) The Assessing Officer or Tax Recovery Officer may, if so authorised by the Principal Chief Commissioner or Chief Commissioner or Principal Commissioner or Commissioner by general or special order, recover any arrears of tax due from an assessee by distraint and sale of his movable property in the manner laid down in the Third Schedule.</p>	<p>realisation of the amount as if it were arrears of dues from him, in the manner provided for under these regulations, and the notice shall have the same effect as an attachment of a debt by the Recovery Officer in exercise of his powers under these regulations.</p> <p>(4) The Recovery Officer may apply to the court in whose custody money belonging to the defaulter is available for payment to him of the entire amount of such money, or, if it is more than the dues, the amount sufficient to discharge the dues.</p> <p>(5) The Recovery Officer may, if so authorised by the Board by general or special order, recover any dues from a defaulter by distraint and sale of his movable property in the manner laid down in these regulations.</p>
<p><b>VII.</b></p>	<p><b>Recovery through State Government.</b></p> <p><b>227.</b> If the recovery of tax in any area has been entrusted to a State</p>	<p><i>(provision may not apply in the context of securities laws, hence no specific modification is suggested)</i></p>

	<p>Government under clause (1) of article 258 of the Constitution, the State Government may direct, with respect to that area or any part thereof; that tax shall be recovered therein with, and as an addition to, any municipal tax or local rate, by the same person and in the same manner as the municipal tax or local rate is recovered.</p>	
<p><b>VIII.</b></p>	<p><b>Recovery of tax in pursuance of agreements with foreign countries.</b></p> <p>228A. (1) Where an agreement is entered into by the Central Government with the Government of any country outside India for recovery of income-tax under this Act and the corresponding law in force in that country and the Government of that country or any authority under that Government which is specified in this behalf in such agreement sends to the Board a certificate for the recovery of any tax due under such corresponding law from a person having any property in India, the Board may forward such certificate to any Tax Recovery Officer within whose jurisdiction such property is situated and thereupon such Tax Recovery Officer shall—</p>	<p><i>(provision may not apply in the context of securities laws, hence no specific modification is suggested)</i></p>

<p>(a) proceed to recover the amount specified in the certificate in the manner in which he would proceed to recover the amount specified in a certificate received from an Income-tax Officer; and</p> <p>(b) remit any sum so recovered by him to the Board after deducting his expenses in connection with the recovery proceedings.</p> <p>(2) Notwithstanding the issue of a certificate under section 222 to the Tax Recovery Officer, where an assessee is in default or is deemed to be in default in making a payment of tax, the Income-tax Officer may, if the assessee has property in a country outside India (being a country with which the Central Government has entered into an agreement for the recovery of income-tax under this Act and the corresponding law in force in that country), forward to the Board a certificate specifying the amount of arrears due from the assessee and the Board may, take such action thereon as it may deem appropriate having regard to the terms of the agreement with such country.</p>	
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<p><b>IX.</b></p>	<p><b>Recovery of penalties, fine, interest and other sums.</b></p> <p><b>229.</b> Any sum imposed by way of interest, fine, penalty, or any other sum payable under the provisions of this Act, shall be recoverable in the manner provided in this Chapter for the recovery of arrears of tax.</p>	<p><i>(section 28A provides the list of dues that could be recovered, however no specific modification is suggested)</i></p>
<p><b>X.</b></p>	<p><b>Recovery by suit or under other law not affected.</b></p> <p><b>232.</b> The several modes of recovery specified in this Chapter shall not affect in any way—</p> <p>(a) any other law for the time being in force relating to the recovery of debts due to Government; or</p> <p>(b) the right of the Government to institute a suit for the recovery of the arrears due from the assessee;</p> <p>and it shall be lawful for the Assessing Officer or the Government, as the case may be, to have recourse to any such law or suit, notwithstanding that the tax due is being recovered from the assessee by any mode specified in this Chapter.</p>	<p><b>Recovery by suit or under other law not affected.</b></p> <p>The several modes of recovery specified in these regulations shall not affect in any way the right of the Board to institute a suit for the recovery of the monies due from the defaulter and it shall be lawful for the Board to have recourse to any such suit, notwithstanding that the amount due is being recovered from the defaulter by any mode specified in these regulations.</p> <p>(May be useful especially in the context of foreign persons to enforce demands)</p>



SEBI may consider incorporating the aforesaid provisions in its regulations to make it comprehensive as the provisions of sections 220 to 227, 228A, 229, 232, the Second and Third Schedules to the Income-tax Act, 1961 and the Income-tax (Certificate Proceedings) Rules, 1962 would then be part of the regulations with necessary modifications.

**VI. KEY MODIFICATIONS TO THE PROCEDURE (UNDER THE INCOME-TAX ACT AND RULES) FOR RECOVERY OF DUES UNDER SECTION 28A**

The procedure pertaining to recovery of dues is exhaustively codified under the Second Schedule to Income-tax Act, 1961 and the Income-tax (Certificate Proceedings) Rules, 1962. The Committee has considered some of the key areas in which changes may be required in the applicable procedure as suggested herein below:

- **RULE 8 OF THE SECOND SCHEDULE TO THE INCOME-TAX ACT, 1961 – DISPOSAL OF PROCEEDS OF EXECUTION:**

**Rationale for modification:**

The Board notified the <sup>36</sup>Securities and Exchange Board of India (Appointment of Administrator and Procedure for Refunding to the Investors) Regulations, 2018 on October 03, 2018. In Regulation 11 thereof, the costs of administration incurred by the Board, if any, and the fees and charges payable to the Administrator and other persons appointed by the administrator which performing its functions under the said

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<sup>36</sup> Regulations for appointing an administrator for selling the properties of the defaulter for repaying to investors and recover disgorgement amount.

regulations, is given priority over other claims. This is so because the administration costs are incurred to ensure that monies are realized to repay the investors or recover the disgorgement amount. It is suggested that along the said lines, the costs and expenses incurred in the course of execution of the certificate drawn up by the Recovery Officer may be given precedence over the other claims. There may be cases where the costs and expenses related to the execution and realization of the amount specified in the certificate could be higher than the amount that may be actually recovered through such process.

SEBI may thus need to consider this aspect and decide the course of action to be taken in such cases accordingly.

**Suggested amendment:**

<b>Provision in Second Schedule of the Income-tax Act, 1961</b>	<b>Suggested amendment</b>
<p><b>Disposal of proceeds of execution.</b>  <b>8.</b> (1) Whenever assets are realised by sale or otherwise in execution of a certificate, the proceeds shall be disposed of in the following manner, namely :—</p> <p>(a) they shall first be adjusted towards the amount due under the certificate in execution of which the assets were realised and the costs incurred in the course of such execution;</p> <p>(b) if there remains a balance after the adjustment referred to in clause (a), the same shall be utilised for satisfaction of any</p>	<p><b>Disposal of proceeds of execution.</b>  (1) Whenever monies are realized by sale of the properties of the defaulter or otherwise, in the execution of a certificate, the proceeds shall be disposed of in the following order, namely:-</p> <p>(a) costs and expenses incurred in the course of execution of the certificate;</p> <p>(b) the principal amount due under the certificate;</p> <p>(c) interest or returns as may be recoverable under the certificate; and</p> <p>(d) where there is more than one</p>

<p>other amount recoverable from the assessee under this Act which may be due on the date on which the assets were realised; and</p> <p>(c) the balance, if any, remaining after the adjustments under clauses (a) and (b) shall be paid to the defaulter.</p> <p>(2) If the defaulter disputes any adjustment under clause (b) of sub-rule (1), the Tax Recovery Officer shall determine the dispute.</p>	<p>certificate drawn up against a defaulter, the Recovery Officer shall appropriate the amount recovered including interest, costs, charges etc. towards the dues arising first in time and then proceed to appropriate the balance amount recovered in respect of the remaining certificates.</p> <p>(2) Any amount remaining after the adjustments referred to in sub-regulation (1), shall be utilized for satisfaction of any other amount recoverable from the defaulter under the Act, the Securities Contracts (Regulations) Act, 1956 or the Depositories Act, 1996 which may be due on the date on which the assets were realized.</p> <p>(3) Any balance amount, remaining after the adjustments under sub-regulations (1) and (2), shall be returned to the defaulter.</p> <p>(4) If the defaulter disputes any adjustment under the aforesaid clauses, the Recovery Officer shall determine the dispute.</p>
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- **RULE 9 – GENERAL BAR TO JURISDICTION OF CIVIL COURTS, SAVE WHERE FRAUD ALLEGED.**

Rule 9 prescribes that a suit may be filed in a civil court in respect of a question relating to the execution, discharge or satisfaction of a certificate, or relating to the confirmation or setting aside by an order of a sale held in execution of such certificate only on the ground of ‘fraud’.

**Rationale for modification:**

Since the Securities Appellate Tribunal is the appellate body in respect of orders passed by the Board and also since the suit/appeal referred to in the relevant provisions of Income-Tax Act and rules being followed by SEBI is an appeal to the Securities Appellate Tribunal, it is felt that the proviso to this provision allowing filing of a suit on the ground of fraud may be omitted. Any challenge to the recovery process/order could be challenged before the Securities Appellate Tribunal in terms of Explanation 3 to section 28A(1).

**Suggested amendment:**

<b>Provision in Second Schedule of the Income-tax Act, 1961</b>	<b>Suggested amendment</b>
<p><b>General bar to jurisdiction of civil courts, save where fraud alleged.</b></p> <p><b>9.</b> Except as otherwise expressly provided in this Act, every question arising between the Tax Recovery Officer and the defaulter or their representatives, relating to the</p>	<p><b>General bar to jurisdiction of civil courts.</b></p> <p>Except as otherwise expressly provided in these regulations, every question arising between the Recovery Officer and the defaulter or their representatives, relating to the</p>

<p>execution, discharge or satisfaction of a certificate, or relating to the confirmation or setting aside by an order under this Act of a sale held in execution of such certificate, shall be determined, not by suit, but by order of the Tax Recovery Officer before whom such question arises :</p> <p><b>Provided</b> that a suit may be brought in a civil court in respect of any such question upon the ground of fraud.</p>	<p>execution, discharge or satisfaction of a certificate, or relating to the confirmation or setting aside by an order under these regulations of a sale held in execution of such certificate, shall be determined, not by suit, but by order of the Recovery Officer before whom such question arises:</p> <p>Provided that before passing any order, the Recovery Officer shall afford an opportunity to the defaulter to make his representation along with supporting evidence.</p>
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- **RULE 39 – PROCLAMATION HOW MADE, RULE 50 – PROCLAMATION OF ATTACHMENT AND RULE 54 – MODE OF MAKING PROCLAMATION**

- i. Rule 39(1) requires the proclamation to be made by beat of drums or other customary mode.
- ii. Rule 50 requires that the order of attachment shall be proclaimed at some place on or adjacent to the property attached by **beat of drum or other customary mode**, and a copy of the order shall be affixed on a conspicuous part of the property and on the notice board of the Tax Recovery Officer.
- iii. Rule 54(1) inter alia requires every proclamation for the sale of immovable property to be made at some place on or near such property by beat of drum or other customary mode.

**Rationale for amendment:**

The “beat of drums” has become an outdated practice and impractical to enforce.

**Suggested amendment:**

Reference to the words “*beat of drum or other customary mode*” may be omitted in the said provisions and proclamation may be made by publication through newspapers and electronic modes.

- **RULE 57 – DEPOSIT BY PURCHASER AND RESALE IN DEFAULT.**

The rules mandate the purchaser of immovable property to immediately (i.e. after he is declared as the purchaser) deposit 25% of the purchase money and the full purchase money to be paid by the purchaser on or before the 15<sup>th</sup> day from the sale of property. The provision to rule 57 is reproduced below:

**Rationale for modification:**

In order to provide extension of time to pay the entire purchase consideration, SEBI may consider extending the period of 15 days to three months subject to the purchaser undertaking to pay interest on the balance amount with interest of 15% p.a.

**Suggested amendment:**

<b>Provision in Second Schedule of the Income-tax Act, 1961</b>	<b>Suggested amendment</b>
<b>Deposit by purchaser and resale in default.</b>	<b>Deposit by the purchaser and resale in default.</b>

<p><b>57.</b> (1) On every sale of immovable property, the person declared to be the purchaser shall pay, immediately after such declaration, a deposit of twenty-five per cent on the amount of his purchase money, to the officer conducting the sale; and, in default of such deposit, the property shall forthwith be resold.</p> <p>(2) The full amount of purchase money payable shall be paid by the purchaser to the Tax Recovery Officer on or before the fifteenth day from the date of the sale of the property.</p>	<p>(1) On every sale of immovable property, the person declared to be the purchaser shall immediately after such declaration deposit twenty-five per cent of the amount of purchase money, including the earnest money, with the officer conducting the sale; and, upon default of such deposit, the property shall be resold forthwith.</p> <p>(2) The full amount of purchase money due shall be paid by the purchaser to the Recovery Officer on or before the fifteenth day from the date of the sale of the property.</p> <p>(3) The period of fifteen days under sub-regulation (2) may be extended by a maximum period of three months, subject to the purchaser making a request for such extension along with an undertaking to pay the remaining sale price together with interest thereon at the rate of fifteen per cent per annum for the period so extended.</p> <p>(4) The application for extension of time for payment shall be accompanied by an unconditional bank guarantee for the remaining outstanding sale price and interest thereon at the rate mentioned hereinabove for a period of three months.</p>
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	(5) The advertisement regarding the auction for sale of properties shall appropriately mention that extension may be granted to pay the consideration subject to compliance with sub-regulations (3) and (4).
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- **RULE 58 – PROCEDURE IN DEFAULT OF PAYMENT.**

As per this provision, the deposit amount paid by the defaulting purchaser would be forfeited to the Government and the property shall be resold.

**Rationale for modification:**

Considering that expenses would be incurred while reselling the property, SEBI may consider offering the property to the next highest bidder at a price equal to the bid made by the highest bidder (i.e. defaulting purchaser).

**Suggested amendment:**

<b>Provision in Second Schedule of the Income-tax Act, 1961</b>	<b>Suggested amendment</b>
<p><b>Procedure in default of payment.</b>  <b>58.</b> In default of payment within the period mentioned in the preceding rule, the deposit may, if the Tax Recovery Officer thinks fit, after defraying the expenses of the sale, be forfeited to the Government, and the property shall be resold, and the defaulting purchaser</p>	<p><b>Procedure in default of payment.</b>  (1) Upon default of payment within the period mentioned in the preceding regulation, the deposit may, if the Recovery Officer thinks fit, after defraying the expenses of the sale, be forfeited, and the property shall be resold, and the defaulting purchaser</p>



<p>shall forfeit all claims to the property or to any part of the sum for which it may subsequently be sold.</p>	<p>shall forfeit all claims to the property or any part of the sum for which it may subsequently be sold.</p> <p>(2) Without prejudice to sub-regulation (1), if the highest bidder fails to pay the purchase price in accordance with the terms of sale, the property may be offered to the next highest bidder at a price equal to the bid made by the highest bidder.</p>
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- **RULE 68B – TIME LIMIT FOR SALE OF ATTACHED IMMOVABLE PROPERTY.**

As per this rule, no sale of immovable property shall be made after the expiry of three years from the end of the financial year in which the order, giving rise to a demand of any tax, interest, fine, penalty or any other sum, for the recovery of which the immovable property has been attached, has become conclusive under the provisions of section 245-I or, as the case may be, final in terms of the provisions of Chapter XX:

Where the immovable property is required to be re-sold due to the amount of highest bid being less than the reserve price or under the circumstances mentioned in rule 57 or rule 58 or where the sale is set aside under rule 61, the aforesaid period of limitation for the sale of the immovable property shall stand extended by one year.

**Rationale for modification:**

In the context of SEBI recovery, the time limits may not be made applicable, especially where monies are due for disgorgement or refundable to investors as such monies are not the assets of the defaulter.

**Suggested amendment:**

SEBI may consider omission of Rule 68B in the context of recovery in the securities markets.

## VII. ENHANCEMENTS IN RECOVERY PROCESS

The Committee is of the view that for better efficiency in the recovery process, certain enhancements in the recovery process may be required. Such enhancements to the recovery process by way of regulations would further the purposes of the Act as specified in Section 30 of the SEBI Act (and analogous provisions in the SCRA and Depositories Act), the same would be perfectly valid.

### A. DEFINE THE TERM “PROPERTY:

Since properties of the defaulter are sought to be attached for the purposes of recovering the dues under the certificate drawn up under section 28A of the SEBI Act, it would be necessary to define the term “property”. This definition may be the same as used by SEBI in its Securities and Exchange Board of India (Appointment of Administrator and Procedure for Refunding to the Investors) Regulations, 2018:

*"property" means and includes assets of any kind, whether movable or immovable, tangible or intangible, corporeal or incorporeal and includes securities, bank accounts, deposits, any right or interest or legal documents or instruments evidencing title to or interest in the property and where the property is capable of conversion into some other form, then the property in the converted form and also includes the proceeds from the property;"*

Since the term “property” includes “securities”, there may be no need to continue with the definition of the expression “share in a corporation” used in rule 1(g) in the Second Schedule of the Income-tax Act, 1961. Accordingly, it is suggested to substitute the expression “share in a corporation” wherever appearing in the proposed regulations with the word “securities”.

## **B. SALE BY ELECTRONIC AUCTION FACILITY**

It is understood that SEBI utilizes the services of e-auction agencies for the purposes of auctioning and selling the attached properties. Further, e-auction is being conducted as a standard process in respect of sale of assets under the SARFAESI Act, DRT etc. This allows for wider participation and transparency in the procedure. It would therefore be appropriate to define the terms “e-auction” and “e-auction agency”.

Suggested text is as follows,-

- **“electronic auction”** shall mean a public auction conducted electronically;
- **“electronic auction agency”** shall mean any company providing an electronic auction platform which is engaged by the Recovery Officer for the purposes of auctioning and selling the attached properties in pursuance of these regulations;
- **“Sale to be by auction.**  
*The sale shall be by public auction, which may be conducted through electronic auction, to the highest bidder and shall be subject to confirmation by the Recovery Officer:  
Provided that no sale under this regulation shall be made if the amount bid by the highest bidder is less than the reserve price, if any, specified.”*

## **C. REGISTERED VALUER**

The role of a registered valuer is very vital to the recovery process as the said professional evaluates the attached property. This value is considered for fixing the

‘reserve price’. His report should be treated as ‘confidential’. For clarity, it would be appropriate to define the term “registered valuer”, thereby restricting the categories of person who may be allowed to act as a ‘valuer’ under the proposed regulations. The expression “registered valuer” is also defined under certain Regulations framed by SEBI.

Suggested text is as follows,-

- **“registered valuer”** shall have the meaning assigned to it under the Companies (Registered Valuers and Valuation) Rules, 2017 or any other statutory modification or re-enactment thereof;
- **“Reserve price”**
  - (1) It shall be competent for the Recovery Officer to fix a reserve price in respect of any property, other than agricultural produce, below which such property shall not be sold.
  - (2) Where a valuation is required to be made in respect of any property, the Recovery Officer may appoint a registered valuer for valuation of such property.
  - (3) The valuation report submitted by a registered valuer shall be confidential.

#### **D. SERVICE OF NOTICES AND ORDERS**

It would be necessary to have clarity on the manner of service of notices and orders in the recovery process. The relevant provisions of the SEBI (Procedure for Holding Inquiry and Imposing Penalties) Rules, 1995 may be considered.

## E. POUNDAGE FEE

The poundage fee is levied in respect of any sale made in execution of a certificate and paid by the purchaser of the defaulter's property. SEBI may consider appropriating such fees as 'costs' of sale of properties in the recovery proceedings to reduce the amount of costs that is appropriated from the proceeds of sale of property.

Further, the word "poundage" may be dropped as it refers to payment of a particular amount per pound sterling of the sum involved in a transaction which terminology is not relevant in the Indian context and is a residue of the British era. Accordingly, the word "fees" may be retained.

Suggested amendment is as follows,-

### ***"Levy and scale of ~~poundage~~ fees.***

*(1) In respect of any sale made in the execution of a certificate, there shall be levied a fee ~~by way of poundage~~ on the gross amount realised by the sale.....*

.....

*(6) The ~~poundage~~ fee collected under this regulation shall be appropriated towards the cost of sale of the properties in execution of the certificate."*

## F. DEPOSIT OF EARNEST MONEY

Under the Income-Tax Rules, bids for purchase of any properties should be accompanied with payment of earnest money calculated at 10% of the reserve price, where the reserve price is up to Rs. 10 crore, subject to a minimum of Rs.50,000/- or Rs.10 lakh plus 5% on the remaining amount of reserve price, where the reserve price is above Rs.10 crore. The deposit of earnest money is stipulated in order to bring in seriousness on the persons who bid. Based on its experience, if SEBI considers that the prescribed percentage is in excess, SEBI may consider lowering the same.

Such earnest money may be returned to unsuccessful bidders within a period of 60 days from the date of confirmation of sale without interest. The earnest money should be forfeited if the bidder does not participate in the auction or when he (after declared as successful bidder) fails to pay the 25% purchase money or on default of payment of the remaining sum of money. However, it is suggested that the earnest money should not be forfeited if the bidder is allowed extension of time to make the payment of bid price.

Suggested text is as follows,-

***“Refund of earnest money.***

*Earnest money deposited by unsuccessful bidders shall be refunded without interest within sixty days from the date of confirmation of sale.*

***Forfeiture of earnest money or other payments.***

*Earnest money or any other part of the purchase price paid by a bidder shall be forfeited on the following circumstances:*

- (a) the bidder not participating in the auction after successfully submitting the bid, or*
- (b) on default in payment of twenty-five per cent of the purchase price, including the earnest money paid, immediately after the auction, or*
- (c) on default in payment of remaining seventy-five per cent within fifteen days of the sale:*

*Provided that the earnest money shall not be forfeited if time for making payment is extended in accordance with sub-regulation (3) of regulation 85.”*

**G. POWER TO SEEK INFORMATION:**

Section 28(4A) of the Recovery of Debts and Bankruptcy Act, 1993, provides that the Recovery Officer may, by order, at any stage of the execution of the certificate of recovery require any person and in case of a company; any of its officers against whom

or which the certificate of recovery is issued, to declare on affidavit the particulars of his or its assets. Such a power to seek information relating to assets and information that may aid in the recovery proceedings and execution of the certificate would be very useful for the Board. Accordingly, a provision to this effect is suggested.

Suggested text is as follows, -

***“Power to seek information.***

*(1) The Recovery Officer may at any stage of the execution of the certificate of recovery, seek from any person, any information which may be relevant to execution of the certificate of recovery or to any investigation or inquiry by the Recovery Officer.*

*(2) Without limiting generality of the foregoing provision, the Recovery Officer may at any stage of the execution of the certificate of recovery, require any person against whom the certificate of recovery is issued, and if such person is a body corporate from any of its officers, to declare on affidavit the particulars of his or its assets.”*

**H. PROVISION IN RESPECT OF PURCHASE BY GOVERNMENT.**

It is possible that a property may not have buyers even if such property is put up for sale thrice through public auction. In such a case, an option should be made available that the Board may offer such property to the Central Government or the State Government of a State where such property is situated, to purchase the property at price which is equivalent to the reserve price or higher than such reserve price. This would enable the Government to purchase the property, if it desires and use it for public good or for its infrastructure needs.



Section 58 of the Bengal Land-Revenue Sales Act, 1859<sup>37</sup>, which provides that ‘*When an estate is put up for sale under this Act for the recovery of arrears of revenue due thereon, if there be no bid, the Collector or other officer as aforesaid may purchase the estate on account of the State Government for one rupee, or if the highest bid be insufficient to cover the said arrears and those subsequently accruing up to the date of sale, the Collector or other officer as aforesaid may take or purchase the estate on account of the State Government at the highest amount of bid; in both which cases the State Government shall acquire the property subject to the provisions of the Act*’. In *Ramrao Jankiram Kadam v State of Bombay*<sup>38</sup> the Hon’ble Supreme Court *inter alia* held that only if a provision existed in the Bombay Land Revenue Code along the lines of Section 58 of the Bengal Land-Revenue Sales Act, 1859 could such sales be called a public auction. Hence, the Committee is of the view that a provision may be made to enable purchase on behalf of the Central Government and State Governments so as to enable the Board to conclude its Recovery proceedings in respect of properties which remain unsold after repeated auctions.

Suggested text is as follows,-

***“Purchase by Government.***

*When an immovable property is put up for sale for recovery of amounts due and if the property remains unsold, the Board may, after giving opportunity to the defaulter to furnish the amounts due under the certificate, offer the same to the Central Government or any State Government, who may submit a bid not lower than the reserve price and purchase the said property:*

*Provided that, -*

- i. offer to the Central or State Government under this regulation shall be made only in case two earlier auctions in respect of the said immovable property have been unsuccessful;*

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<sup>37</sup> An Act to improve the law relating to sales of land for arrears of revenue in Bengal Presidency.

<sup>38</sup> AIR 1963 SC 827, 1963 SCR Supp. (1) 322.

- ii. *the Board may afford such time as may be deemed fit to such Central or State Government to convey its willingness to purchase and to make payment of the consideration; and*
- iii. *where the property is put up for sale for recovery of any penalty due or other amount payable to the Central Government and the reserve price does not exceed the amount due, the Central Government may acquire the property by extinguishing the liability of the defaulter equal to the reserve price.*

**I. RESIDUARY CLAUSE FOR DEVISING PROCEDURE FOR SITUATIONS NOT COVERED  
BY REGULATIONS**

It may also be necessary to provide for an enabling provision so that the Board can deal with unforeseen difficulties. An enabling provision would aid SEBI to devise a suitable procedure in such circumstances.

Suggested text is as follows,-

***“Power to determine procedure in certain circumstances.***

*In a situation not provided for in these regulations, the Recovery Officer, with the approval of the Board, may determine the procedure for specific matters, as may be required.”*

Further, as generally seen in various SEBI Regulations, the proposed regulations may also provide for a regulation to enable the Board to issue clarifications in case any difficulty arises in the interpretation or applicability of the regulations.

**J. COMPREHENSIVE REGULATIONS TO AMALGAMATE PROVISIONS OF THE  
NOTIFIED ADMINISTRATOR REGULATIONS WITH THE PROPOSED RECOVERY  
REGULATIONS**

SEBI had notified the SEBI (Appointment of Administrator and Procedure for making Refunds to Investors) Regulations, 2018 (“Administrator Regulations”). The said regulations apply in respect of all or any of the following matters -

- (a) appointment of Administrator pursuant to failure to comply with disgorgement or refund orders passed by the Board;
- (b) sale of properties attached by the Recovery Officer of the Board under the Act;
- (c) collection of claim documents and verification of claims of investors for the purpose of effecting refunds;
- (d) refund of monies to the investors pursuant to disgorgement or refund orders passed by the Board;
- (e) recovery of disgorgement amounts directed by the Board;
- (f) any act incidental or connected thereto.

Since the Securities and Exchange Board of India (Appointment of Administrator and Procedure for Refunding to the Investors) Regulations, 2018 is intrinsically connected with ‘recovery’, SEBI may consider incorporating the provisions of such regulations into the proposed regulations for recovery.

Accordingly, the draft regulations appended herein below have suitably incorporated the provisions of the Administrator Regulations also. When such comprehensive regulations dealing with recovery and administration are notified, then SEBI would be appropriately empowered to repeal the Administrator Regulations.

## **VIII. DRAFT REGULATIONS**

The Committee recommends that the following regulations may be issued by the Board,-

**THE GAZETTE OF INDIA**  
**EXTRA-ORDINARY**  
**PART –III – SECTION 4**  
**PUBLISHED BY AUTHORITY**  
**SECURITIES AND EXCHANGE BOARD OF INDIA**  
**NOTIFICATION**  
**Mumbai, the ..... day of ....., 2020**  
**SECURITIES AND EXCHANGE BOARD OF INDIA (RECOVERY)**  
**REGULATIONS, 2020**

In exercise of the powers conferred by section 30 read with sub-section (1) of section 11 and section 28A of the Securities and Exchange Board of India Act, 1992 (15 of 1992), section 23JB of the Securities Contracts (Regulations) Act, 1956 and section 19-IB of the Depositories Act, 1996, the Board hereby makes the following regulations to specify the procedure for recovering the amounts due under the said Acts and for matters incidental or connected thereto, namely,-

### **CHAPTER I**

#### **PRELIMINARY**

#### **Short title and commencement.**

1. (1) These regulations may be called the Securities and Exchange Board of India (Recovery) Regulations, 2020.

(2) They shall come into force on the date of their notification in the Official Gazette.

**Definitions.**

2. (1) In these regulations, unless the context otherwise requires,-

(a) “Act” means the Securities and Exchange Board of India Act, 1992 [15 of 1992];

(b) “Administrator” means a person registered with the Insolvency and Bankruptcy Board of India as an Insolvency Resolution Professional and who has been engaged by the Recovery Officer for the purposes of these regulations.

(c) “advertisement” includes, -

(i) notices, brochures, pamphlets, circulars, showcards, catalogues, hoardings, placards, posters, insertions in newspapers, pictures, films and cover pages of offer documents;

(ii) any publicity through print medium, radio, television programmes or electronic media;

(d) “auditor” means a person qualified to audit the accounts of companies under the Companies Act, 2013;

(e) “public auction” includes,-

(i) an electronic auction; and

(ii) a purchase by the government under regulation 98.

(f) “Board” means the Securities and Exchange Board of India established under section 3 of the Act;

(g) "certificate" means the statement drawn up by the Recovery Officer under section 28A of the Act or section 23JB of the Securities Contracts (Regulations) Act, 1956 or section 19-IB of the Depositories Act, 1996, in respect of any defaulter referred to in those sections, and shall not include a sale certificate;

(h) “collective investment scheme” shall have the same meaning as assigned to it under section 11AA of the Act and the regulations framed thereunder;

(i) "defaulter" means the person mentioned as the defaulter in the certificate;

(j) “electronic auction” shall mean a public auction conducted electronically;

- (k) “electronic auction agency” shall mean any company providing an electronic auction platform, which is engaged by the Recovery Officer for the purposes of auctioning and selling the attached properties in pursuance of these regulations;
- (l) "execution" in relation to a certificate, means the recovery of dues in pursuance of the certificate;
- (m) “investor” means the person, whether identified or not, in whose favour the refund of monies had been directed by the Board;
- (n) "property" means and includes assets of any kind, whether movable or immovable, tangible or intangible, corporeal or incorporeal and includes securities, bank accounts, deposits, any right or interest or legal documents or instruments evidencing title to or interest in the property and where the property is capable of conversion into some other form, then the property in the converted form and also includes the proceeds from the property;
- (o) "officer" means a person authorised to make an attachment or sale under these regulations;
- (p) “Recovery Officer” means an officer of the Board, who is authorised by a general or special order in writing, to exercise the powers of a recovery officer under section 28A of the Act or section 23JB of the Securities Contracts (Regulations) Act, 1956 or section 19IB of the Depositories Act, 1996;
- (q) “refund order” means a direction of the Board, issued under the Act or the Securities Contracts (Regulation) Act, 1956 or the Depositories Act, 1996, to refund monies to the investors;
- (r) “recovery proceedings” means the proceedings, initiated by a Recovery Officer, for recovery of amounts under section 28A of the Act or section 23JB of the Securities Contracts (Regulations) Act, 1956 or section 19IB of the Depositories Act, 1996;
- (s) “registered valuer” shall have the meaning assigned to it under the Companies (Registered Valuers and Valuation) Rules, 2017 or any other statutory modification or re-enactment thereof;

(2) Words and expressions used and not defined in these regulations but defined in the Act, the Securities Contracts (Regulation) Act, 1956 and the Depositories Act, 1996 or rules and regulations framed thereunder, shall have the meanings respectively assigned to them in such Acts or rules and regulations.

## **CHAPTER II**

### **GENERAL PROVISIONS**

#### **Amounts when payable.**

3. (1) Any penalty or refund of monies or disgorgement of amounts or fees due to the Board, under the Act or the Securities Contracts (Regulation) Act, 1956 or the Depositories Act, 1996, shall be paid within thirty days of service of notice or in terms of the regulations issued or an order passed by the Board:

Provided that where the Recovery Officer has reason to believe that it will be detrimental if the full period of thirty days as aforesaid is allowed, he may, with the previous approval of the Board, direct that the sum specified in the notice of demand shall be paid within such period being a period less than the period of thirty days, as may be specified by him in the notice of demand.

Explanation. – The order imposing penalty, directing refund or directing disgorgement shall be deemed to be a notice of demand.

(2) Where any notice of demand has been served upon any person and any appeal or other proceeding, as the case may be, is filed or initiated in respect of the amount specified in the said notice of demand, either by the person or the Board, then such demand shall be deemed to be valid till the disposal of the proceedings, as the case may be, and any such notice of demand shall have the following effect:

- (a) where the dues are enhanced in such appeal or proceedings or interest accrues on such monies due to passage of time, another notice of demand only in

respect of the amount by which such dues are enhanced, without the service of any fresh notice of demand, be continued from the stage at which such proceedings stood immediately before such disposal;

(b) where the dues are reduced in such appeal or proceedings, an intimation of the fact of such reduction to the person shall be issued;

(c) no proceedings in relation to such dues (including the imposition of penalty or charging of interest) shall be invalid by reason only that no fresh notice of demand was served upon the person after the disposal of such appeal or proceeding or that such dues have been enhanced or reduced in such appeal or proceeding:

Provided that where any dues are reduced in such appeal or proceeding and the person is entitled to any refund thereof, such refund shall be made in accordance with the provisions of these regulations.

(3) For removal of doubts, it is hereby declared that no fresh notice of demand shall be necessary in any case where the amount of dues is not varied as a result of any order passed in any appeal or other proceeding.

(4) The person who is liable to pay the dues as specified in sub- regulation (1), shall be liable to pay simple interest at the rate of 18% per annum on amounts in default from the date such amounts became due or from the date of passing of the original order by the Board or the Adjudicating Officer till the date of actual payment or realization of such dues, whichever is earlier:

Provided that where the amount of dues has been enhanced or reduced by virtue of any order passed in appeal or proceedings, the interest thereon shall be enhanced or reduced accordingly.

(5) Where the Recovery Officer draws up any notice of demand or a certificate, the Recovery Officer shall include therein the interest as specified above.

(6) Without prejudice to the provisions contained in this regulation, on an application made by the person before the expiry of the due date under sub- regulation (1), the Board or the Recovery Officer on approval of the Board, for reasons to be recorded in writing, may extend the time for payment or allow payment by instalments, subject to



such conditions as may be imposed considering the facts and circumstances of the case:

Provided that extension of time or payment by instalments shall not be granted beyond a period of twenty-four months from the date of expiry of the period specified in sub-regulation (1).

(7) If the amount is not paid within the time specified in sub-regulation (1) or extended under sub-regulation (6), as the case may be, the person shall be deemed to be in default.

(8) Where payment by instalments is allowed under sub-regulation (6), the person who commits a default in paying any one of the instalments within the time fixed under that sub-regulation, shall be deemed to be in default as to the whole of the amount then outstanding, and the other instalment or instalments shall be deemed to have been due on the same date as the instalment which is actually in default.

(9) Where the person has presented an appeal before the Securities Appellate Tribunal, the Board or the Recovery Officer may in his discretion and subject to such conditions as he may think fit to impose in the circumstances of the case, and for reasons to be recorded in writing, treat the person as not being in default in respect of the amount due, even though the time for payment has expired, as long as such appeal remains undisposed of.

**Liability for other action.**

4. A person in default or deemed to be in default in making payment of dues, in addition to the amount which is due and the amount of interest payable on such dues, may be liable for other action under the Act or the Securities Contracts (Regulation) Act, 1956 or the Depositories Act, 1996, as may be applicable.

**Certificate.**

5. (1) When a person is in default or is deemed to be in default in making a

payment of dues, namely, -

- (e) a penalty imposed by the adjudicating officer under the Act, the Securities Contracts (Regulations) Act, 1956 or the Depositories Act, 1996; or
- (f) any amount payable on failure of any person to refund any monies as directed by the Board; or
- (g) any amount payable on failure of any person to disgorge monies as directed by the Board; or
- (h) any fees due to the Board,

the Recovery Officer shall draw up under his signature, a written statement in the form mentioning the amount due from such person (such statement being hereafter referred to as "certificate") and shall proceed to recover from such person the amount specified in the certificate by one or more of the modes specified in these regulations and in accordance with these regulations.

(2) The Recovery Officer may take action under sub-regulation (1), notwithstanding that proceedings for recovery of the arrears by any other mode have been taken.

**Issue of notice.**

- 6. (1) When a certificate has been drawn up by the Recovery Officer for recovery of amounts from the defaulter, a notice shall be caused to be served by the Recovery Officer upon the defaulter requiring such defaulter to pay the amounts specified in the certificate within a period of fifteen days from the date of service of the notice.

(2) The notice mentioned in sub-regulation (1) shall put the defaulter on notice that in case of default in complying with the notice, steps would be taken under the provisions of the Act, the Securities Contracts (Regulation) Act, 1956 or the Depositories Act, 1996, as the case may be, and these regulations to realize the amount as specified in the certificate.

**Mode of recovery.**

- 7. If the amount mentioned in the notice is not paid within the time specified

therein or within such further time as the Recovery Officer may grant in his discretion, the Recovery Officer shall proceed to realise the amount by one or more of the following modes:—

- (a) by attachment and sale of the defaulter's movable property;
- (b) by attachment of the defaulter's bank accounts;
- (c) by attachment and sale of the defaulter's immovable property;
- (d) by arrest of the defaulter and his detention in prison;
- (e) by appointing a receiver for the management of the defaulter's movable and immovable properties.

**Recovery Officer by whom recovery is to be effected.**

8. (1) The Recovery Officer competent to take action shall be—

- (a) the Recovery Officer within whose jurisdiction the person carries on his business or profession or within whose jurisdiction the principal place of his business or profession is situate, or
- (b) the Recovery Officer within whose jurisdiction the person resides or any movable or immovable property of the person is situate, or

the jurisdiction for this purpose being the jurisdiction assigned to the Recovery Officers under the orders or directions issued by the Board.

(2) Where a person has property within the jurisdiction of more than one Recovery Officer and the Recovery Officer by whom the certificate is drawn up—

- (a) is not able to recover the entire amount by sale of the property, movable or immovable, within his jurisdiction, or
- (b) is of the opinion that, for the purpose of expediting or securing the recovery of the whole or any part of the amount, it is necessary so to do,

he may send the certificate or, where only a part of the amount is to be recovered, a copy of the certificate certified in the specified manner and specifying the amount to be recovered to a Recovery Officer within whose jurisdiction the person resides or has property and, thereupon, that Recovery Officer shall also proceed to recover the amount under these regulations as if the certificate or a copy thereof had been drawn

up by him.

**Validity of certificate and cancellation or amendment thereof.**

9. No person shall be allowed to dispute the correctness of any certificate drawn up by the Recovery Officer on any ground whatsoever, but it shall be lawful for the Recovery Officer to cancel the certificate if, for any reason, he thinks it necessary so to do, or to correct any clerical or mathematical error therein.

**Stay of proceedings in pursuance of certificate and amendment or cancellation thereof.**

10. (1) It shall be lawful for the Recovery Officer to grant time for the payment of any dues and when he does so, he shall stay the proceedings for the recovery of such dues until the expiry of the time so granted.  
(2) Where the order giving rise to a demand of dues for which a certificate has been drawn up is modified in appeal or other proceeding under the Act or the Securities Contracts (Regulation) Act, 1956 or the Depositories Act, 1996, and, as a consequence thereof, the demand is reduced but the order is the subject-matter of further proceedings under the said laws, the Recovery Officer shall stay the recovery of such part of the amount specified in the certificate as pertains to the said reduction for the period for which the appeal or other proceeding remains pending.  
(3) Where a certificate has been drawn up and subsequently the amount of the outstanding demand is reduced as a result of an appeal or other proceeding under the Acts mentioned in sub-regulation (2), the Recovery Officer shall, when the order which was the subject-matter of such appeal or other proceeding has become final and conclusive, amend the certificate, or cancel it, as the case may be.

**Other modes of recovery.**

11. (1) Where a certificate has been drawn up, the Recovery Officer may, without prejudice to the modes of recovery specified in regulation 7, recover the dues by any one or more of the other modes provided in these regulations.

(2) If any person is in receipt of any income in the nature of salary, the Recovery Officer may require any person paying the same to deduct from any payment subsequent to the date of such requisition any dues from such person, and such person shall comply with any such requisition and shall pay the sum so deducted to the credit of the Board or as directed by the Recovery Officer:

Provided that any part of the salary exempt from attachment in execution of a decree of a civil court under section 60 of the Code of Civil Procedure, 1908 (5 of 1908), shall be exempt from any requisition made under this sub-regulation.

(3) (i) The Recovery Officer may, at any time or from time to time, by notice in writing require any person from whom money is due or may become due to the defaulter or any person who holds or may subsequently hold money for or on account of the defaulter to pay to the Recovery Officer either forthwith upon the money becoming due or being held or at or within the time specified in the notice (not being before the money becomes due or is held) so much of the money as is sufficient to pay the amount due by the defaulter in respect of dues or the whole of the money when it is equal to or less than that amount.

Provided that wherever the defaulter has a right to demand payment of any amount before such amount becomes payable under any contract, certificate or instrument, it shall be lawful for the Recovery Officer to demand payment of the amount forthwith.

(ii) A notice under this sub-regulation may be issued to any person who holds or may subsequently hold any money for or on account of the defaulter jointly with any other person and for the purposes of this sub-regulation the shares of the joint holders in such account shall be presumed, until the contrary is proved, to be equal.

(iii) A copy of the notice shall be forwarded to the defaulter at his last address known to the Recovery Officer, and in the case of a joint account to all the joint holders at their last addresses known to the Recovery Officer.

(iv) Save as otherwise provided in this sub-regulation, every person to whom a notice is issued under this sub-regulation shall be bound to comply with such

notice, and, in particular, where any such notice is issued to a post office, banking company or an insurer, it shall not be necessary for any pass book, deposit receipt, policy or any other document to be produced for the purpose of any entry, endorsement or the like being made before payment is made, notwithstanding any rule, practice or requirement to the contrary.

(v) Any claim in respect of any property in relation to which a notice under these regulations has been issued arising after the date of the notice shall be void as against any demand contained in the notice.

(vi) Where a person to whom a notice under this sub-regulation is sent objects to it by a statement on oath that the sum demanded or any part thereof is not due to the defaulter or that he does not hold any money for or on account of the defaulter, then nothing contained in this sub-regulation shall be deemed to require such person to pay any such sum or part thereof, as the case may be, but if it is discovered that such statement was false in any material particular, such person shall be personally liable to the Recovery Officer to the extent of his own liability to the defaulter on the date of the notice, or to the extent of the defaulter's liability for any sum due under these regulations, whichever is less.

(vii) The Recovery Officer may, at any time or from time to time, amend or revoke any notice issued under this sub-regulation or extend the time for making any payment in pursuance of such notice.

(viii) The Recovery Officer shall grant a receipt for any amount paid in compliance with a notice issued under this sub-regulation, and the person so paying shall be fully discharged from his liability to the defaulter to the extent of the amount so paid.

(ix) Any person discharging any liability to the defaulter after receipt of a notice under this sub-regulation shall be personally liable to the Recovery Officer to the extent of his own liability to the defaulter so discharged or to the extent of the defaulter's liability for any sum due under these regulations, whichever is less.

(x) If the person to whom a notice under this sub-regulation is sent fails to

make payment in pursuance thereof to the Recovery Officer, he shall be deemed to be a person in default in respect of the amount specified in the notice and further proceedings may be taken against him for the realisation of the amount as if it were due from him, and the notice shall have the same effect as an attachment of a debt by the Recovery Officer in exercise of his powers under these regulations.

(4) The Recovery Officer may apply to the court or tribunal in whose custody there is money belonging to the defaulter for payment to him of the entire amount of such money, or, if it is more than the dues, an amount sufficient to discharge the dues.

(5) The Recovery Officer may, if so authorised by the Board by general or special order, recover any dues from a defaulter by distraint and sale of his movable property in the manner laid down in these regulations.

#### **Service of notices and orders.**

12. A notice or an order issued in execution of a certificate shall be served upon a person in the following manner:

(a) by delivering or tendering it to that person or his duly authorised agent; or

(b) by sending it to the person by fax or electronic mail or courier or speed post with acknowledgement due or registered post with acknowledgement due to the address of his place of residence or his last known place of residence or the place where he carried on, or last carried on, business or personally works, or last worked, for gain:

Provided that a notice sent by fax shall bear a note that the same is being sent by facsimile and in case the document contains annexure(s), the number of pages being sent shall also be mentioned:

Provided further that a notice sent through electronic mail shall be digitally signed by the Recovery Officer and bouncing of the electronic mail shall not constitute valid service.

(c) if the notice cannot be served under clause (a) or clause (b), by affixing it on the outer door or some other conspicuous part of the premises in which that

person resides or is known to have last resided, or carries on business or personally works or last worked for gain and a written report of such affixture should be witnessed by two persons;

(d) if the notice cannot be affixed as per clause (c), by publishing the notice in at least two newspapers, one in an English daily newspaper having nationwide circulation and another in a newspaper having wide circulation published in the language of the region where that person was last known to have resided or carried on business or personally worked for gain.

**When certificate may be executed.**

13. No step in execution of a certificate shall be taken until the period of fifteen days has elapsed since the date of the service of the notice required under regulation 6:

Provided that if the Recovery Officer is satisfied that the defaulter is likely to conceal, remove, transfer or dispose of the whole or any part of such of his property as would be liable to attachment and that the realization of the amount of the certificate would in consequence be delayed or obstructed, he may at any time direct, for reasons to be recorded in writing, an attachment of the whole or any part of such property:

Provided further that if the defaulter whose property has been so attached furnishes security to the satisfaction of the Recovery Officer, such attachment shall be cancelled from the date on which such security is accepted by the Recovery Officer.

**Interest, costs and charges recoverable.**

14. In addition to the amount payable under the order giving rise to the certificate, there shall be recoverable, in the proceedings in execution of every certificate,—

- (a) such interest on the amount to which the certificate relates as is payable in accordance with securities laws; and
- (b) all charges incurred in respect of—
  - (i) the service of notice upon the defaulter to pay the arrears, and of warrants and other processes, and



(ii) all other proceedings taken for realising the arrears.

**Purchaser's title.**

15. (1) Where property is sold in execution of a certificate, there shall vest in the purchaser merely the right, title and interest of the defaulter at the time of the sale, even though the property itself be specified.

(2) Where immovable property is sold in execution of a certificate, and such sale has become absolute, the purchaser's right, title and interest shall be deemed to have vested in him from the time when the property is sold, and not from the time when the sale becomes absolute.

**Suit against purchaser not maintainable on ground of purchase being made on behalf of plaintiff.**

16. (1) No suit shall be maintained against any person claiming title under a purchase certified by the Recovery Officer in the manner laid down in these regulations, on the ground that the purchase was made on behalf of the plaintiff or on behalf of someone through whom the plaintiff claims.

(2) Nothing in this regulation shall bar a suit to obtain a declaration that the name of any purchaser certified as aforesaid was inserted in the certificate fraudulently or without the consent of the real purchaser, or interfere with the right of a third person to proceed against that property, though ostensibly sold to the certified purchaser, on the ground that it is liable to satisfy a claim of such third person against the real owner.

**Disposal of proceeds of execution.**

17. (1) Whenever monies are realized by sale of the properties of the defaulter or otherwise, in execution of a certificate, the proceeds shall be disposed of in the following order, namely:-

- (a) costs and expenses incurred in the course of execution of the certificate;
- (b) the principal amount due under the certificate;

- (c) interest or returns as may be recoverable under the certificate; and
- (d) where there is more than one certificate drawn up against a defaulter, the Recovery Officer shall appropriate the amount recovered including interest, costs, charges etc. towards the dues arising first in time and then proceed to appropriate the balance amount recovered in respect of the remaining certificates.

(2) Any amount remaining after the adjustments referred to in sub-regulation (1), shall be utilized for satisfaction of any other amount recoverable from the defaulter under the Act, the Securities Contracts (Regulations) Act, 1956 or the Depositories Act, 1996 which may be due on the date on which the assets were realized.

(3) Any balance amount, remaining after the adjustments under the preceding sub-regulations, shall be returned to the defaulter.

(4) If the defaulter disputes any adjustment under the aforesaid clauses, the Recovery Officer shall determine the dispute.

#### **General bar to jurisdiction of civil courts.**

18. Except as otherwise expressly provided in these regulations, every question arising between the Recovery Officer and the defaulter or their representatives, relating to the execution, discharge or satisfaction of a certificate, or relating to the confirmation or setting aside by an order under these regulations of a sale held in execution of such certificate, shall be determined by an order of the Recovery Officer before whom such question arises:

Provided that before passing any order, the Recovery Officer shall afford an opportunity to the defaulter to make his representation along with supporting evidence.

#### **Property exempt from attachment.**

19. (1) All such property as is by the Code of Civil Procedure, 1908 (5 of 1908), exempted from attachment and sale in execution of a decree of a civil court shall be exempt from attachment and sale under these regulations.

(2) The decision of the Recovery Officer as to what property is so entitled to exemption shall be conclusive.

**Investigation by Recovery Officer.**

20.(1) Where any claim is preferred to, or any objection is made to the attachment or sale of, any property in execution of a certificate, on the ground that such property is not liable to such attachment or sale, the Recovery Officer shall proceed to investigate the claim or objection:

Provided that no such investigation shall be made where the Recovery Officer considers that the claim or objection was designedly or unnecessarily delayed.

(2) Where the property to which the claim or objection applies has been advertised for sale, the Recovery Officer ordering the sale may postpone it pending the investigation of the claim or objection, upon such terms as to security or otherwise as the Recovery Officer shall deem fit.

(3) The claimant or objector must adduce evidence to show that—

(a) in the case of immovable property; at the date of the service of the notice issued under these regulations to pay the arrears, or

(b) in the case of movable property; at the date of the attachment, he had some interest in, or was possessed of the property in question.

(4) Whereupon the said investigation, the Recovery Officer is satisfied that, for the reason stated in the claim or objection, such property was not, at the said date, in the possession of the defaulter or of some person in trust for him or in the occupancy of a tenant or other person paying rent to him, or that, being in the possession of the defaulter at the said date, it was so in his possession, not on his own account or as his own property, but on account of or in trust for some other person, or partly on his own account and partly on account of some other person, the Recovery Officer shall make an order releasing the property, wholly or to such extent as he thinks fit, from attachment or sale.

(5) Where the Recovery Officer is satisfied that the property was, at the said date, in the possession of the defaulter as his own property and not on account of any other

person, or was in the possession of some other person in trust for him, or in the occupancy of a tenant or other person paying rent to him, the Recovery Officer shall disallow the claim.

Provided that before disallowing the claim, an opportunity of hearing may be granted to the person objecting to the attachment.

(7) Where, in the course of investigation, the Recovery Officer is satisfied that the property is subject to a mortgage or charge (other than a mortgage or charge referred to in rule 16 of the Second Schedule to the Income-tax Act) in favour of a person not in possession, and thinks fit to continue the attachment, he may do so, subject to such mortgage or charge.

#### **Removal of attachment on satisfaction or cancellation of certificate.**

21. Where —

- (a) the amount due, with costs and all charges and expenses resulting from the attachment of any property or incurred in order to hold a sale, are paid to the Recovery Officer, or
- (b) the certificate is cancelled,

the attachment shall be deemed to be withdrawn and, in the case of immovable property, the withdrawal shall, if the defaulter so desires, be proclaimed at his expense, and a copy of the proclamation shall be affixed in the manner provided by these regulations for a proclamation of sale of immovable property.

#### **Entrustment of functions by Recovery Officer.**

22.(1) The attachment and sale of property may be made by such persons as the Recovery Officer may from time to time direct.

(2) The Recovery Officer may, as may be approved by the Board, entrust any of his functions as a Recovery Officer to any other officer lower than him in rank and such officer shall, in relation to the functions so entrusted to him, be deemed to be a Recovery Officer.

**Reserve price.**

- 23.(1) It shall be competent for the Recovery Officer to fix a reserve price in respect of any property, other than agricultural produce, below which such property shall not be sold.
- (2) Where valuation is required to be made in respect of any property for the purposes of these regulations, the Recovery Officer may appoint a registered valuer for valuation of such property.
- (3) The valuation report submitted by a registered valuer shall be confidential.

**Proclamation of sale.**

24. For the purpose of ascertaining the matters to be specified in a proclamation of sale, the Recovery Officer may summon any person whom he thinks necessary to summon and may examine him in respect of any matters relevant to the proclamation and require him to produce any document in his possession or power relating thereto.

**Auction of properties.**

- 25.(1) Notwithstanding anything in these regulations, public auction of properties in execution of recovery certificate may be conducted through an auction made through an electronic platform.
- (2) The electronic auction specified at sub-regulation (1) may be conducted through an electronic auction platform, if any, of the Board or by engaging an electronic auction agency.

**Levy and scale of fees.**

- 26.(1) In respect of any sale made in the execution of a certificate, there shall be levied a fee on the gross amount realised by the sale, calculated at the rate of two per cent. on such gross amount up to rupees one thousand and at the rate of one per cent on the excess of such gross amount over rupees one thousand.
- (2) The fee leviable under sub-regulation (1) shall be calculated on multiples of rupees

twenty-five, that is to say, a fee of fifty paise shall be levied for every rupee twenty-five, or part of rupees twenty-five, realised by the sale up to rupees one thousand and in the case of the proceeds of the sale exceeding rupees one thousand, an additional fee of twenty-five paise for every rupee twenty-five or part thereof on the excess of such amount over rupees one thousand, shall be levied.

(3) Where the sale is in more than one lot, the fee shall be calculated with reference to the sale proceeds of each lot separately.

(4) The fee under sub-regulation (1) shall be paid by the purchaser of the property along with payment of remaining purchase price to be paid under these regulations.

(5) When a sale of immovable property is set aside under sub-regulation (2) of regulation 89, the Recovery Officer may make an order for payment, by the defaulter or by the person at whose instance the sale is set aside, of the fees paid by the purchaser of the property.

(6) The fee collected under this regulation shall be appropriated towards the cost of sale of the properties in execution of the certificate.

#### **Defaulting purchaser answerable for loss on resale.**

27. Any deficiency of price which may happen on a resale by reason of the purchaser's default, and all expenses attending such resale, shall be recoverable from the defaulting purchaser under the procedure provided by these regulations:

Provided that no such application shall be entertained unless filed within fifteen days from the date of resale.

#### **Adjournment or stoppage of sale.**

28. (1) The Recovery Officer may, in his discretion, adjourn any sale hereunder to a specified day and hour; and the officer conducting any such sale may, in his discretion, adjourn the sale, recording his reasons for such adjournment.

(2) Where a sale of immovable property is adjourned under sub-regulation (1) for a longer period than one calendar month, a fresh proclamation of sale shall be made

unless the defaulter consents to waive it.

(3) Every sale shall be stopped if, before the lot is knocked down, the arrears and costs (including the costs of the sale) are tendered to the officer conducting the sale, or proof is given to his satisfaction that the amount of such arrears and costs has been paid to the Recovery Officer who ordered the sale.

**Private alienation to be void in certain cases.**

29.(1) Where a notice has been served on a defaulter under regulation 6, the defaulter or his representative in interest shall not be competent to mortgage, charge, lease or otherwise deal with any property belonging to him except with the permission of the Recovery Officer, nor shall any civil court issue any process against such property in execution of a decree for the payment of money.

(2) Where an attachment has been made under these regulations, any private transfer or delivery of the property attached or of any interest therein and any payment to the defaulter of any debt, dividend or other moneys contrary to such attachment, shall be void as against all claims enforceable under the attachment.

(3) The sub-regulations (1) and (2) shall apply *mutatis mutandis* in case of any attachment under securities laws which has been ordered prior to initiation of recovery proceedings under these regulations.

**Prohibition against bidding or purchase by officer.**

30.No person having any duty to perform in connection with any sale under these regulations shall, either directly or indirectly, bid for, acquire or attempt to acquire any interest in the property sold.

**Prohibition against sale on holidays.**

31. No sale under this regulation shall take place on a Sunday or other general holidays recognised by the Central Government or the concerned State Government or on any day which has been notified by the concerned State

Government to be a local holiday for the area in which the sale is to take place.

**Assistance by police.**

32. Any Officer authorised to attach or sell any property or to arrest the defaulter or charged with any duty to be performed under these regulations, may apply to the officer-in-charge of the nearest Police Station for such assistance as may be necessary in the discharge of his duties, and the authority to whom such application is made shall depute sufficient number of Police Officers for providing such assistance.

**CHAPTER III**

**ATTACHMENT AND SALE OF MOVABLE PROPERTY**

**PART I – ATTACHMENT**

**Warrant.**

33. Except as otherwise provided in these regulations, when any movable property is to be attached, the Officer shall be furnished by the Recovery Officer (or other officer empowered by him in that behalf) a warrant in writing and signed with his name specifying the name of the defaulter and the amount to be realized.

**Service of copy of warrant.**

34. The Officer shall cause a copy of the warrant to be served on the defaulter.

**Attachment.**

35. If, after service of the copy of the warrant, the amount is not paid forthwith, the Officer shall proceed to attach the movable property of the defaulter.

**Property in defaulter's possession.**



36. Where the property to be attached is movable property (other than agricultural produce) in the possession of the defaulter, the attachment shall be made by the actual seizure and the Officer shall keep the property in his own custody or the custody of one of his subordinates and shall be responsible for due custody thereof:

Provided that when the property seized is subject to speedy and natural decay or when the expense of keeping it in custody is likely to exceed its value, the Officer may sell it at once, in such manner as deemed fit and necessary.

**Agricultural produce.**

37. (1) Where the property to be attached is agricultural produce, the attachment shall be made by affixing a copy of the warrant of attachment—

(a) where such produce is growing crop—on the land on which such crop has grown, or

(b) where such produce has been cut or gathered,—on the threshing floor or place for treading out grain or the like, or fodder-stack, or in such other place such produce is kept or deposited,

and another copy on the outer door or on some other conspicuous part of the house in which the defaulter ordinarily resides, or with the leave of the Recovery Officer, on the outer door or on some other conspicuous part of the house in which he carries on business or personally works for gain, or in which he is known to have last resided or carried on business or personally worked for gain.

(2) The produce shall, thereupon, be deemed to have passed into the possession of the Recovery Officer.

**Provisions as to agricultural produce under attachment.**

38.(1) Where agricultural produce is attached, the Recovery Officer shall make such arrangements for the custody, watching, tending, cutting and gathering thereof as he may deem sufficient; and he shall have power to defray the cost of such arrangements.

(2) Subject to such conditions as may be imposed by the Recovery Officer in this behalf, either in the order of attachment or in any subsequent order, the defaulter may tend, cut, gather and store the produce and do any other act necessary for maturing or preserving it; and, if the defaulter fails to do all or any of such acts, any person appointed by the Recovery Officer in this behalf may, subject to like conditions, do all or any of such acts, and the costs incurred by such person shall be recoverable from the defaulter as if they were included in the certificate.

(3) Agricultural produce attached as a growing crop shall not be deemed to have ceased to be under attachment or to require reattachment merely because it has been severed from the soil.

(4) Where an order for the attachment of a growing crop has been made at a considerable time before the crop is likely to be fit to be cut or gathered, the Recovery Officer may suspend the execution of the order for such time as he thinks fit, and may, in his discretion, make a further order prohibiting the removal of the crop pending the execution of the order of attachment.

(5) A growing crop which from its nature does not admit of being stored shall not be attached under this regulation at any time less than twenty days before the time at which it is likely to be fit to be cut or gathered.

**Debts, shares, etc.**

39. (1) In the case of—

- (a) a debt not secured by a negotiable instrument,
- (b) securities, or
- (c) other movable property not in the possession of the defaulter except property deposited in, or in the custody of, any court,

the attachment shall be made by a written order prohibiting,—

- (i) in the case of the debt—the creditor from recovering the debt and the debtor from making payment thereof until the further order of the Recovery Officer;
- (ii) in the case of securities, the person in whose name such security may be standing, from transferring the same or receiving any dividend or benefit or

interest thereon;

(iii) in the case of the other movable property (except as aforesaid)—the person in possession of the same from giving it over to the defaulter.

(2) A copy of such order shall be affixed on some conspicuous part of the office of the Recovery Officer, and another copy shall be sent, in the case of the debt, to the debtor, in the case of the securities, to the proper officer of the corporation or other body corporate, and in the case of the other movable property (except as aforesaid), to the person in possession of the same.

(3) A debtor prohibited under clause (i) of sub-regulation (1) may pay the amount of his debt to the Recovery Officer, and such payment shall discharge him as effectually as payment to the party entitled to receive the same.

### **Recovery of monies due to the defaulter**

40. Notwithstanding anything contained in this Chapter, the Recovery Officer may recover the amount due to the defaulter by mode of recovery specified in sub-regulation 3 of regulation 11.

### **Attachment of decree.**

41. (1) The attachment of a decree of a civil court for the payment of money or for sale in enforcement of a mortgage or charge shall be made to the civil court by a notice requesting the civil court to stay the execution of the decree unless and until—

(i) the Recovery Officer cancels the notice, or

(ii) the Recovery Officer or the defaulter applies to the court receiving such notice to execute the decree.

(2) Where a civil court receives an application under clause (ii) of sub-regulation (1), it shall, on the application of the Recovery Officer or the defaulter and subject to the provisions of the Code of Civil Procedure, 1908 (5 of 1908), proceed to execute the attached decree and apply the net proceeds in satisfaction of the certificate.

(3) The Recovery Officer shall be deemed to be the representative of the holder of the

attached decree, and to be entitled to execute such attached decree in any manner lawful for the holder thereof.

**Share in movable property.**

42. Where the property to be attached consists of the share or interest of the defaulter in a movable property belonging to him and another as co-owners, the attachment shall be made by a notice to the defaulter prohibiting him from transferring the share or interest or charging it in any way.

**Salary of government servants.**

43. Attachment of the salary or allowances of servants of the Government or a local authority may be made in the manner provided by rule 48 of Order 21 of the First Schedule to the Code of Civil Procedure, 1908 (5 of 1908), and the provisions of the said rule shall, for the purposes of this regulation, apply subject to such modifications as may be necessary.

**Attachment of negotiable instrument.**

44. Where the property is a negotiable instrument not deposited in a court or in the custody of a public officer, the attachment shall be made by actual seizure, and the instrument shall be brought before the Recovery Officer and held subject to his orders.

**Attachment of property in custody of court or public officer.**

45. Where the property to be attached is in the custody of any court or a public officer, the attachment shall be made by a notice to such court or officer, requesting that such property, and any interest or dividend becoming payable thereon, may be held subject to the further orders of the Recovery Officer by whom the notice is issued:

Provided that where such property is in the custody of a court, any question of title or priority arising between the Recovery Officer and any other person, not being the

defaulter, claiming to be interested in such property by virtue of any assignment, attachment or otherwise, shall be determined by such court.

**Attachment of partnership property.**

46.(1) Where the property to be attached consists of an interest of the defaulter, being a partner, in the partnership property, the Recovery Officer may make an order charging the share of such partner in the partnership property and profits with payment of the amount due under the certificate, and may, by the same or subsequent order, appoint a receiver of the share of such partner in the profits, whether already declared or accruing and of any other money which may become due to him in respect of the partnership, and direct accounts and inquiries and make an order for the sale of such interest or such other order as the circumstances of the case may require.

(2) The other persons shall be at liberty at any time to redeem the interest charged or, in the case of a sale being directed, to purchase the same.

**Inventory.**

47. In the case of attachment of movable property by actual seizure, the officer shall, after attachment of the property, prepare an inventory of all the property attached, specifying in it the place where it is lodged or kept, and shall forward the same to the Recovery Officer and a copy of the inventory shall be delivered by the Officer to the defaulter.

**Attachment not to be excessive.**

48. The attachment by seizure shall not be excessive and the property so attached shall be as nearly as possible proportionate to the amount specified in the warrant.

**Power to break open doors, etc.**

49. The Officer may break open any inner or outer door or window of any building and enter any building in order to seize any movable property, if the officer has reasonable grounds to believe that such building contains movable property liable to seizure under the warrant and the Officer has notified his authority and intention of breaking open if admission is not given:

Provided the Officer shall give all reasonable opportunity to women to withdraw.

**Custody at place of attachment.**

50.(1) Where the property attached is of such a nature that its removal from the place of attachment is impracticable or its removal involves expenditure out of proportion to the value of the property, the Officer attaching such property (hereinafter referred to as "attaching officer") shall, subject to any directions which the Recovery Officer may issue in this behalf, arrange for the proper maintenance and custody of the property at the place of attachment.

(2) The attaching officer shall forthwith send a report of having done so to the Recovery Officer.

(3) On receipt of a report from the attaching officer under sub-regulation (1), the Recovery Officer may either order the removal of the property to a place which he shall specify or sanction its maintenance and custody at the place of attachment under such conditions as he may think fit.

**Removal and custody of property in other cases.**

51. Where the attached property is not kept at the place of attachment, it shall be kept in the custody of an officer (hereinafter referred to as the "custody officer") subordinate to the Recovery Officer and authorised by the Recovery Officer for this purpose. The custody officer may remove the property to the office of the Recovery Officer for custody under his own supervision or, with the approval of the Recovery Officer, may make such arrangements as may be

convenient and economical for its safe custody with any other fit person under his own supervision and the Recovery Officer may fix the remuneration to be allowed to such person.

**Property may be handed over to the defaulter.**

52. Notwithstanding anything contained in regulation 50 or regulation 51, the attaching officer or the custody officer may, with the previous approval of the Recovery Officer, entrust, subject to his right of supervision, the attached property to the defaulter on his executing a bond, which may be so varied as the circumstances of each case may require.

Explanation.—Where the Recovery Officer proceeds to recover any dues from the defaulter by attachment and sale of, or by appointing a receiver for the management of, any movable or immovable property which is held by or stands in the name of, any of the persons referred to in the Explanation to sub-section (1) of section 28A of the Act or section 23 JB of the Securities Contracts (Regulation) Act, 1956 or section 19-IB of the Depositories Act, 1996 and which is included in the defaulter's movable or immovable property by virtue of that Explanation, the reference to "defaulter" in these regulations, as may be applicable, shall, in relation to such movable or immovable property, be construed as a reference to the person referred to in the said Explanation.

**Custody of attached cash, securities, etc.**

53. (1) If the property attached consists of cash, it shall be deposited in the bank account of the Board.

(2) If the property attached consists of government or other securities, bullion, jewellery or other valuables, the attaching officer shall seize such property and entrust the properties to the Recovery Officer along with an inventory thereof.

**Claim of any person other than the defaulter to the property under attachment.**

54. When the property remains at the place where it is attached in the custody of

the attaching officer, and any person other than the defaulter claims the same, or any part thereof, the officer shall nevertheless remain in possession and shall direct the claimant to prefer his claim before the Recovery Officer.

**Return of property on cancellation or withdrawal of attachment.**

55. (1) If in consequence of withdrawal or cancellation of the attachment, the defaulter becomes entitled to receive back the movable property attached, the possession thereof shall be given to him on payment of costs, charges and expenses due, if any, in respect of the execution of the certificate against such property.

(2) For the purpose of giving possession under sub-regulation (1), the attaching officer shall inform the defaulter that the property is at his disposal.

(3) In the absence of any person to take charge of the property the officer may, if the property has been moved from the premises in which it was seized, replace it where it was found at the time of seizure.

**Property may be sold if costs, etc. not paid.**

56. In default of the payment of costs, charges and expenses, the movable property or such portion thereof as may be necessary shall be sold by auction and after defraying the expenses of such sale and the costs, charges and expenses aforesaid, the balance, if any, of the movables so party as has not been sold shall be handed over to the defaulter.

**Feeding and tending of livestock under attachment.**

57. Whenever livestock is kept at the place where it has been attached, the defaulter shall be at liberty to undertake the due feeding and tending of it, under the supervision of the attaching officer.

**Removal of livestock.**

58. In the event of the defaulter failing to feed attached livestock, the livestock may



be placed in the custody of the custody officer or may be placed in a pound maintained by the Government or a local authority.

**Custody of livestock in pound.**

59. If there be any such pound near the office of the Recovery Officer, the attaching officer or the custody officer may place in it such attached livestock as can properly be kept therein in which case the pound-keeper shall be responsible for the livestock and shall receive the same rates for accommodation and maintenance thereof as are payable in respect of impounded cattle of the same description.

**Custody with a person other than custody officer.**

60. Notwithstanding anything contained in regulation 58, the custody officer may, with the approval of the Recovery Officer, entrust the attached livestock to any other person under his own supervision and the Recovery Officer may fix the remuneration to be allowed to such person after taking into account the local circumstances and the charges which such person may have to incur for the maintenance and custody of such livestock.

**Expenses of custody, maintenance, etc.**

61. The expenses of maintenance and custody of movable property including the remuneration payable to the person concerned under this Chapter shall be deemed to be costs of attachment or sale.

**PART II - SALE**

**Sale.**

62. The Recovery Officer may direct that any movable property attached under this regulation or such portion thereof as may seem necessary to satisfy the certificate shall be sold.

**Issue of proclamation.**

63. When any sale of movable property is ordered by the Recovery Officer, the Recovery Officer shall issue a proclamation, in the language of the district, of the intended sale, specifying the time and place of sale and whether the sale is subject to confirmation or not.

**Proclamation how made.**

64. (1) Such proclamation shall be made by publication in newspapers circulating in the locality, notice in the Office of the Registering Authority, publication through digital/electronic modes like publication on the website of the Board, Registering Authority, etc.—

(a) in the case of property attached by actual seizure—

(i) in the locality where the property was seized; and

(ii) at such other places as the Recovery Officer may direct;

(b) in the case of property attached otherwise than by actual seizure, in such places, if any, as the Recovery Officer may direct.

(2) A copy of the proclamation shall also be affixed in a conspicuous part of the office of the Recovery Officer.

**Sale after fifteen days.**

65. Except where the property is subject to speedy and natural decay or when the expense of keeping it in custody is likely to exceed its value, no sale of movable property under these regulations shall, without the consent in writing of the defaulter, take place until after the expiry of at least fifteen days calculated from the date on which a copy of the sale proclamation was affixed in the office of the Recovery Officer.

**Sale of agricultural produce.**

66. (1) Where the property to be sold is agricultural produce, the sale shall be

held,—

- (a) if such produce is a growing crop—on or near the land on which such crop has grown, or
- (b) if such produce has been cut or gathered—at or near the threshing floor or place for treading out grain or the like, or fodder-stack, on or in which it is deposited:

Provided that the Recovery Officer may direct the sale to be held at the nearest place of public resort, if he is of opinion that the produce is thereby likely to sell to greater advantage.

(2) Where, on the produce being put up for sale,—

- (a) a fair price, in the estimation of the person holding the sale, is not offered for it, and
- (b) the owner of the produce, or a person authorised to act on his behalf, applies to have the sale postponed till the next day or, if a market is held at the place of sale, the next market day,

the sale shall be postponed accordingly, and shall be then completed, whatever price may be offered for the produce.

### **Special provisions relating to growing crops.**

67. (1) Where the property to be sold is a growing crop and the crop from its nature admits of being stored but has not yet been stored, the day of the sale shall be so fixed as to admit of the crop being made ready for storing before the arrival of such day, and the sale shall not be held until the crop has been cut or gathered and is ready for storing.

(2) Where the crop from its nature does not admit of being stored or can be sold to a greater advantage in an unripe stage, it may be sold before it is cut and gathered, and the purchaser shall be entitled to enter on the land, and to do all that is necessary for the purpose of tending or cutting or gathering the crop.

### **Sale to be by auction.**

68. The property shall be sold by public auction in one or more lots as the officer

may consider appropriate, and if the amount to be realised by sale is satisfied by the sale of a portion of the property, the sale shall be immediately stopped with respect to the remainder of the lots.

**Sale by public auction.**

69.(1) Where movable property is sold by public auction, the price of each lot shall be paid at the time of sale or as soon after as the officer holding the sale directs and in default of payment, the property shall forthwith be resold.

(2) On payment of the purchase-money, the officer holding the sale shall grant a certificate specifying the property purchased, the price paid and the name of the purchaser, and the sale shall become absolute.

(3) Where the movable property to be sold is a share in goods belonging to the defaulter and a co-owner, and two or more persons, of whom one is such co-owner, respectively bid the same sum for such property or for any lot, the bidding shall be deemed to be the bidding of the co-owner.

**Irregularity not to vitiate sale.**

70.No irregularity in publishing or conducting the sale of movable property shall vitiate the sale.

**Negotiable instruments and securities.**

71. Notwithstanding anything contained in these regulations, where the property to be sold is a negotiable instrument or a security, the Recovery Officer may, instead of directing the sale to be made by public auction, authorise the sale of such instrument or security through a stock broker or other intermediary.

**Delivery of movable property, debts and shares.**

72.(1) Where the property sold is movable property of which actual seizure has been made, it shall be delivered to the purchaser.

(2) Where the property sold is movable property in the possession of some person

other than the defaulter, the delivery thereof to the purchaser shall be made by giving notice to the person in possession prohibiting him from delivering possession of the property to any person except the purchaser and requiring him to deliver possession of the property to the purchaser within the time stipulated by the Recovery Officer.

(3) Where such person in possession of the property fails without reasonable cause to deliver possession of the property to the purchaser within the time stipulated by the Recovery Officer, or within such further time as may be allowed by him, the Recovery Officer shall cause the property to be seized and delivered to the purchaser and the provisions of these regulations shall, as far as may be, apply to such seizure.

(4) Where the property sold is a debt not secured by a negotiable instrument, the delivery thereof to the purchaser shall be made by a written order of the Recovery Officer prohibiting the creditor from receiving the debt or any interest thereon and the debtor from making payment thereof to any person except the purchaser and requiring the debtor to make payment thereof to the purchaser within the time stipulated by the Recovery Officer.

(5) Where the debtor fails to make such payment to the purchaser within the time stipulated by the Recovery Officer, or within such further time as may be allowed by him, the Recovery Officer may take further proceedings to recover the amount due from the debtor as if the debtor were a defaulter in respect of whom the Recovery Officer had drawn up a certificate for the recovery of the payment.

(6) Where the property sold is a security, the delivery thereof to the purchaser may be made by a written order of the Recovery Officer prohibiting the person in whose name the securities may be standing, from making any transfer of the share to any person except the purchaser, or receiving payment of any dividend or interest thereon and requiring him to deliver the security certificate or other document of title along with the instrument of transfer duly completed by him to the Recovery Officer within the time stipulated by the Recovery Officer and prohibiting the manager, secretary, or other proper officer of the corporation from permitting any such transfer or making any such payment to any person except the purchaser:

Provided that if the securities are held in a depository, delivery of securities shall be

effected through transfer from such dematerialised account, in accordance with the provisions of the Depositories Act, 1996 and the rules, regulations or bye-laws made thereunder, to the credit of the purchaser.

(7) Where the person in whose name the security may be standing, fails to deliver the share certificate or other document of title to the Recovery Officer within the time stipulated by him, or within such further time as may be allowed by him, the Recovery Officer may take steps to obtain a duplicate of the share certificate or other document of title as if the share certificate or other document of title had been lost or destroyed: Provided that if securities are held in a depository, the Recovery Officer shall issue appropriate directions to such depository for effecting transfer to the purchaser.

### **Transfer of negotiable instruments and shares.**

73. (1) Where the execution of a document or the endorsement of the party in whose name a negotiable instrument or a security is standing is required to transfer such negotiable instrument or security to a person who has purchased it under a sale under these regulation, the Recovery Officer may execute such document or make such endorsement as may be necessary and such execution or endorsement shall have the same effect as an execution or endorsement by the party.

(2) The Recovery Officer may cause the document to be executed on proper stamp paper and to be registered if its registration is required by any law for the time being in force and the expenses of such execution and registration shall be borne by the purchaser.

(3) Until the transfer of such negotiable instrument or share, the Recovery Officer may, by order, appoint some person to receive any interest or dividend due thereon and to sign a receipt for the same; and any receipt so signed shall be as valid and effectual for all purposes as if the same had been signed by the party himself.

(4) Notwithstanding anything contained hereinabove, in case of shares or other securities held in an electronic form, the Recovery Officer may, by an order, direct any depository or custodian or any other person in whose custody the shares or securities

are held, to transfer such shares or securities to the purchaser.

**Vesting order in case of other property.**

74. In the case of any movable property not hereinbefore provided for, the Recovery Officer may make an order vesting such property in the purchaser or as the purchaser may direct; and such property shall vest accordingly.

**CHAPTER IV**

**ATTACHMENT AND SALE OF IMMOVABLE PROPERTY**

**PART I – ATTACHMENT**

**Attachment.**

75. Attachment of the immovable property of the defaulter shall be made by an order prohibiting the defaulter from transferring or charging the property in any way and prohibiting all persons from taking any benefit under such transfer or charge.

**Service of notice of attachment.**

76. A copy of the order of attachment shall be served on the defaulter.

**Proclamation of attachment.**

77. The order of attachment shall be proclaimed by publication in newspapers circulating in the locality, publication on website of the Board etc., and a copy of the order shall be affixed on a conspicuous part of the property or such other place as may be specified by the Recovery Officer and on the notice board of the office of the Recovery Officer.

**Attachment to relate back from the date of service of notice.**

78. Where any immovable property is attached under this regulation, the attachment shall relate back to, and take effect from, the date on which the notice to pay the dues, was issued under these regulations and served upon the defaulter.

**PART II – SALE**

**Sale and proclamation of sale.**

79. (1) The Recovery Officer may direct that any immovable property which has been attached, or such portion thereof as may seem necessary to satisfy the certificate, shall be sold.

(2) Where any immovable property is ordered to be sold, the Recovery Officer shall cause a proclamation of the intended sale to be made in the language of the district.

**Contents of proclamation.**

80. A proclamation of sale of immovable property shall be drawn up after notice to the defaulter, and shall state the time and place of sale, and shall specify, as fairly and accurately as possible,—

- (a) the property to be sold;
- (b) the revenue, if any, assessed upon the property or any part thereof;
- (c) the amount for the recovery of which the sale is ordered;
- (d) the reserve price, if any, below which the property may not be sold; and
- (e) any other thing which the Recovery Officer considers it material for a purchaser to know, in order to judge the nature and value of the property.

**Mode of making proclamation.**

81. (1) Every proclamation for the sale of immovable property shall be made by publication in newspapers circulating in the locality, publication on website of



the Board etc. and a copy of the proclamation shall be affixed on a conspicuous part of the property or such other place as may be specified by the Recovery Officer and also upon a conspicuous part of the office of the Recovery Officer.

(2) Where the Recovery Officer so directs, such proclamation shall also be published in the Official Gazette and the cost of such publication shall be deemed to be costs of the sale.

(3) Where the property is divided into lots for the purpose of being sold separately, it shall not be necessary to make a separate proclamation for each lot, unless proper notice of the sale cannot, in the opinion of the Recovery Officer, otherwise be given.

**Time of sale.**

82. No sale of immovable property under this regulation shall, without the consent in writing of the defaulter, take place until after the expiry of at least thirty days calculated from the date on which a copy of the proclamation of sale has been affixed on the property or in the office of the Recovery Officer, whichever is later.

**Sale to be by auction.**

83. The sale shall be by public auction, which may be conducted through electronic auction, to the highest bidder and shall be subject to confirmation by the Recovery Officer:

Provided that no sale under this regulation shall be made if the amount bid by the highest bidder is less than the reserve price, if any, specified.

**Deposit of earnest money.**

84.(1) The bids for purchase of any property shall be accompanied with payment of earnest money calculated at:

(a) ten per cent of the reserve price, where the reserve price is up to rupees ten crore, subject to a minimum of rupees fifty thousand; or

(b) rupees ten lakhs plus five per cent on the remaining amount of reserve price,

where the reserve price is above rupees ten crore.

(2) The earnest money so calculated shall be rounded to the nearest rupees thousand.

**Deposit by purchaser and resale in default.**

85.(1) On every sale of immovable property, the person declared to be the purchaser shall pay, immediately after such declaration, a deposit of twenty-five per cent on the amount of purchase money, including the earnest money, to the officer conducting the sale; and, in default of such deposit, the property shall forthwith be resold.

(2) The full amount of purchase money payable shall be paid by the purchaser to the Recovery Officer on or before the fifteenth day from the date of the sale of the property.

(3) The period of fifteen days under sub-regulation (2) may be extended by a maximum period of three months, subject to the purchaser making a request for such extension along with an undertaking to pay the remaining sale price together with interest thereon at the rate of fifteen per cent per annum for the period so extended.

(4) The application for extension of time for payment shall be accompanied by an unconditional bank guarantee for the remaining outstanding sale price and interest thereon at the rate mentioned hereinabove for a period of three months.

(5) The advertisement regarding the auction for sale of properties shall appropriately mention that extension to pay the consideration may be allowed subject to compliance with sub-regulations (3) and (4).

**Procedure in default of payment.**

86.(1) Upon default of payment within the period mentioned in the preceding regulation, the deposit may, if the Recovery Officer thinks fit, after defraying the expenses of the sale, be forfeited, and the property shall be resold, and the defaulting purchaser shall forfeit all claims to the property or to any part of the sum for which it may subsequently be sold.

(2) Without prejudice to sub-regulation (1), if the highest bidder fails to pay the

purchase price in accordance with the terms of sale, the property may be offered to the next highest bidder at a price equal to the bid made by the highest bidder.

**Refund of earnest money.**

87. Earnest money deposited by unsuccessful bidders shall be refunded without interest within sixty days from the date of confirmation of sale.

**Forfeiture of earnest money or other payments.**

88. Earnest money or any other part of the purchase price paid by a bidder shall be forfeited on the following circumstances:

- (a) the bidder not participating in the auction after successfully submitting the bid, or
- (b) on default in payment of twenty-five per cent of the purchase price, including the earnest money paid, immediately after the auction, or
- (c) on default in payment of remaining seventy-five per cent within fifteen days of the sale:

Provided that the earnest money shall not be forfeited if time for making payment is extended in accordance with sub-regulation (3) of regulation 85.

**Application to set aside sale of immovable property on deposit.**

89.(1) Where immovable property has been sold in execution of a certificate, the defaulter, or any person whose interests are affected by the sale, may, at any time within thirty days from the date of the sale, apply to the Recovery Officer to set aside the sale, on his depositing —

- (a) the amount specified in the proclamation of sale as that for the recovery of which the sale was ordered, with interest thereon at the rate of one and one-fourth per cent for every month or part of a month, calculated from the date of the proclamation of sale to the date when the deposit is made; and

(b) for payment to the purchaser, as penalty, a sum equal to five per cent of the purchase money.

(2) Where a person makes an application under regulation 90 for setting aside the sale of his immovable property, he shall not, unless he withdraws that application, be entitled to make or prosecute an application under this regulation.

**Application to set aside sale of immovable property on ground of non-service of notice or irregularity.**

90. Where immovable property has been sold in execution of a certificate, the defaulter, or any person whose interests are affected by the sale, may, at any time within thirty days from the date of the sale, apply to the Recovery Officer to set aside the sale of the immovable property on the ground that notice was not served on the defaulter to pay the arrears as required by this regulation or on the ground of a material irregularity in publishing or conducting the sale:

Provided that—

- (a) no sale shall be set aside on any such ground unless the Recovery Officer is satisfied that the applicant has sustained substantial injury by reason of the non-service or irregularity; and
- (b) an application made by a defaulter under this regulation shall be disallowed unless the applicant deposits the amount recoverable from him in the execution of the certificate.

**Setting aside sale where defaulter has no saleable interest.**

91. At any time within thirty days of the sale, the purchaser may apply to the Recovery Officer to set aside the sale on the ground that the defaulter had no saleable interest in the property sold.

**Confirmation of sale.**

92.(1) Where no application is made for setting aside the sale under these regulations or where such an application is made and disallowed by the

Recovery Officer, the Recovery Officer shall (if the full amount of the purchase money has been paid) make an order confirming the sale, and, thereupon, the sale shall become absolute.

(2) Where such application is made and allowed, and where, in the case of an application made to set aside the sale on deposit of the amount and penalty and charges, the deposit is made within thirty days from the date of the sale, the Recovery Officer shall make an order setting aside the sale:

Provided that no order shall be made unless notice of the application has been given to the persons affected thereby.

**Return of purchase money in certain cases.**

93. Where a sale of immovable property is set aside, any money paid or deposited by the purchaser on account of the purchase, together with the penalty, if any, deposited for payment to the purchaser, and such interest as the Recovery Officer may allow, shall be paid to the purchaser.

**Sale certificate.**

94.(1) Where a sale of immovable property has become absolute, the Recovery Officer shall grant a certificate of sale specifying the property sold, and the name of the person who at the time of sale is declared to be the purchaser.

(2) Such sale certificate shall state the date on which the sale became absolute.

**Registration of sale.**

95.(1) Every Recovery Officer granting a certificate of sale to the purchaser of immovable property sold under these regulations shall send a copy of such certificate to the registering officer concerned under the Indian Registration Act, 1908 (16 of 1908), within the local limits of whose jurisdiction the whole or any part of the immovable property comprised in the certificate is situated.

(2) The Recovery Officer or any officer acting under the direction of the Recovery Officer shall be exempted from personal appearance at the registration office.

**Postponement of sale to enable defaulter to raise amount due under certificate.**

96.(1) Where an order for the sale of immovable property has been made, if the defaulter can satisfy the Recovery Officer that there is reason to believe that the amount of the certificate may be raised by the mortgage or lease or private sale of such property, or some part thereof, or of any other immovable property of the defaulter, the Recovery Officer may, on his application, postpone the sale of the property comprised in the order for sale, on such terms, and for such period as he thinks proper, to enable the defaulter to raise the amount.

(2) In such case, the Recovery Officer shall grant a certificate to the defaulter, authorizing him, within a period to be mentioned therein, and notwithstanding anything contained in this regulation, to make the proposed mortgage, lease or sale:

Provided that all moneys payable under such mortgage, lease or sale shall be paid, not to the defaulter, but to the Recovery Officer:

Provided further that no mortgage, lease or sale under this regulation shall become absolute until it has been confirmed by the Recovery Officer.

**Fresh proclamation before re-sale.**

97. Every resale of immovable property, in default of payment of the purchase money within the period allowed for such payment, shall be made after the issue of a fresh proclamation in the manner and for the period hereinbefore provided for the sale.

**Purchase by Government.**

98. When an immovable property is put up for sale for recovery of amounts due and if the property remains unsold, the Board may, after giving opportunity to the defaulter to furnish the amounts due under the certificate, offer the same to the Central Government or any State Government, who may submit a bid not lower than the reserve price and purchase the said property:

Provided that, -

- i. offer to the Central or State Government under this regulation shall be made only in case where two earlier auctions in respect of the said immovable property have been unsuccessful;
- ii. the Board may afford such time as may be deemed fit to such Central or State Government to convey its willingness to purchase and to make payment of the consideration; and
- iii. where the property is put up for sale for recovery of any penalty due or other amount payable to the Central Government and the reserve price does not exceed the amount due, the Central Government may acquire the property by extinguishing the liability of the defaulter equal to the reserve price.

**Bid of co-sharer to have preference.**

99. Where the property sold is a share of undivided immovable property, and two or more persons, of whom one is a co-sharer, respectively bid the same sum for such property or for any lot, the bid shall be deemed to be the bid of the co-sharer.

**Delivery of immovable property in occupancy of defaulter.**

100. (1) Where the immovable property sold is in the occupancy of the defaulter or of some person on his behalf or of some person claiming under a title created by the defaulter subsequently to the attachment of such property and a certificate of sale in respect thereof has been granted under regulation 94, the Recovery Officer shall, on the application of the purchaser, order delivery to be made by putting such purchaser or any person whom the purchaser may appoint to receive delivery on his behalf in possession of the property, and if need be, by removing any person who refuses to vacate the same.

(2) For the purposes of sub-regulation (1), if the person in possession does not afford free access, the Recovery Officer may, after giving reasonable warning and facility to

any woman not appearing in public according to the customs of the country to withdraw, remove or open any lock or bolt or break open any door or do any other act necessary for putting the purchaser, or any person whom the purchaser may appoint to receive delivery on his behalf, in possession.

**Delivery of immovable property in occupancy of tenant.**

101. Where the immovable property sold is in the occupancy of a tenant or other person entitled to occupy the same and a certificate of sale in respect thereof has been granted under regulation 94, the Recovery Officer shall, on the application of the purchaser, order delivery to be made by affixing a copy of the certificate of sale in some conspicuous place on the property or such other place as may be deemed appropriate by the Recovery Officer, and proclaiming to the occupant by any customary mode, at some convenient place that the interest of the defaulter has been transferred to the purchaser.

**Resistance or obstruction to possession of immovable property.**

102. (1) Where the purchaser of immovable property sold in execution of a certificate is resisted or obstructed by any person in obtaining possession of the property, he may make an application to the Recovery Officer complaining of such resistance or obstruction within thirty days of the date of such resistance or obstruction.

(2) The Recovery Officer shall fix a day for investigating the matter and shall summon the party against whom the application is made to appear and answer the same.

**Resistance or obstruction by defaulter.**

103. Where the Recovery Officer is satisfied that the resistance or obstruction was occasioned without any just cause by the defaulter or by some other person at his instigation, he shall direct that the applicant be put into possession of the property, and where the applicant is still resisted or obstructed in obtaining possession, the Recovery Officer may also, at the instance of the applicant, take



steps to put the applicant into possession of the property by removing the defaulter or any person acting at his instigation.

**Resistance or obstruction by bona fide claimant.**

104. Where the Recovery Officer is satisfied that the resistance or obstruction was occasioned by any person (other than the defaulter) claiming in good faith to be in possession of the property on his own account or on account of some person other than the defaulter, the Recovery Officer shall make an order dismissing the application.

**Dispossession by purchaser.**

105. (1) Where any person other than the defaulter is dispossessed of immovable property sold in execution of a certificate by the purchaser thereof, he may make an application to the Recovery Officer complaining of such dispossession within thirty days of such dispossession.

(2) The Recovery Officer shall fix a day for investigating the matter and shall summon the party against whom the application is made to appear and answer the same.

**Bona fide claimant to be restored to possession.**

106. Where the Recovery Officer is satisfied that the applicant was in possession of the property on his own account or on account of some person other than the defaulter, he shall direct that the applicant be put into possession of the property.

**Regulations not applicable to transferee pendente lite.**

107. Nothing in the foregoing regulations shall apply to resistance or obstruction by a person to whom the defaulter has transferred the property after the service of a notice under regulation 6 or to the dispossession of any such person.

## CHAPTER V

### APPOINTMENT OF A RECEIVER

#### **Appointment of receiver for business.**

108. (1) Where the property of a defaulter consists of a business, the Recovery Officer may attach the business and appoint a person as receiver to manage the business.

(2) Attachment of a business under this regulation shall be made by an order prohibiting the defaulter from transferring or charging the business in any way and prohibiting all persons from taking any benefit under such transfer or charge, and intimating that the business has been attached under this regulation.

(3) A copy of the order of attachment shall be served on the defaulter, and another copy shall be affixed on a conspicuous part of the premises in which the business is carried on and on the notice board of the office of the Recovery Officer.

#### **Appointment of receiver for immovable property.**

109. Where immovable property is attached, the Recovery Officer may, instead of directing a sale of the property, appoint a person as receiver to manage such property.

#### **Powers of receiver.**

110. (1) Where any business or other property is attached and taken under management under the foregoing regulations, the receiver shall, subject to the control of the Recovery Officer, have such powers as may be necessary for the proper management of the property.

(2) A receiver appointed under these regulations shall have all such powers, as to bringing in and defending suits and for the realization, management, protection and preservation of the property, the collection of the rents and profits thereof, the

application and disposal of such rents and profits, and the execution of documents as the owner himself has, or such of those powers as the Recovery Officer thinks fit.

(3) The profits, or rents and profits, of such business or other property, shall, after defraying the expenses of management, be adjusted towards discharge of the arrears, and the balance, if any, shall be paid to the defaulter.

**Remuneration of a receiver.**

111. The Recover Officer may, by general or special order, fix the amount to be paid as remuneration for the services of the receiver.

**Duties of a receiver.**

112. (1) Every receiver so appointed shall—

- (a) furnish such security (if any) as the Recovery Officer thinks fit, duly to account for what he shall receive in respect of the property;
- (b) submit his accounts at such periods and in such form as the Recovery Officer directs;
- (c) pay the amount due from him as the Recovery Officer directs; and
- (d) be responsible for any loss occasioned to the property by his wilful default or gross negligence.

(2) The receiver shall maintain true and regular accounts of the receivership and shall in particular maintain a cash book in which shall be entered from day to day all receipts and payments and also a ledger.

(3) The receiver shall also maintain a counterfoil receipt book with the leaves numbered serially in print, from which shall be given, as far as possible, all receipts for payments made to the receiver.

(4) Unless the Recovery Officer otherwise directs, the receiver shall, as soon as may be, after his appointment, open an account in the name of the receivership in such bank as the Recovery Officer may direct and shall deposit therein all moneys received in the course of the receivership immediately on receipt thereof save any minimum sums that may be required for meeting day to day current expenses. All payments by the receiver

shall, as far as possible, be made by cheques drawn on the bank account.

(5) Unless otherwise ordered, a receiver shall submit his accounts once in every three months:

Provided the first of such accounts commencing from the date of his appointment and ending with the expiry of three months therefrom shall be submitted within fifteen days of the expiry of the said period of three months and the subsequent accounts brought down to the end of each succeeding period of three months within fifteen days of the expiry of each such period of three months.

**Enforcement of receiver's duties.**

113. (1) Where a receiver fails to submit his accounts at such periods and in such form as the Recovery Officer directs, the Recovery Officer may direct his property to be attached until such time as such accounts are submitted to him.

(2) The Recovery Officer may at any time make an enquiry as to the amount, if any, due from the receiver, as shown by his accounts or otherwise, or an inquiry as to any loss to the property occasioned by his wilful default or gross negligence and may order the amount found due, if not already paid by the receiver, or the amount of the loss so occasioned, to be paid by the receiver within a period to be fixed by the Recovery Officer.

(3) Where the receiver fails to pay any amount which he has been ordered to pay under sub-regulation (2) within the period specified, the Recovery Officer may direct such amount to be recovered from the security (if any) furnished by the receiver or by attachment and sale of his property or, if his property has been attached under sub-regulation (1), by the sale of such property and may direct the sale proceeds to be applied in making good any amount found due from the receiver or any such loss occasioned by him and the balance (if any) of the sale proceeds shall be paid to the receiver.

(4) If a receiver fails to submit his accounts at such periods and in such form as directed by the Recovery Officer without reasonable cause or improperly retains any cash in his hands, the Recovery Officer may disallow the whole or any portion of the

remuneration due to him for the period of the accounts with reference to which the default is committed and may also charge interest at a rate not exceeding twelve per cent per annum on the moneys improperly retained by him for the period of such retention without prejudice to any other proceedings which might be taken against the receiver.

**Withdrawal of management.**

114. The attachment and management under the foregoing regulation may be withdrawn at any time at the discretion of the Recovery Officer, or if the arrears are discharged by receipt of such profits and rents or are otherwise paid.

**CHAPTER VI**

**ARREST AND DETENTION OF THE DEFAULTER**

**Notice to show cause.**

115. (1) No order for the arrest and detention in civil prison of a defaulter shall be made unless the Recovery Officer has issued and served a notice upon the defaulter calling upon him to appear before him on the date specified in the notice and to show cause why he should not be committed to civil prison, and unless the Recovery Officer, for reasons recorded in writing, is satisfied—
- (a) that the defaulter, with the object or effect of obstructing the execution of the certificate, has dishonestly transferred, concealed, or removed any part of his property, or
  - (b) that the defaulter has, or has had since the drawing up of the certificate by the Recovery Officer, the means to pay the arrears or some substantial part thereof and refuses or neglects or has refused or neglected to pay the same.

(2) Notwithstanding anything contained in sub-regulation (1), a warrant for the arrest of the defaulter may be issued by the Recovery Officer if the Recovery Officer is satisfied, by affidavit or otherwise, that with the object or effect of delaying the execution of the certificate, the defaulter is likely to abscond or leave the local limits of the jurisdiction of the Recovery Officer.

(3) Where appearance is not made in obedience to a notice issued and served under sub-regulation (1), the Recovery Officer may issue a warrant for the arrest of the defaulter.

(4) A warrant of arrest issued by a Recovery Officer under sub-regulation (2) or sub-regulation (3) may also be executed by any other Recovery Officer within whose jurisdiction the defaulter may for the time being be found.

(5) Every person arrested in pursuance of a warrant of arrest under this regulation shall be brought before the Recovery Officer issuing the warrant as soon as practicable and in any event within twenty-four hours of his arrest (exclusive of the time required for the journey):

Provided that, if the defaulter pays the amount entered in the warrant of arrest as due and the costs of the arrest to the officer arresting him, such officer shall at once release him.

Explanation.—For the purposes of this regulation,

- (i) where the defaulter is a company, the directors and other officers who are in default shall be deemed to be the defaulters;
- (ii) where the defaulter is a partnership firm, all partners of the firm shall be deemed to be the defaulters; and
- (iii) where the defaulter is a Hindu undivided family, the Karta thereof shall be deemed to be the defaulter.

### **Hearing.**

116. When a defaulter appears before the Recovery Officer in obedience to a notice to show cause or is brought before the Recovery Officer under regulation 115, the Recovery Officer shall give the defaulter an opportunity of showing

cause as to why he should not be committed to civil prison.

**Custody pending hearing.**

117. Pending the conclusion of the inquiry, the Recovery Officer may, in his discretion, order the defaulter to be detained in the custody of such officer as the Recovery Officer may think fit or release him on his furnishing security to the satisfaction of the Recovery Officer for his appearance whenever required.

**Order of detention.**

118. (1) Upon the conclusion of the inquiry, the Recovery Officer may make an order for the detention of the defaulter in the civil prison and shall in that event cause him to be arrested if he is not already under arrest:

Provided that in order to give the defaulter an opportunity of satisfying the dues under the certificate along with any other dues under these regulations, the Recovery Officer may, before making the order of detention, leave the defaulter in the custody of the officer arresting him or of any other officer for a specified period not exceeding fifteen days, or release him on his furnishing security to the satisfaction of the Recovery Officer for his appearance at the expiration of the specified period if the arrears are not so satisfied.

(2) When the Recovery Officer does not make an order of detention under sub-regulation (1) he shall, if the defaulter is under arrest, direct his release.

**Prison in which defaulter may be detained.**

119. A person against whom an order of detention has been passed may be detained in the civil prison of the district in which the office of the Recovery Officer ordering the detention is situated, or, where such civil prison does not afford suitable accommodation, in any other place which the State Government may appoint for the detention of persons ordered by the civil courts of such district to be detained.

**Detention in and release from prison.**

120. (1) Every person detained in the civil prison in execution of a certificate may be so detained,—

- (a) where the certificate is for a demand of an amount exceeding two hundred and fifty rupees—for a period of six months, and
- (b) in any other case—for a period of six weeks:

Provided that he shall be released from such detention—

- (i) on the amount mentioned in the warrant for his detention being paid to the officer-in-charge of the civil prison, or
  - (ii) on the request of the Recovery Officer on any ground other than the grounds mentioned in regulations 117 and 118.
- (2) A defaulter released from detention under this regulation shall not, merely by reason of his release, be discharged from his liability for the arrears; but he shall not be liable to be rearrested under the certificate in execution of which he was detained in the civil prison.

**Subsistence allowance.**

121. (1) When a defaulter is arrested or detained in the civil prison, the sum payable for the subsistence of the defaulter from the time of arrest until he is released shall be borne by the Recovery Officer.

(2) Such sum shall be calculated on the scale fixed by the State Government for the subsistence of judgment-debtors arrested in execution of a decree of a civil court.

(3) Sums payable under this regulation shall be deemed to be costs in the proceeding: Provided that the defaulter shall not be detained in the civil prison or arrested on account of any sum so payable.

(4) The subsistence allowance shall be supplied by the Recovery Officer by monthly instalments in advance before the first day of each month.

(5) The first payment shall be made to the Recovery Officer for such portion of the current month as remains unexpired before the defaulter is committed to the civil prison, and the subsequent payment (if any) shall be made to the officer in charge of



the civil prison.

**Release.**

122. (1) The Recovery Officer may order the release of a defaulter who has been arrested in execution of a certificate upon being satisfied that he has disclosed the whole of his property and has placed it at the disposal of the Recovery Officer and that he has not committed any act of bad faith.

(2) If the Recovery Officer has ground for believing the disclosure made by a defaulter under sub-regulation (1) to have been untrue, he may order the re-arrest of the defaulter in execution of the certificate, but the period of his detention in the civil prison shall not in the aggregate exceed that authorised by regulation 120.

**Release on ground of illness.**

123. (1) At any time after a warrant for the arrest of a defaulter has been issued, the Recovery Officer may cancel it on the ground of his serious illness.

(2) Where a defaulter has been arrested, the Recovery Officer may release him if, in the opinion of the Recovery Officer, he is not in a fit state of health to be detained in the civil prison.

(3) Where a defaulter has been committed to the civil prison, he may be released therefrom by the Recovery Officer on the ground of the existence of any infectious or contagious disease, or on the ground of his suffering from any serious illness.

(4) A defaulter released under this regulation may be rearrested, but the period of his detention in the civil prison shall not in the aggregate exceed that authorised by regulation 120.

**Entry into dwelling house.**

124. For the purpose of making an arrest under this regulation —

(a) no dwelling house shall be entered after sunset and before sunrise;

(b) no outer door of a dwelling house shall be broken open unless such dwelling house or a portion thereof is in the occupancy of the defaulter and he or other

occupant of the house refuses or in any way prevents access thereto; but, when the person executing any such warrant has duly gained access to any dwelling house, he may break open the door of any room or apartment if he has reason to believe that the defaulter is likely to be found there;

- (c) no room, which is in the actual occupancy of a woman who, according to the customs of the country, does not appear in public, shall be entered into unless the officer authorised to make the arrest has given notice to her that she is at liberty to withdraw and has given her reasonable time and facility for withdrawing;
- (c) no room, which is in the actual occupancy of a woman, shall be entered into unless the officer authorised to make the arrest has given reasonable notice to her and such officer is a woman or is accompanied by a woman officer.

**Prohibition against arrest of women or minors, etc.**

125. The Recovery Officer shall not order the arrest and detention in the civil prison of,-

- (a) a woman, or
- (b) any person who, in his opinion, is a minor or of unsound mind.

**CHAPTER VII**

**APPOINTMENT OF ADMINISTRATOR AND PROCEDURE FOR REFUNDING TO THE INVESTORS**

**PART I – PRELIMINARY**

**Applicability.**

126. (1) Without prejudice to the other provisions of these regulations, this provisions under this Chapter shall be applicable for all or any of the following:
- a. appointment of Administrator pursuant to failure to comply with disgorgement

or refund orders passed by the Board;

- b. sale of properties attached by the Recovery Officer of the Board under the Act;
- c. collection of claim documents and verification of claims of investors for the purpose of effecting refunds;
- d. refund of monies to the investors pursuant to disgorgement or refund orders passed by the Board;
- e. recovery of disgorgement amounts directed by the Board;
- f. any act incidental or connected thereto.

(2) Unless otherwise specifically ordered, these regulations shall not be applicable to cases where the Securities Appellate Tribunal or a Court has appointed an administrator or any other person for the purposes of recovery and/or repayment to investors.

(3) The provisions of these regulations shall apply *mutatis mutandis* in respect of the proceedings under the Securities Contracts (Regulation) Act, 1956 or the Depositories Act, 1996.

#### **Appointment of an Administrator.**

127. (1) For the purposes of this Chapter, the Board shall, after attachment of the properties of the defaulter by the Recovery Officer, appoint an Administrator in the manner specified:

(2) Notwithstanding the generality of sub-regulation (1), the Board may decide not to appoint an Administrator—

- (i) in case where the cost of administration would be higher than the amount that can be recovered from the defaulter through the means specified under the Act and these regulations; or
- (ii) in such other circumstances that may be specified by the Board.

#### **Eligibility norms for appointment as an Administrator.**

128. (1) The Administrator shall be a person registered with the Insolvency and Bankruptcy Board of India as an Insolvency Resolution Professional and

empanelled by the Board from time to time.

(2) No person shall be appointed as an Administrator where such an appointment may be objected to on the grounds that give rise to justifiable doubts as to the independence or impartiality of such a person:

Provided that any question involving issues of conflict of interest in the appointment of an Administrator shall be decided by the Recovery Officer.

(3) The Administrator shall provide an undertaking to the Board of absence of any conflict of interest with the defaulter, its directors, promoters, key managerial personnel and its group entities.

(4) The Administrator shall also forthwith disclose to the Board any conflict of interest which may come to his knowledge during his tenure:

(5) For the purposes of these regulations, the Administrator shall be deemed to be a public servant within the meaning of section 21 of the Indian Penal Code (45 of 1860) and sections 22 and 23 of the Act shall accordingly apply to him.

### **Terms of appointment.**

129. The terms and conditions of appointment including remuneration shall be specified by the Board, on a case to case basis, after taking into consideration the quantum of work, the number of investors and the quantum of money involved.

## **PART II - FUNCTIONS OF THE ADMINISTRATOR**

### **Functions.**

130. (1) An Administrator shall perform the following functions –

(a) As may be directed by the Recovery Officer, obtain from the defaulter or any other person, any information or document including documents relating to ownership and possession of properties, details of amount raised from investors, claims of investors, amount claimed to have been refunded to investors;

- (b) Make a record of the properties that have been attached by the Recovery Officer including the additional properties that have been entrusted by the Recovery Officer from time to time and those properties which are not part of the attachment order;
  - (c) Make a record of the bank accounts and dematerialised accounts of the defaulter and value of the monies and securities held thereunder;
  - (d) Arrange for a proclamation for the sale of the property and arrange affixation of the copy of such proclamation;
  - (e) Open an interest bearing bank account, under the control of the Recovery Officer, with a scheduled public sector bank for depositing the proceeds of the money recovered from the sale of the assets and for making repayment to the investors;
  - (f) Sell the attached properties in accordance with these regulations or as may be directed by the Recovery Officer;
  - (g) Call for claims, in the manner specified in these regulations or as may be directed by the Recovery Officer, for the purposes of repayment to investors, pursuant to an order of the Board for refunds;
  - (h) Verify the claims of investors and also that of the defaulter in respect of repayment of monies, either partly paid or wholly paid, claimed to have been made to investors on the basis of documentary evidence:  
Explanation – Verification may involve forensic auditing.
  - (i) Carry out any other necessary incidental and supplementary act, with the prior approval of the Recovery Officer that may be required for the purpose of carrying out its obligations under these regulations.
- (2) While discharging the functions under these regulations, the Administrator -
- (a) may engage the services of a peer reviewed chartered accountant for verifying the claims of investors on the basis of documentary evidence and for submission of a certified report to the Administrator;
  - (b) shall engage the services of a registered valuer to evaluate the properties of defaulter that are attached by the Recovery Officer and for submission of a

certified valuation report in accordance with the guidelines issued by the Board;

- (c) may engage the services of a registrar and share transfer agent registered with the Board or such other agency as may be approved by the Recovery Officer, for managing the entire repayment process.

Provided that the fees paid for such services shall be fixed by the Administrator taking into account the relevant factors including –

- (a) the number of investors and the claims that are made;
- (b) quantum of work involved;
- (c) the number of assets to be evaluated;
- (d) the geographical location of the property and its proximity with the valuer's place of business;

and such fees shall be within the overall remuneration fixed by the Board for the Administrator:

Provided further that the intermediary or such other person engaged by the Administrator, shall not have any conflict of interest which would impede their independence or impartiality.

(3) The Administrator shall submit a monthly report or a report as and when called for by the Recovery Officer on the progress of work entrusted including the monies realised pursuant to the sale of the properties and the repayments made to the investors.

### **PART III – SALE OF ASSETS**

#### **Sale of assets.**

131. (1) The Administrator shall undertake the process of sale of properties after conducting an independent valuation of such properties by a registered valuer.

(2) After considering the valuation report, the Recovery Officer may decide on the reserve price below which the property may not be sold.

(3) The Administrator may undertake the sale of properties through electronic auction process and for this purpose engage an electronic auction agency and shall in consultation with the Recovery Officer repeat the auction process till the time such properties are disposed of or otherwise directed.

(4) The process of disposing off the properties shall be under the supervision of the Recovery Officer.

(5) On completion of the sale and receipt of the sale consideration, the Recovery Officer shall issue an order confirming such sale.

(6) The amount realized in respect of sale of properties of the defaulter shall be deposited in a separate bank account with a scheduled public sector bank in terms of clause (e) of sub-regulation (1) of regulation 130 and such account shall be under the control of the Recovery Officer.

#### **PART IV – DISGORGEMENT OR REFUND OF MONIES**

##### **Disgorgement or Refund to investors.**

132. (1) For the purposes of inviting claims from the investors, the Administrator shall -

(a) issue advertisements in an English and a Hindi newspaper having nationwide circulation and if so directed by the Recovery Officer, issue such advertisement in vernacular newspaper(s) having circulation in the area(s) where the investors are concentrated;

(b) direct the defaulter to issue advertisement in its website, if available.

(2) The advertisement referred to sub-regulation (1) may also be hosted on the website of the Board.

(3) The advertisements referred to in sub-regulation (1) shall contain instructions on the manner of making claims by investors and the documents and information that are to be submitted for verifying and processing their claim applications.

(4) The filing of claims from the investors shall be through electronic mode or be received in the office of the Administrator as directed:

Provided that the investors' claims received, if any, by the Board and forwarded to the Administrator shall also be included in the relevant records maintained by the Administrator.

(5) The Administrator or the chartered accountant engaged by the Administrator, shall consider the total eligible claims as against the monies available for distribution to investors in order to determine whether the whole amount or a proportionate amount may be repaid to the investors as may be directed by the Recovery Officer.

(6) Upon ascertaining the eligibility, the Administrator in consultation with the Recovery Officer, shall repay the money to the eligible investors only through pay orders, demand drafts and electronic transfer through NEFT or RTGS.

(7) The refund process shall be kept open for an appropriate period as may be decided in consultation with the Recovery Officer.

(8) The monies remaining in the interest bearing escrow bank account after satisfying all the permissible claims of investors and other charges, shall be retained therein for a period of three years in order to meet the claims that may be received from any unpaid investor.

(9) Upon completion of the period specified under sub-regulation (8), the unpaid monies due to investors, if any, shall be transferred to the Investor Protection and Education Fund of the Board:

Provided that monies transferable under the Companies Act, 2013 [18 of 2013] to the Investor Education and Protection Fund shall be transferred to such fund.

(10) In case any claim is received from an unpaid investor in respect of monies transferred to the Investor Protection and Education Fund after the refund process has been closed, the same may be made from the Investor Protection and Education Fund after necessary verification by the Administrator in consultation with the Recovery Officer:

Provided that the claim shall be made within a period of three years from the date of transfer of monies to the Investor Protection and Education Fund in terms of sub-regulation (9).

(11) The defaulter, and its officers who are in default as defined under section 2 of the



Companies Act, 2013, as applicable, shall furnish an undertaking that they shall be liable for payment if any complaint is received in future by the Board from any investor.

**Costs incurred in administration and repayment process.**

133. (1) The entire costs incurred in relation to the sale of properties, verification of investors' claims, remuneration of Administrator including the fees paid, if any, to the chartered accountant or valuer or such other person engaged by the Administrator and registrar and share transfer agent and all other expenses incurred in connection with the recovery and/or the repayment process shall be borne by the defaulter(s), failing which, the monies recovered by the Board shall be appropriated in priority to the other liabilities.

(2) The cost and expenses referred to in sub-regulation (1) shall be reasonable and directly related to and necessary for the act and purposes referred to in these regulations.

(3) Where the Administrator is appointed on the request of a person against whom an order for disgorgement or refund had been issued by the Board, the remuneration of the Administrator and the other costs incurred in respect of recovery and/or refund to the investors shall be borne by such person.

**Priority in distribution of sale proceeds.**

134. The proceeds from the sale of properties of the defaulter shall be distributed in the following order of priority, namely, -

- i. the costs of administration incurred by the Board, if any, and the fees and charges payable to the Administrator and other persons appointed by the administrator in performing its functions under these regulations;
- ii. disgorgement and/or monies payable to investors;
- iii. any other penalty or fees due from the defaulter to the Board under the provisions of the Act, the Securities Contracts (Regulation) Act, 1956 or

the Depositories Act, 1996.

**Refund in tranches.**

135. (1) Where recovery has not been completed but the Board is satisfied that refund to investors should be initiated based on the monies realized at the relevant time, the Board may direct the Administrator to initiate the process of refund to investors.
- (2) Unless otherwise decided by the Administrator, the investors in the same class shall receive proportionately.
- (3) The Administrator may refund claims in tranches by value.

**Return of monies exceeding the liability.**

136. In case the proceeds realised by way of sale of properties of the defaulter is in excess of the monies due from him under the certificate and the applicable interest and other charges, the excess money shall be paid to the defaulter after completion of three years from the date of completion of the refund process.

**Filing of the repayment report.**

137. Upon completion of the repayments to all investors or recovery of the disgorgement amount from the defaulter, the Administrator shall file a detailed repayment/recovery report to the Recovery Officer or Board, as the case may be, within the period as may be specified.

**PART V – DISGORGEMENT OF AMOUNTS**

**Application of this Chapter to disgorgement.**

138. The provisions of these Chapter shall be applied in so far as it is

applicable and the disgorgement amount so recovered shall be credited to the Investor Protection and Education Fund of the Board unless distributed to eligible investors.

Provided that no investor shall be eligible for receiving disgorgement monies unless,-

- i. The investor has been identified by an order issued by the Board;
- ii. The investor's claim is in the nature of restitution for monies *had and received* by the defaulter(s) and not compensatory in nature.

Explanation 1. –A claim for restitution means a claim where the wrongful loss to the claimant directly resulted in, and amounted to the wrongful gain of the defaulter(s) which has been disgorged and now claimed.

Explanation 2. – A claim for compensation means a claim where the wrongful loss to the claimant did not directly result in, and amount to the wrongful gain of the defaulter(s) against whom disgorgement has been done but in the gain of someone else.

## **PART VI - GENERAL OBLIGATIONS AND RESPONSIBILITIES**

### **Obligations and Responsibilities**

139. An Administrator -

- a) shall maintain high standards of integrity, promptitude and fairness in the conduct of all his business;
- b) shall act with due skill, care and diligence in the conduct of all his business;
- c) shall not misrepresent any facts or situations and shall refrain from being involved in any action that would bring disrepute to the profession;
- d) shall act with objectivity during the course of his professional dealings by ensuring that all decisions are made without any bias, conflict of interest, coercion, or undue influence of any party, whether directly or indirectly connected to sale of properties, verification of claims and refund of monies;
- e) shall not acquire, directly or indirectly, any of the assets of the defaulter;

- f) shall maintain complete independence in all professional relationships and conduct the verification and refund process, as the case may be, independent of external influences;
- g) shall not conceal any material information or knowingly make a misleading statement to the Recovery Officer or the Board;
- h) shall not act with *mala fide* or be negligent while performing the functions and duties under the regulations;
- i) shall provide all information and records as may be required by the Recovery Officer within the time specified by him;
- j) shall ensure that confidentiality of the information relating to the sale of properties, verification and refund process, is maintained at all times;  
Provided that the Administrator may disclose any information after obtaining written authorization of the Recovery Officer or the Board;
- k) shall disclose all costs towards the verification and refund process and endeavour to ensure that such costs are not unreasonable; and
- l) shall comply with the terms and conditions of its appointment.

#### **PART VII - ACTION IN CASE OF DEFAULT**

##### **By an Administrator.**

140. (1) The Recovery Officer may, for reasons to be recorded in writing, recommend for replacement of the Administrator, in case the Administrator has -
- a) failed to comply with the terms and conditions of appointment;
  - b) engaged valuers or chartered accountants or such other persons who are ineligible to act so;
  - c) failed to comply with any of the obligations and responsibilities specified under these regulations;
  - d) acted against the instructions of the Recovery Officer or the Board; or

**e)** acted in such manner that is prejudicial to the interest of the investors.

(2) Without prejudice to the actions detailed under sub-regulation (1), the Recovery Officer may recommend for initiation of any appropriate action under securities laws.

(3) On receipt of such recommendation or suo moto, the Board may take appropriate action against the Administrator or such intermediary or such other person engaged by the Administrator, including the following:

(a) remove such Administrator from the Panel;

(b) forward the matter to the Insolvency and Bankruptcy Board of India for appropriate action against the Administrator who is an Insolvency Resolution Professional; and

(c) issue suitable directions restraining such person from engaging in activities in the securities market in his professional capacity.

#### **Loss of registration.**

141. If the registration of an Administrator with the Insolvency and Bankruptcy Board of India is cancelled or suspended at any time, such Administrator shall be deemed to have been removed from the Panel till such cancellation or suspension is in effect and be forthwith relieved of any duties under these regulations.

## **CHAPTER IX**

### **MISCELLANEOUS**

#### **Power to take evidence.**

142. The Recovery Officer or other officer acting under the provisions of these regulations shall have the powers of a civil court while trying a suit for the purpose of receiving evidence, administering oaths, enforcing the attendance of witnesses and compelling the production of documents.

**Continuance of certificate.**

143. No certificate shall cease to be in force by reason of the death of the defaulter.

**Procedure on death of defaulter.**

144. If at any time after the certificate is drawn up by the Recovery Officer, the defaulter dies, the proceedings under these regulations (except arrest and detention) may be continued against the legal representative of the defaulter in terms of section 28B of the Act or section 23JC of the Securities Contracts (Regulation) Act, 1956 or section 19-IC of the Depositories Act, 1996, and the provisions of these regulation shall apply as if the legal representative is the defaulter.

**Recovery from surety.**

145. Where any person has become surety for the amount due by the defaulter, he may be proceeded against under these regulations as if he were the defaulter.

**Recovery by suit or under other law not affected.**

146. The several modes of recovery specified in these regulations shall not affect in any way the right of the Board to institute a suit for the recovery of the amount due from the defaulter and it shall be lawful for the Board to have recourse to any such suit, notwithstanding that the amount due is being recovered from the defaulter by any mode specified in these regulations.

**Costs and charges.**

147. (1) The following costs and expenses shall be recoverable in execution of a certificate -

(a) costs incurred in attachment of movable properties, including expenses incurred in execution of attachment proceedings,

- (b) charges incurred in valuation of movable and immovable properties,
- (c) costs of publishing notices, orders etc. including in newspapers,
- (d) costs incurred in service of notices,
- (e) costs incurred in maintaining custody of articles attached, and
- (f) such other costs and expenses that may be incurred in realizing the amounts due under the certificate.

**Power to seek information.**

148. (1) The Recovery Officer may at any stage of the execution of the certificate of recovery, seek from any person, any information which may be relevant to execution of the certificate of recovery or to any investigation or inquiry by the Recovery Officer.

(2) Without limiting the generality of the foregoing provision, the Recovery Officer may at any stage of the execution of the certificate of recovery, require any person against whom or which the certificate of recovery is issued, and if such person is a body corporate from any of its officers, to declare on affidavit the particulars of his or its assets.

**Continuance of pending proceedings.**

149. All proceedings for the recovery of amounts initiated and pending before the coming into force of these regulations shall be continued under these regulations, and, for this purpose, every certificate issued by the Recovery Officer before coming into force of these regulations shall be deemed to be a certificate drawn up by the Recovery Officer under the corresponding provisions of these regulations.

**Officers deemed to be acting judicially.**

150. The Recovery Officer or other officers shall, in the discharge of functions under Act or the Securities Contracts (Regulation) Act, 1956 or the Depositories Act, 1995 and these regulations, be deemed to be acting judicially within the

meaning of the Judicial Officers Protection Act, 1850 (18 of 1850).

**Forms.**

151. The Board or the Recovery Officer may specify by way of a circular the forms to be used for any order, notice, warrant, or certificate to be issued under these regulations.

**Power of the Board to issue clarifications.**

152. In order to remove any difficulties in the application or interpretation of these regulations, the Board may issue clarifications and guidelines, as deemed necessary.

**Power to determine procedure in certain circumstances.**

153. In a situation not provided for in these regulations, the Recovery Officer, with the approval of the Board, may determine the procedure for specific matters, as may be required.

**Repeal and Savings.**

154. (1) On the commencement of these regulations,-
- i. the Securities and Exchange Board of India (Appointment of Administrator and Procedure for Refunding to the Investors) Regulations, 2018 shall stand repealed and any action taken under those regulations shall be deemed to have been taken under these regulations and continued under these regulations; and
  - ii. any ongoing proceedings before a Recovery Officer appointed by the Board may be continued under these regulations.

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**PART-C**

**QUANTIFICATION OF 'DISPROPORTIONATE GAIN OR UNFAIR  
ADVANTAGE' AND 'LOSS CAUSED TO AN INVESTOR OR GROUP OF  
INVESTORS AS A RESULT OF THE DEFAULT' AND RELATED ISSUES**

## I. RELEVANCE OF QUANTIFICATION OF ‘PROFIT’ AND ‘LOSS’

### AN INTRODUCTION

Securities laws require the Board and the Adjudicating Officer to take into account relevant factors for the purpose of arriving at a suitable penalty to be levied on the persons who violate securities laws, viz. -

- (i) the amount of disproportionate gain or unfair advantage, wherever quantifiable, as a result of the default;
- (ii) the amount of loss caused to an investor or group of investors as a result of the default; and
- (iii) the repetitive nature of default.

The existing settlement regulations also require the Board to take into account these factors.<sup>39</sup> In the Report on the Settlement mechanism of the Board, this Committee has dealt with the factors relating to the ‘*repetitive nature of the default*’. In the Indian context, the first notable attempt to lay down the manner of quantification in relation to securities fraud was made by the Hon’ble Supreme Court of India in the matter of *Trojan & Co. Ltd v R. M. N. N. Nagappa Chettiar*<sup>40</sup>, wherein the apex court *inter alia* held as follows, -

“Ordinarily the market rate of the shares on the date when the fraud was practised would represent their real price in the absence of any other circumstance. *If, however, the market was vitiated or was in a state of flux or panic in consequence of the very fact that was fraudulently concealed, then the real value of the shares has to be determined on a consideration of a variety of circumstances disclosed by the evidence led by the parties. (emphasis supplied)*

Thus though ordinarily the market rate on the earliest date when the real facts became known may be taken as the real value of the shares, nevertheless, if there

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<sup>39</sup> Regulations 9 and 10 of the Settlement Regulations.

<sup>40</sup> AIR 1953 SC 235, 1953 SCR 780.

is no market or there is no satisfactory evidence of a market rate for some time which may safely be taken as the real value, then if the representee sold the shares, although not bound to do so, and if the resale has taken place within a reasonable time and on reasonable terms and has not been unnecessarily delayed, then the price fetched at the resale may well be taken into consideration in determining retrospectively the true market value of the shares on the crucial date. *If there is no market at all or if the market rate cannot, for reasons referred to above, be taken as the real or fair value of the thing and the representee has not sold the things, then in ascertaining the real or fair value of the thing on the date when deceit was practised subsequent events may be taken into account, provided such subsequent events are not attributable to extraneous circumstances which supervened on account of the retaining of the thing. These, we apprehend, are the well settled rules for ascertaining the loss and damage suffered by a party, in such circumstances. (emphasis supplied)*

...

In order to determine the real price of these 3,000 shares sold to plaintiff by concealment of certain facts, the first question that needs decision is whether the market for these shares, the rate prevailing wherein would prima facie be a true index of their value, had been affected by the very fact concealed of which the plaintiff complains. *In this case from the proved facts it is clear that the market rate of these shares was seriously affected by reason of the impending decision of the Stock Exchange for closing it to stop the wave of speculation that had taken the frenzy of the market by reason of the merger of the two steel companies doing business in northern India. (emphasis supplied)* The market reports for the week ending March 19, show that the Indian Irons were standing at or around Rs. 55. By Saturday the 3rd April after the announcement of the terms of the merger by reason of the keen speculation the shares were being dealt at around Rs. 73. On Monday the 6th April the price was Rs. 77. On Tuesday the 6th, the day when the decision was taken to close the market for two days, these shares touched Rs. 79 but by the close of business fell back to Rs. 72 a sudden drop of Rs. 7. On Wednesday the 7th April in the Calcutta market they closed at

Rs. 58, a drop of Rs. 14 in a day. These sudden rises and falls in the market during the course of these two days are sufficient indication of the fact that the drop was due to the decision of the Stock Exchange to close the Exchange for two days. There is no evidence that any other factor was then disturbing the market rate of these shares.

...

Considering the whole of this material, *we are satisfied that the market rate prevailing on the 5th, 6th and 7th had been affected by reason of the decision of the Calcutta Stock Exchange to keep the market closed on the 8th and 9th and the market did not settle down till about the 17th or 18th and the prices then ruling can in the circumstances of this case be said to be their true market price. (emphasis supplied)* In our judgment, Rs. 46 per share was the real price of these shares when they were put in the plaintiff's pocket and he got Rs. 46 for each share in lieu of what he paid for either at Rs. 77 or at Rs. 77-4-0. *He is entitled to commission also which he would have to pay on the sale of these shares. (emphasis supplied)* The difference between these two rates is the damage that he has suffered and he is entitled to it.”

Thus, where a person is induced to purchase shares at a certain price by fraud, the measure of damages<sup>41</sup> which he is entitled to recover from the seller is the difference between the price which he paid for the shares and the real price of the shares on the date on which the shares were purchased. *Ordinarily the market rate of the shares on the date when the fraud was practised would represent their real price in the absence of any other circumstance. If, however, the market was vitiated or was in a state of flux or panic as a consequence of the very fact that was fraudulently concealed, then the real value of the shares has to be determined on a consideration of a variety of circumstances.*

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<sup>41</sup> Fraud is also a part of the law relating to Torts and contracts for which damages may be awarded. Damages in law are of several kinds and ordinary damages are directly linked to the loss caused. Thus quantification of damages indirectly leads to quantification of loss caused and is relevant to the entire exercise.

However, post this decision, the Committee is at pains to find any further judicial decision laying down, in substantial detail, principles relating to quantification.

The scope for revision is abundantly clear from the manner in which the Board has fared before appellate forums in the recent past, in particular,<sup>42</sup> the manner of quantification of profit by the Board was questioned and matter(s) remanded for SEBI to lay down the norms for determining illegal profits. Unless the manner of quantification is laid down in a transparent manner it will be difficult to justify why a particular amount should be disgorged or a particular penalty be levied, leaving abundant scope for defaulters to obtain favourable orders to the detriment of investors and the integrity of the securities market as a whole. The quantification of illegitimate profit and loss to investors is a complex exercise that involves consideration of several factors such as, - the determination of net gains and amounts that may be deducted, joint and several liability, applying the correct financial economics techniques, tax considerations, the nature of the violation, etc. The Committee has attempted to understand the various global practices and works by experts available on the subject to distil a probable methodology for quantification.

#### **NEED FOR PRESENT REVISION**

The Committee has had several deliberations with the officers of the Board as well as other experts. It has also had the advantage of studying the settlement and enforcement mechanisms in a holistic manner. The Committee is of the view that a clear public guidance is needed in the manner of quantification for the following reasons, -

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<sup>42</sup> *B Ramalinga Raju v SEBI*, SAT order dated 12.05.2017, available at <[http://sat.gov.in/english/pdf/E2017\\_JO2014286.PDF](http://sat.gov.in/english/pdf/E2017_JO2014286.PDF)>; *SRSR Holdings Pvt Ltd v SEBI*, SAT order dated 11.08.2017, available at <[http://sat.gov.in/english/pdf/E2017\\_JO2015463.PDF](http://sat.gov.in/english/pdf/E2017_JO2015463.PDF)> Also see, *Somani Overseas Ltd & Ors v SEBI*, SAT order dated 30.06.2016, available at <[http://sat.gov.in/english/pdf/E2016\\_JO2014227.PDF](http://sat.gov.in/english/pdf/E2016_JO2014227.PDF)> *inter alia* directing SEBI to set out the norms for determining illegal gains, -

“while upholding the decision of WTM of SEBI that the appellants are liable to disgorge the illegal gains made on sale of SIL scrip during the investigation period, we set aside the illegal profits quantified at Rs. 4,69,40,232/- and direct that the quantum of illegal profits be determined afresh by setting out the norms laid down by SEBI for determining the illegal profits.” (*emphasis supplied*)

1. The existing manner of quantification of profit is very basic and can be enhanced in view of the technical and financial resources available with the Board. It is presently limited to very specific cases and several best practices can be adopted in them;
2. The manner of quantification of loss to investors, as a guidance for levy of penalties needs to be laid down;
3. In the meeting held with the members of the High Power Advisory Committee constituted under the Settlement Regulations, the need to lay down the manner of quantification was stressed upon;
4. The Securities Appellate Tribunal has required the Board to set out the principles of quantification<sup>43</sup>;
5. The Committee's Report on Settlement Mechanism had recommended settlement based on a factual consideration of all types of cases including insider trading. This was linked to quantification of profit made and loss caused to the investors;
6. Quantification in the long run, would be a major deterrent in cases relating to fraud, tipper-tippee liability, front-running, etc.; and
7. Quantification will also enable the Board to justify its orders before appellate forums, which may otherwise reduce the penalties and disgorgement amounts since there is no appropriate guidance for the appellate authorities that may justify the penalties levied and monies disgorged.

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<sup>43</sup> *Ibid.*

## GLOBAL SCENARIO

In the Committee's earlier report, the Committee had made an examination of the laws, processes and practices prevailing in the USA and UK. While the UK processes do require that various factors be taken into account while taking an action or settling the violations, there is however little jurisprudence available in the public domain in respect of quantification.

The United States of America is known for the constitutional protection afforded to its citizens and many of our constitutional and securities laws principles are borrowed from them. Their system is also known for enforcement of securities laws and decades have been spent in developing their present guidelines. Their methods of quantification reflect in their quasi-judicial orders, from which the securities laws jurisprudence of our country can be enriched and the outcome experienced in the recent cases be avoided in the future.<sup>44</sup>

In the USA, the federal courts alone are competent to impose penalties, as well as order imprisonment, based on profit and loss factors. Hence there is abundant jurisprudence available in the public domain where the federal courts have calculated the profit and loss caused to the investors. In the instance of insider trading alone, the USA judicial system now takes into account several different methods (including statistical methods to be done by economists) of calculating the gains as a result of the default. Depending on the circumstances, the courts adopt the best method, to distinguish between 'legitimate' gains and 'illegal' gains.<sup>45</sup>

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<sup>44</sup> See Umakanth Varottil, "SAT Order in the Satyam Case", available at <<https://indiacorplaw.in/2017/05/sat-order-in-satyam-case.html>>:

*"Courts in several jurisdictions have sought to set out principles on how to compute wrongful profits or gains in case of securities offences such as insider trading or market manipulation, but this area is riddled with controversies. In the end, it might be necessary for SEBI to establish clearer guidelines on determining sanctions so that the outcome experienced in the Satyam case can be avoided in the future."* (emphasis supplied)

<sup>45</sup> See Lai PY, "The Calculation of Illicit Profit in US Insider Trading Cases", (2013) J Stock Forex Trad 2:105. doi:10.4172/2168-9458.1000105, available at <<https://www.omicsonline.org/open-access/the-calculation-of-illicit-profit-in-us-insider-trading-cases-2168-9458-2-105.pdf>>, the article shows the approaches across jurisdictions are

## **A BIRD'S EYE VIEW OF SOME OF THE GLOBAL METHODOLOGIES FOR CALCULATING THE AMOUNT DUE FOR DISGORGEMENT IN INSIDER TRADING CASES**

### **INTRODUCTION:**

The economic activities of the capital market of a nation are one of the key segments to boost the economic growth of the country. A healthy capital market can be created if the stock exchanges are well regulated. As the business world continues to expand in global markets, trading of shares, bonds, derivatives and other instruments continues to increase. One form of trading that has received considerable regulatory and academic interest in recent years is *insider trading*. Around the world, an active enforcement of criminal laws and regulations has increased its focus on preventing and/or punishing insider trading and market abuse.

Bhattacharya & Daouk<sup>46</sup>, in a study of 103 countries that have securities markets, revealed that only 87 countries have laws dealing with insider trading and only 38 countries have successfully enforced their laws against this crime. This situation is the result of a dispute between the two main theoretical streams.<sup>47</sup> The first is convinced that a ban on insider trading reduces market efficiency and managers' compensation, while the other states that the insider trader appropriates the value of the preferential information to the detriment of other investors and consequently the repression of this crime increases the investors' trust in the market, and hence its liquidity. Further, a ban on it reduces market efficiency, the insider, by carrying out his strategy, pushes

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similar; *Alexandra A.E. Shapiro & Nathan H. Seltzer*, "Measuring "Gain" Under The Insider Trading Sentencing Guideline Based On Culpability For The Deception", *Federal Sentencing Reporter*, Vol. 20, No. 3, February 2008, p 194, available at, <<https://www.lw.com/thoughtLeadership/measuring-gain-under-insider-trading-sentencing-guideline>>.

<sup>46</sup> *Utpal Bhattacharya & Hazem Daouk*, "The World Price of Insider Trading", pp 3, available at <[https://faculty.fuqua.duke.edu/~charvey/Teaching/BA453\\_2005/BD\\_The\\_world.pdf](https://faculty.fuqua.duke.edu/~charvey/Teaching/BA453_2005/BD_The_world.pdf)> : *The Journal of Finance* Vol. 57, No. 1 (Feb., 2002), pp. 75-108

<sup>47</sup> *Marcello Minenna*, '*Insider Trading, Abnormal Return and Preferential Information: Supervising through a Probabilistic Model*', available at <<https://nscpolteksby.ac.id/ebook/files/Ebook/Journal/2015/Banking%20and%20Finance/Vol.%2027/Volume%2027%20Issue%201/Page%2059-86/Insider%20trading-abnormal%20return%20and.pdf>>.



the stock price faster towards the value that better reflects the fundamentals of the company.<sup>48</sup> According to the ‘misappropriation’ theory, the preferential information is property of the company. Therefore, any exploitation of information carried out by a subject other than the owner, i.e., the company, could be considered to be a theft.<sup>49</sup> As a consequence, other investors do not have the same investment opportunities as the insider and this is unacceptable according to the ‘market egalitarianism’ theory.<sup>50</sup> According to this view, making this a crime increases investors’ trust in the market, and enhance its integrity.

Regulation and enforcement of insider trading laws is important because investors are likely to be more confident in the financial statements of companies that operate in countries with strong insider trading laws. In addition, investments within countries having insider trading laws may be viewed as less risky as the information is considered to be more reliable. Therefore, some quantitative procedures have to be used in order to detect the phenomenon, to compute the value of preferential information and hence, to calculate the disgorgement, which is the undue wealth gained by the insider through the exploitation of preferential information. This estimate offers, in all legal jurisdictions punishing the crime of insider trading, a benchmark to identify the sanction to be imposed against the insider and, as such, can be considered the link between the financial and legal aspects.

### **WHAT IS DISGORGEMENT?**

The paramount purpose of enforcing the prohibition against insider trading by ordering disgorgement is to make sure that wrongdoers will not profit from their wrongdoing. Disgorgement is an equitable remedy, imposed to force a defendant to give up the amount by which he was unjustly enriched (*FTC v. Bronson Partners*<sup>51</sup>).

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<sup>48</sup> Finnerty, J., 1976. Insiders and market efficiency. *Journal of Finance* 31, 1141–1148.

<sup>49</sup> Georges, S., 1976. L’utilisation en bourse d’informations privilégiées dans le droit des Etats-Unis, *Economica*.

<sup>50</sup> Langevoort, L., 1987. *Insider trading: regulation, enforcement and prevention*. Clark Boardman Company, New York; Loss, S., 1983. *Fundamentals of securities regulation*. Clark Boardman Company, Boston.

<sup>51</sup> *Federal Trade Commission v. Bronson Partners, LLC*, 654 F.3d 359 (2d Cir. 2011), available at <https://www.courtlistener.com/opinion/223605/ftc-v-bronson-partners-llc/>.

By forcing wrongdoers to give back the fruits of their illegal conduct, disgorgement also “has the effect of deterring subsequent fraud” (*SEC v. Cavanagh*<sup>52</sup>). Because disgorgement does not serve a punitive function, the disgorgement amount may not exceed the amount obtained through the wrongdoing.

Hence, the difficulty in identifying an objective, realistic, and effective way of computing this value can give rise to problems in assessing the damage caused by the insider to the market and, consequently, to the enforcement action.<sup>53</sup>

### **THE CALCULATION OF ILLICIT PROFIT/ DISGORGEMENT IN INSIDER TRADING CASES**

There are currently divergent approaches for calculating illicit profit in insider trading cases. What constitutes ‘profit’ differs from case to case as different court decisions confront each other, however a closer look will reveal that each method is relevant to the facts in which it was applied and there is no real conflict to resolve. The major approaches which have been adopted worldwide are the (1) net profit approach, (2) the notional profit approach (also known as market absorption approach), (3) the event studies approach and (4) the potential probabilistic disgorgement approach.

**NET PROFIT APPROACH:** The net profit approach is the approach which considers the total increase in value realized through trading in securities. Gain is the total profit actually made from a defendant’s illegal securities transactions. Applying this can sometimes include legal gains also, hence its universal application is inappropriate.

**NOTIONAL PROFIT: THE MARKET ABSORPTION APPROACH:** The notional approach is the approach which treats the relevant profit as those gains made by the insider dealer

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<sup>52</sup> *SEC v. Cavanagh*, No. 98-Civ.-1818-DLC, 2004 WL 1594818, at 30 (S.D.N.Y. July 16, 2004), *aff’d*, 445 F.3d 105 (2d Cir.2006).

<sup>53</sup> Marcello Minenna, ‘*Insider Trading, Abnormal Return and Preferential Information: Supervising through a Probabilistic Model*’, available at <https://nscpolteksby.ac.id/ebook/files/Ebook/Journal/2015/Banking%20and%20Finance/Vol.%2027/Volume%2027%20Issue%201/Page%2059-86/Insider%20trading-abnormal%20return%20and.pdf>.

when the information was made public and the market had a reasonable opportunity to digest the information. The gain is to be measured by reference to the market value of the shares at that date. At that date, the amount of the insider dealer's profit, whether realized or not, was fixed once and for all. Subsequent changes in market prices are irrelevant. This method requires proper choice of the 'relevant' period when the market can be said to have absorbed the information and reflect it into the price.

**THE EVENT STUDIES APPROACH: STANDARD APPROACH:** The event-study analysis, which estimates the effect on stock returns of occurrences, such as mergers, acquisitions, takeovers, announcements, variation of the regulation in the reference micro-economical system, etc., is widely used. Event studies is an econometric approach as it seeks to isolate the impact of inside information from other market factors because a genuine event studies approach would require regression analysis using logical reasoning and statistical methods.

The constraints of the event study approach are as follows,-

- a. The methodology requires time-series data, i.e. it is useful for scrips that have been listed for at least some time (around 2 years), therefore not useful for listing defaults.
- b. The insider-trading examination is subordinated to the determination of a statistically significant reference index, which plays the role of a market portfolio proxy. This approach would be difficult to implement in the case of a large number of thinly traded stocks. Therefore, stock selection is an important criteria, it may apply to some and not apply to some scrips.
- c. The choice of a long time horizon could include events that changed the company capital structure, such as mergers, acquisitions, regulation variation, etc. to help understand scrip specific movements.
- d. This methodology requires the testing of all the hypotheses related to a linear regression model. If those hypotheses cannot be verified, the results can be invalid or lead to inevitable methodological problems.

- e. Rumors relating to the stock could generate spikes in the returns during the stipulated period (the reference time for the estimate).
- f. The event-study methodology applied to insider trading estimates the future stock returns by a linear regression model. Therefore, it relies on the assumption that the returns on a narrow interval are generated by the same linear model coming from a set of information belonging to a definitely wider time window.
- g. The methodology calculates only one cumulative abnormal return in relation to the preferential information. By doing so, it does not take into account differences in the trading strategies of insiders that usually represent differences in their knowledge of the preferential information

**POTENTIAL PROBABILISTIC DISGORGEMENT APPROACH:** The Potential Probabilistic Disgorgement approach is a new procedure for computing the economic value of the information exploited by the insider, based on a probabilistic approach.<sup>54</sup> This methodology overcomes the issues connected to the event-study procedure and can be applied by construction to all insider-trading schemes and not only to the simplest ones. In fact, the model parameters are defined by using the trading strategy of the single insider; thus, if insider trading takes place, the model is able to offer a disgorgement computation; hence, by hypotheses of its construction, it is able to detect the difference between insiders and followers.

The advantages of the potential probabilistic computation are as follows,-

- a. The definition of the parameters is extremely realistic and difficult to break down, since it represents the insider-trading strategy on the stock under investigation carried out in the period which includes the insider trading- days before the disclosure of the information to the market and consequently entails

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<sup>54</sup> Marcello Minenna, '*Insider Trading, Abnormal Return and Preferential Information: Supervising through a Probabilistic Model*', available at <https://nscpolteksby.ac.id/ebook/files/Ebook/Journal/2015/Banking%20and%20Finance/Vol.%2027/Volume%2027%20Issue%201/Page%2059-86/Insider%20trading-abnormal%20return%20and.pdf>.

the set of information composed by prices and quantities which create the portfolio of the insider on the stock.

- b. It allows the determination of all the possible paths of the stock under investigation under a predictive dynamic logic.
- c. It cannot be invalidated by the fact that the company has been recently quoted, since if the insider can trade the stock, the procedure can return, by means of the parameters-estimation procedure, a disgorgement computation.
- d. It does not require a regressor since the stock path forecast depends only on the prices of the stock under investigation incorporated in the insider trader portfolio.
- e. It does not require the definition of time horizons longer than the insider-trading days for estimating the parameters to be employed in the analysis; therefore, it is not affected by the stock liquidity, by the discontinuity of the time series, and other typical issues of econometric procedures.
- f. It offers a customized methodology for the single subject under investigation, since the model behaves differently according to the single insider-trading strategy. Further, by assuming that the insider who is closer to the information will have the more profitable trading strategy, it gives a higher disgorgement to the subjects who are closer to the preferential information and therefore it is able to distinguish between insiders and followers (i.e., tippers and other insiders).
- g. The stochastic process employed benefits from the Markov property. This property makes the model absolutely coherent with the weak form of market efficiency.
- h. It is a more intuitive approach, since it works directly on prices and not on return and it is a faster and easier procedure, in terms of implementation, than the potential econometric disgorgement computation, since it can skip all the issues related to the statistical robustness tests.

## INTERNATIONAL PRACTICE

SEC has mostly adopted the Event Study methodology for calculating illicit profit, however, the divergent approaches are considered by courts for calculating Disgorgement depends on the facts and circumstance of each case and the arguments raised by the defendants. This Report takes into account various such methods, each of which depend on the facts and circumstances under consideration.

In the case of, *United States v. Nacchio*<sup>55</sup> the event studies approach was used for the disgorgement calculation, however, in the case of *United States v. Raj Rajaratnam*<sup>56</sup> the market absorption approach was considered under the disgorgement calculation. Hong Kong <sup>57</sup> has also adopted the market absorption approach to calculate disgorgement. The Italian regulator Commissione Nazionale per le Società e la Borsa (CONSOB), has developed two methods: (i) a Modified Event Study Method that has been adjusted to the behaviour of the Italian securities markets; and (ii) a new Potential Probabilistic Method for calculating the disproportionate gains due for disgorgement.

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In this respect the Committee has examined the law prevalent in other jurisdictions and arrived at certain important conclusions after drawing upon some well-established principles, as follows, -

1. The Indian law of insider trading<sup>58</sup> is similar to that of the USA<sup>59</sup>. This makes it easier for adopting similar means and methods for quantification of gains and

<sup>55</sup> *United States v. Nacchio* (2009) (10th Cir.) 573 F.3d 1062, available at <<https://casetext.com/case/us-v-nacchio-11>>.

<sup>56</sup> *United States v. Raj Rajaratnam*, (2012) (RJH) 09 Cr. 1184, available at <<https://www.leagle.com/decision/infco20120207b98.xml>>.

<sup>57</sup> *The Insider Dealing Tribunal v. Shek Mei Ling*, (1999) 2 HKCFAR 205, available at <<https://www.hongkongcaselaw.com/the-insider-dealing-tribunal-v-shek-mei-ling/>>; *HKSAR v. Du Jun* (2009) DCCC787/2008, available <<https://www.hongkongcaselaw.com/hksar-v-du-jun-2/>>.

<sup>58</sup> See, clauses (d) and (e) of Section 12A and Section 15G of the SEBI Act.

<sup>59</sup> See, The Insider Trading Sanctions Act, 1984 and the Insider Trading and Securities Fraud Enforcement Act, 1988 which *inter alia* amended the Securities Exchange Act, 1934, available at

losses.<sup>60</sup> The Committee has already noted that there are many ways to calculate gains relating to insider trading. In so far as liability of an insider who is a tippee is concerned, the quantification of gains requires the Board to adopt certain innovative approaches which are already well settled in the USA insider trading law<sup>61</sup>;

2. Even the anti-fraud provisions in both the jurisdictions are similar, rather it may be appropriate to state that the wordings of Section 12A of the SEBI Act are borrowed from the provisions of Section 10b of the USA Securities Exchange Act, 1934<sup>62</sup> and Rule 10b-5 of the SEC Rules.<sup>63</sup>
3. The concept of securities market price being a reflection of the ‘information’ being assimilated has universal application across various jurisdiction. The

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<<https://www.govtrack.us/congress/bills/98/hr559/text>> and <<https://www.gpo.gov/fdsys/pkg/STATUTE-102/pdf/STATUTE-102-Pg4677.pdf>> respectively; Rules 10b-5, 10b5-1 and 10b5-2 of the General Rules And Regulations, Securities Exchange Act Of 1934, Subpart A—Rules and Regulations Under the Securities Exchange Act of 1934 at 17 C.F.R. (Code of Federal Regulations) available at <[https://www.ecfr.gov/cgi-bin/text-idx?SID=6172e3128b122545ee8bec9d0e5d519d&mc=true&tpl=/ecfrbrowse/Title17/17cfr240\\_main\\_02.tpl](https://www.ecfr.gov/cgi-bin/text-idx?SID=6172e3128b122545ee8bec9d0e5d519d&mc=true&tpl=/ecfrbrowse/Title17/17cfr240_main_02.tpl)>.

<sup>60</sup> For application of US law by Indian authorities, see SAT order dated 08.10.2012 in the matter of *V K Kaul v Adjudicating Officer*, available at <<https://indiacorplaw.in/wp-content/uploads/2012/12/1349843808090.pdf>>.

<sup>61</sup> See *Salman v. U.S.*, 137 S. Ct. 420 (2016), available at <[https://www.supremecourt.gov/opinions/16pdf/15-628\\_m6ho.pdf](https://www.supremecourt.gov/opinions/16pdf/15-628_m6ho.pdf)> where the U. S. Supreme Court held that the “personal benefit” to a tipper that is required to establish liability for insider trading can consist of the “gift” of that material, non-public information to a family member or friend. As such, the Court affirmed the “personal benefit” analysis articulated in the landmark 1983 case *Dirks v. SEC*, 463 U. S. 646 (1983), available at <<https://supreme.justia.com/cases/federal/us/463/646/case.html>>. Also See *SEC v. Contorinis*, US Court of Appeals, No. 12-1723 (2d Cir. 2014) upholding tipper liable to disgorge amount equal to the profit made by the person who traded, available at <<https://www.dlapiper.com/~media/files/insights/publications/2014/02/sec-v-contorinis.pdf?la=en&hash=2AB6FF5A06DE029A72FC92CC2E4E9B8CD8F1155F>>. The Court *inter alia* held that, -

“[i]n *SEC v. Warde* we held that, in the determination of a disgorgement amount, “[a] tippee’s gains are attributable to the tipper, regardless whether benefit accrues to the tipper.” 151 F.3d 42, 49 (2d Cir. 1998). That principle has deep roots in parallel civil remedial structures. For example, in *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 165 (2d Cir. 1980), we concluded that “[t]rades by tippees are attributed to the tipper” in determining liability for damages, and in *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1308 (2d Cir. 1971), the foundational case for insider trading liability, we required a tipper to make common law civil restitution “for the profits derived by his tippees.””

<sup>62</sup> See pp 89-91, available at <<http://legcounsel.house.gov/Comps/Securities%20Exchange%20Act%20of%201934.pdf>>.

<sup>63</sup> See the General Rules And Regulations, Securities Exchange Act Of 1934, Subpart A—Rules and Regulations Under the Securities Exchange Act of 1934 at 17 C.F.R. (Code of Federal Regulations) §240.10b-5: Employment of manipulative and deceptive devices., available at <[https://www.ecfr.gov/cgi-bin/text-idx?SID=6172e3128b122545ee8bec9d0e5d519d&mc=true&node=se17.4.240\\_110b\\_65&rgn=div8](https://www.ecfr.gov/cgi-bin/text-idx?SID=6172e3128b122545ee8bec9d0e5d519d&mc=true&node=se17.4.240_110b_65&rgn=div8)>

methods for quantification used by various regulators reflect this underlying principle. This is also reflected in the approach adopted by the Indian Supreme Court in the *Trojan* case. It is also reflected in the SEBI (Prohibition of Insider Trading) Regulations, 2015 which inter alia require, *‘the compliance officer taking into account various factors including the unpublished price sensitive information in question becoming generally available and being capable of assimilation by the market, which in any event shall not be earlier than forty-eight hours after the information becomes generally available.’*

4. The issue of quantification of gains made and losses caused arises only after a guilt determination. The defaulter is the only person aware of the actual gains made by him and the quasi-judicial authorities are only making a ‘best judgment’ assessment of the gains made and losses caused. As such, due to the dynamic nature of the market, only an approximation can be made, uncertainty is inherent in the act of the defaulter for which the defaulter himself must bear the risk of uncertainty.<sup>64</sup> The authorities can make an assessment only on the basis of available information and is not required to make an exact assessment of the losses caused and gains made.<sup>65</sup> Similar principles should be applied to assessments made by the Board as well;
5. The authorities conducting investigation, inquiry, audit and inspection have to look closely in order to be able to ascertain the relevant factors for the quantification of gains made and losses caused in case of negligence and director

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<sup>64</sup> *SEC v Drexel Burnham Lambert, Inc.*, 837 F. Supp. 587 (S.D.N.Y. 1993), *aff’d sub nom.*, *SEC v Posner*, 16 F.3d 530 (2<sup>nd</sup> Cir. 1994), cert. denied, 513 U.S. 1077 (1995) quoting *SEC v Bilzerian* 814 F. Supp. 116, 121 (S.D.N.Y. 1993), available at <<https://law.justia.com/cases/federal/district-courts/FSupp/837/587/2377774/>>:

*“Since it is difficult in many cases to separate ‘legal’ from illegal profit... it is proper to assume that all profits gained while the defendants were in violation of the law constituted ill-gotten gains.”* (emphasis supplied)

<sup>65</sup> See, *U.S. v Rutkoske*, 506 F.3d 170, 179 (2<sup>d</sup> Cir. 2007), available at <<https://www.courtlistener.com/opinion/1292285/united-states-v-rutkoske/>> ; *U.S. v Zolp*, 479 F.3d 715, 720-21 (9<sup>th</sup> Cir. 2007), available at <<https://law.resource.org/pub/us/case/reporter/F3/479/479.F3d.715.05-50822.html>>; *U.S. v Berger*, 587 F.3d 1038, 1045 (9<sup>th</sup> Cir. 2009), available at <<https://www.courtlistener.com/opinion/1345996/united-states-v-berger/>> ; *SEC v Calvo*, 378 F.3d 1211 (11<sup>th</sup> Cir. 2004), available at <<https://www.leagle.com/decision/20041589378f3d121111462>>; and *SEC v Svoboda*, 409 F. Supp. 2d 331 (S.D.N.Y. 2006), available at <<https://www.courtlistener.com/opinion/2404810/ussec-v-svoboda/>>.



related defaults<sup>66</sup>, such as related party transactions or where they have by their acts, directly or indirectly, adversely affected the company and its investors;

6. There is no one universally applicable way of quantification and each method has its defects and advantages depending on the factual matrix in which it may be applied<sup>67</sup>, thus wherever possible multiple calculations should be made by the investigation, inquiry, audit and inspection authorities for consideration of alternatives during proceedings under securities laws, including settlement and the most approximate and appropriate one may be selected. E.g. the *US Sentencing Guidelines*<sup>68</sup> *inter alia* notes the possibility of alternative methods in respect of the quantification of losses due to fraud in securities markets, as follows, -

**“(ix) Fraudulent Inflation or Deflation in Value of Securities or Commodities.—**In a case involving the fraudulent inflation or deflation in the value of a publicly traded security or commodity, *the court in determining loss may use any method that is appropriate and practicable under the circumstances. One such method* the court may consider is a method under which the actual loss attributable to the change in value of the security or commodity is the amount determined by—

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<sup>66</sup> *SEC v Church of God Inc.*, 429 F. Supp. 2d 1045 (S.D. Ind. 2005), available at <<https://www.courtlistener.com/opinion/2487525/ussec-v-church-exten-of-church-of-god-inc/>> (balancing fact that the defendants provided ‘real and valuable services’ with the fact that, but for the fraud, the business would have collapsed earlier and they would not have been employed and ordering each defendant to disgorge one-half of base-salary for one year for which the business operated.); *SEC v Drexel Burnham Lambert, Inc.*, 837 F. Supp. 587 (S.D.N.Y. 1993), *aff’d sub nom.*, *SEC v Posner*, 16 F.3d 530 (2<sup>nd</sup> Cir. 1994), cert. denied, 513 U.S. 1077 (1995) (disgorgement of all compensation paid to officers where fraud enabled defendants to gain control of company and place themselves in highly-paid positions; court rejected ‘any contention’ that the defendants’ services were of ‘real value to the company’.), available at <<https://law.justia.com/cases/federal/district-courts/FSupp/837/587/2377774/>>; *SEC v Alpha Telecomms., Inc* 187 Supp. 1250 (D. Ore. 2002), *aff’d*, 350 F. 2d 1034 (9<sup>th</sup> Cir. 2003), available at <<https://law.justia.com/cases/federal/district-courts/FSupp2/187/1250/2310241/>> (disgorgement of all wages, loans and compensation paid by the company to the defaulter who ran the collective investment scheme).

<sup>67</sup> See, J Duncan, *Recalculating “Loss” in Securities Fraud*, (2013) 3 Harvard Business Law Review 257, available at <[http://www.hblr.org/wp-content/uploads/2013/10/HLB202\\_crop.pdf](http://www.hblr.org/wp-content/uploads/2013/10/HLB202_crop.pdf)>.

<sup>68</sup> Sentencing Guidelines p 99, available at <<https://www.uscc.gov/sites/default/files/pdf/guidelines-manual/2016/GLMFull.pdf>>; See Committee’s Report on Settlement Mechanism, pp 27-28 for detailed understanding of the US Sentencing Guidelines, available at <[https://www.sebi.gov.in/reports/reports/aug-2018/report-on-settlement-mechanism-by-the-high-level-committee-to-review-the-enforcement-and-settlement-mechanism\\_39967.html](https://www.sebi.gov.in/reports/reports/aug-2018/report-on-settlement-mechanism-by-the-high-level-committee-to-review-the-enforcement-and-settlement-mechanism_39967.html)>.

- (I) calculating the difference between the average price of the security or commodity during the period that the fraud occurred and the average price of the security or commodity during the 90-day period after the fraud was disclosed to the market, and
- (II) multiplying the difference in average price by the number of shares out-standing.<sup>69</sup>

In determining whether the amount so determined is a reasonable estimate of the actual loss attributable to the change in value of the security or commodity, the court may consider, among other factors, the extent to which the amount so determined includes significant changes in value not resulting from the offense (*e.g.*, changes caused by external market forces, such as changed economic circumstances, changed investor expectations, and new industry- specific or firm-specific facts, conditions, or events).”

The Committee notes the similarities, with understandable deviations, in the USA approach relating to quantification of loss to investors in cases of fraud and the manner of quantification adopted by the Hon’ble Supreme Court of India in the matter of *Trojan & Co. Ltd v R. M. N. N. Nagappa Chettiar*<sup>70</sup> and is hopeful that with the express recognition of class action suits under Section 245 the Companies Act, 2013 and the Commercial Courts, Commercial Division and Commercial Appellate Division of High Courts Act, 2015 which *inter alia* deal with disputes relating to shareholder agreements, agreements for sale of goods,<sup>71</sup> subscription and investment agreements pertaining to financial services and related contracts of agency, there will be substantial development within India on these aspects.<sup>72</sup>

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<sup>69</sup> Out-standing shares is a market term used for calculating earnings per share and market capitalization; see <<https://www.nasdaq.com/article/shares-outstanding-cm550633>> and <<https://www.upcounsel.com/outstanding-shares>>.

<sup>70</sup> AIR 1953 SC 235, 1953 SCR 780.

<sup>71</sup> Securities are goods, See clause (7) of section 2 of the Sale of Goods Act, 1930.

<sup>72</sup> Law Commission of India’s *188th Report on Proposals for Constitution of Hi-Tech Fast – Track Commercial Divisions In High Courts*, p 146, available at <<http://lawcommissionofindia.nic.in/reports/188th%20report.pdf>>:

## **II. KEY RECOMMENDATIONS AND RATIONALE**

The Committee has examined the existing global approaches in detail and recommends the issuance of non-mandatory public guidelines. In this Chapter, the Committee examines the key recommendations in the proposed guidelines and the rationale for them.

### **1. NEED FOR GUIDANCE**

The present situation, where there is no public guidance, has resulted in limited quantification of the factors indicated in Section 15J of the SEBI Act, Section 19I of the Depositories Act and Section 23J of the SCRA.

Securities laws impose the burden of quantifying these factors on the quasi-judicial authorities and not on the fact-finding authorities, though from a practical point of view the quasi-judicial authorities are primarily dependent on the facts unearthed by the investigating authorities. It is the quasi-judicial authority that should be independently satisfied whether these factors are indeed quantifiable or not. Since, the Committee is mindful of the challenges faced by the officers and Members of the Board in exercise of their quasi-judicial functions, in view of which appropriate guidance must be issued to the investigation, inquiry, inspection and audit authorities who recommend action to the Board so as to enable them to include various factors and indicate the methods required for quantification for levy of penalty or to order disgorgement after taking into account, factors such as profit made, loss caused and the repetitive nature of the default.

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*“In fact, in several cases, the National Consumer Commission has refused to entertain cases for justifiable reasons such as for example, where serious issues of fraud, cheating or conspiracy are involved. Such cases can still be filed in the High Court and brought before the proposed Commercial Division.”*

However, quantification as a process cannot exclude the noticee against whom action is proposed, doing so will only serve to give grounds of appeal and lengthen the quasi-judicial process.

In the Report on Settlement, this Committee discussed how the USA Sentencing Reform Act of 1984 (SRA) which went into effect on November 1, 1987, served as the legal foundation for the issue of non-mandatory public guidelines for federal courts in the exercise of their functions. This brought in a huge amount of certainty for the prosecutors as well as the accused, and also served as the basis of having a successful plea bargaining system which has worked better than that in India. These guidelines which create a framework for sentencing without taking away the discretion of the Judge to deviate for reasons to be recorded were upheld by the USA Supreme Court in *Mistretta v United States*.<sup>73</sup>

Even Self-Regulatory Organizations such as the Financial Industry Regulatory Authority, (FINRA) have developed publicly available Sanction Guidelines<sup>74</sup>. FINRA published the *FINRA Sanction Guidelines* ("Guidelines") in 1993 so that the members and associated persons could become familiar with the disciplinary sanctions that could result from the typical securities industry rule violations.

The Sanction Guidelines apply to all formal FINRA disciplinary actions, whether settled or fully litigated. FINRA's adjudicatory bodies—Hearing Panels and the National Adjudicatory Council (NAC)—rely on FINRA's Sanction Guidelines to determine appropriate remedial sanctions. *The Sanction Guidelines state in clear and unequivocal language that they are intended to be guidelines and that they are not absolute.* In both- settled cases and litigated matters, depending on the facts and circumstances of each case, the sanctions imposed may fall outside the ranges recommended in the Sanction Guidelines. Fines on a “per violation” basis, were the default option under the

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<sup>73</sup> 488 U.S. 361 (1989), available at <<https://www.courtlistener.com/opinion/112173/mistretta-v-united-states/>>.

<sup>74</sup> Latest FINRA Sanction Guidelines available at <[http://www.finra.org/sites/default/files/Sanctions\\_Guidelines.pdf](http://www.finra.org/sites/default/files/Sanctions_Guidelines.pdf)>.

Sanction Guidelines. Since 1998, the revised general principles applicable to all sanction determinations have stated that an aggregation of violations may be appropriate for the purpose of determining sanctions if the violative conduct was unintentional or negligent, did not result in injury to public investors, or the violations resulted from a single systemic problem or a cause that has been corrected. With these revisions, the NAC clarified FINRA's existing policy on the aggregation or "batching" of violations for the purpose of sanctions by highlighting when it is appropriate to consider sanctions on a "per violation" basis and when aggregation is acceptable.<sup>75</sup>

In the Report on Settlement Mechanism, the Committee had adopted the device of non-mandatory statutory guidance in respect of the factor relating to 'repetitive nature of default' by recommending a new regulation<sup>76</sup> (extant regulation 32) which declares the relevance of Schedule II of the settlement regulations which maintains the discretion of the quasi-judicial authorities in deciding how a repetitive default may be treated and how the monies due may be quantified. The Committee's Report on Settlement Mechanism provides guidance in respect of the factor- 'repetitive nature of the default'; this report concerns the remaining two statutory factors.

It may be noted that the Hon'ble Supreme Court in its recent order dated 28.02.2019 in the matter of *Adjudicating Officer, SEBI v Bhavesh Pabari*<sup>77</sup> has also interpreted the factor relating to 'repetitive nature of default' in line with the recommendations of this Committee and *inter alia* held as follows,-

“13. There is a distinction between a continuing offence and a repeat offence. The continuing offence is a one which is of a continuous nature as distinguished from one which is committed once and for all. The term “continuing offence” was explained and elucidated by giving several illustrations in *State of Bihar vs.*

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<sup>75</sup> For a more detailed discussion, See *May 2018 Revisions to the Sanction Guidelines – FAQ*, available at <<http://www.finra.org/industry/revisions-sanction-guidelines-faq>>.

<sup>76</sup> Regulation 32 of the proposed draft Regulations in the Report on Settlement Mechanism, p 161, available at <[https://www.sebi.gov.in/reports/reports/aug-2018/report-on-settlement-mechanism-by-the-high-level-committee-to-review-the-enforcement-and-settlement-mechanism\\_39967.html](https://www.sebi.gov.in/reports/reports/aug-2018/report-on-settlement-mechanism-by-the-high-level-committee-to-review-the-enforcement-and-settlement-mechanism_39967.html)>.

<sup>77</sup> 2019 (3) SCALE 447, available at <[https://www.supremecourtindia.nic.in/supremecourt/2013/36291/36291\\_2013\\_Judgement\\_28-Feb-2019.pdf](https://www.supremecourtindia.nic.in/supremecourt/2013/36291/36291_2013_Judgement_28-Feb-2019.pdf)>.

*Deokaran Nenshi & Ors*<sup>78</sup>. In case of continuing offence, the liability continues until the rule or its requirement is obeyed or complied with. On every occasion when disobedience or noncompliance occurs and reoccurs, there is an offence committed. Continuing offence constitutes a fresh offence every time or occasion it occurs. In *Union of India & Anr. Vs. Tarsem Singh*,<sup>79</sup> continuing offence or default in service law was explained as a single wrongful act which causes a continuing injury. A recurring or successive wrong, on the other hand, are those which occur periodically with each wrong giving rise to a distinct and separate cause of action. We have made reference to this legal position in view of clause (c) of Section 15J of the SEBI Act which refers to repetitive nature of default and not a continuing default. The word “repetitive” as used therein would refer to a recurring or successive default. (*emphasis supplied*) This factum has to be taken into consideration while deciding upon the quantum of penalty.”

It must be noted that there is nothing unique in having non-mandatory public guidelines through a non-statutory or statutory device for the exercise of quasi-judicial process as long as discretion is preserved. Guidelines for judicial officers exist in various

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<sup>78</sup> AIR 1973 SC 908, 1973(3) SCR 1004: the Court examined whether failure to file annual return at the due date was a continuing offence or an offence completed by non-filing on the due date. Held, that such non-compliance was not a continuing offence. It was held that a continuing offence is one which is susceptible of continuance and is distinguishable from the one which is committed once and for all. The distinction between the two kinds of offences is between an act or omission which constitutes an offence once and for all and an act or omission which continues, and therefore, constitutes a fresh offence every time or occasion on which it continues. In the case of a continuing offence, there is thus the ingredient of continuance of the offence which is absent in the case of an offence which takes place when an act or omission is committed once and for all.

*Contra see Bhagirath Kanoria v. State of Madhya Pradesh*, AIR 1984 SC 1688, 1985 (1) SCR 626, where the Hon'ble Supreme Court held that the imposition of penalty not confined to the first default, but with reference to the continued default is obviously on the footing that non-compliance with the obligation of making return is an infraction as long as the default continued. Without sanction of law, no penalty is impossible with reference to the defaulting conduct. The position that penalty is imposable not only for the first default, but as long as the default continues and such penalty is to be calculated at a prescribed rate on monthly basis is indicative of the legislative intention in unmistakable terms that as long as the assessee does not comply with the requirements of law, he continues to be guilty of the infraction and exposes himself to the penalty provided by law.

The later Supreme Court decision in *Bhagirath Kanoria v. State of Madhya Pradesh*, has accordingly ruled that the decision in *State of Bihar v. Deokaran Nenshi*, 'must be confined' to such cases only, that is, cases where such default in submitting the return has been made penal, but the penal liability has not been continued so long as the default continues, such as withholding payment after due date.

<sup>79</sup> (2008) 8 SCC 648.

jurisdictions, not just USA.<sup>80</sup> The argument that guidelines somehow restrict the discretion of authorities is unwarranted and merely an excuse used by miscreants to take advantage of the loopholes afforded by the present system. Codification of the possible methods through public non-mandatory guidelines will ensure that quasi-judicial and investigating officers can utilise the same in furtherance of their public duties. In respect of quantification, the Committee recommends an indirect manner of quantification whereby the burden of applying the principles in the first instance will be placed on the fact-finding authorities and not the quasi-judicial authorities.

**RECOMMENDATION:** In respect of quantification of profit made and loss caused to the investors as a result of the default, the Committee is of the view that public non-mandatory guidelines may be issued for the benefit of all stakeholders, which can be constantly revised and updated with ease.

## **2. WHETHER QUANTIFICATION IS NECESSARY IN EVERY INSTANCE OF QUASI-JUDICIAL PROCESS?**

Though Section 15J of the SEBI Act, Section 19I of the Depositories Act and Section 23J of the SCRA are couched in mandatory terms, the following need to be considered, -

- i. It may be noted that the Hon'ble Supreme Court in its recent order dated 28.02.2019 in the matter of *Adjudicating Officer, SEBI v Bhavesh Pabari*<sup>81</sup> has not considered the failure to quantify in each and every case as fatal to the levy of penalty. The court *inter alia* held that,-

“10. The above apart, the circumstances enumerated in clauses (a), (b) and (c) of Section 15J of the SEBI Act may have no relevance and may never

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<sup>80</sup> Several jurisdictions have Sentencing Guidelines- USA, UK, Uganda (judicial), and Hong Kong (judicial). See The Law Library of Congress, Report on Sentencing Guidelines (2014) <<https://www.loc.gov/law/help/sentencing-guidelines/index.php>>. Some countries have Guideline judgments: Canada, Australia, New Zealand: <<http://www.judiciary.go.ug/files/downloads/PRINCIPALS%20OF%20SENTENCINT%20A%20GLOBAL%20REGIONAL%20%20NATIONAL%20PERSPECTIVE%20final.pdf>>.

<sup>81</sup> 2019 (3) SCALE 447, available at <[https://www.supremecourtfindia.nic.in/supremecourt/2013/36291/36291\\_2013\\_Judgement\\_28-Feb-2019.pdf](https://www.supremecourtfindia.nic.in/supremecourt/2013/36291/36291_2013_Judgement_28-Feb-2019.pdf)>.

arise in case of contraventions contemplated by certain provisions of the SEBI Act, for instance Section 15A, 15B or 15C of the SEBI Act. Failure to furnish information, return, etc.; failure to enter into agreement with clients; and failure to redress investors' grievances cannot give rise to the circumstances set out in clauses (a), (b) and (c) of Section 15J.

...

12. At this stage, we must also deal with and reject the argument raised by some of the private appellants that the conditions stipulated in clauses (a) to (c) of Section 15J are mandatory conditions which must be read into Sections 15A to 15HA in the sense that unless the conditions specified in clauses (a) to (c) are satisfied, penalty cannot be imposed by the Adjudicating Officer under the substantive provisions of Sections 15A to 15HA of the SEBI Act. The argument is too farfetched to be accepted. Section 15J of the SEBI Act enumerates by way of illustration(s) the factors which the Adjudicating Officer should take into consideration for determining the quantum of penalty imposable. The imposition of penalty depends upon satisfaction of the substantive provisions as contained in Sections 15A to Section 15HA of the SEBI Act [*and not the provisions of Section 15J](supplied).*”

- ii. Further, the statutory language is very clear, it refers to taking note of the quantification of gains and losses caused to the investors as result of the default along with taking into account the repetitive nature of the default. The focus is on the default and not on the defaulter.<sup>82</sup> In case of loss the statute is explicit that the loss may be calculated in respect of an individual investor or a group of investors. Further, in cases involving more than one defaulter, it may not be ideal to pin point how much loss is attributable to a particular defaulter. While it is tempting to do so, it amounts to applying impossible equitable considerations

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<sup>82</sup> See the Committee's Report on Settlement Mechanism, p 27, available at [https://www.sebi.gov.in/reports/reports/aug-2018/report-on-settlement-mechanism-by-the-high-level-committee-to-review-the-enforcement-and-settlement-mechanism\\_39967.html](https://www.sebi.gov.in/reports/reports/aug-2018/report-on-settlement-mechanism-by-the-high-level-committee-to-review-the-enforcement-and-settlement-mechanism_39967.html).



between defaulters; those who come with unclean hands have no right to equity until after the full amount has been paid by all or any one of them.<sup>83</sup> In cases where more than one person abets a fraud, the default that caused a loss or resulted in a profit is a composite whole and need not be broken up for considering the profit or loss and the liability is to be considered on a joint and several basis. The Committee will discuss this aspect further later in this Report. In case of fraudulent and unfair trade practices, even the persons who abet the fraudulent and unfair trade practice are covered under the SEBI Act, 1992 and the SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003, which defines 'fraud', provides that the penalty is directly linked to the profit arising out of such practices. Especially, where the person is part of a fraudulent scheme, artifice or device, then such scheme or artifice or device may be considered as a singular composite default for the purpose of quantification of illegal gains and/or loss rather than separate defaults and the *illegal profit has to be calculated on a holistic basis rather than an individual basis, though different persons may have had different roles to play.*

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<sup>83</sup> See *Dharni Dhar and Ors v Chandra Shekhar & Ors*, AIR 1951 All 774, discussing contribution by joint tort-feasors and its applicability in India depending on the facts and circumstances of each case:

"The rule [of *Merrywhether v Nixon* (1799) 8 T. R. 186: 16 R. R. 810 : 101 E. R. 1337] (*supplied*) was thus modified and came to be stated in these words :

"No person who has been guilty of fraud or any other form of wilful wrong-doing, and has been made liable in damages, has any right of contribution or indemnity against any other person who was a joint wrong-doer with him...."

66. Where a civil wrong is committed jointly by certain persons as against another, they purge themselves of the consequences of the wrong when they repair the damage caused to that person. It cannot, therefore, be said that the hands of tort-feasor who has repaired the damage are unclean. Indeed the hands of the person who has not yet contributed his share of the loss are unclean and there is no justice in denying the relief to the person who has repaired the whole of the damage caused by the action of both of them."

Further see *Kushro S. Gandhi & Ors v N.A. Gajdar & Ors*, 1970 (SC) AIR 1468, 1969 SCR (2) 959, holding that the recovery of the entire liability could be made from all or any of the persons jointly liable before they rely on accord and satisfaction without going into the correctness of *Dharni Dhar and Ors v Chandra Shekhar & Ors*, AIR 1951 All 774.

- iii. There is no direct co-relation between the charging sections of securities laws for imposing monetary penalties or fines, and the loss caused to investors as a result of the default. This is due to the distinct nature of the securities markets; the loss caused to investors by a defaulter may not be commensurate to the actual profit made by him. Issuer financial frauds may create huge investor losses when the artificial high price of an issuer's stock plummets with the public dissemination of information about the issuer's actual financial condition. In fact, securities laws violations may cause investor losses that dwarf, by several orders of magnitude, any profit that the defaulters may have made. In a non-zero sum game scenario, linking penalty directly to the loss caused to investors could cause the penalty to be excessive and beyond the paying capacity of any defaulter. It is for this reason that penalties under securities laws is not a multiple of loss caused to investors. Further, SEBI does not have the power of directing compensation; but loss caused to investors is not totally ignored, it is used only for the purpose of guidance, between the minimum and maximum ranges permitted by law, which may also be tied to profit. The Committee is of the view that loss co-relation is indirect and for guidance only. *When imposing penalties, it is more appropriate in cases of joint and several liabilities or in case of the main accused, rather than for each and every individual involved, unless it is a serious violation, and for considering the amount of penalty to be levied within the range provided by law.* It is well settled that SEBI has no power to order loss compensation; such jurisdiction is vested with the ordinary civil courts and company courts, as the case may be.
- iv. Quantification of the amount of disproportionate gain or unfair advantage, wherever quantifiable, as a result of the default is a different matter altogether. Except in case of fraudulent and unfair trade practices, insider trading, non-disclosure of acquisition of shares and takeovers and excess brokerage charged by a broker, there is no direct co-relation in respect of any other monetary penalties specified in the statute with the amount of disproportionate gain or unfair advantage as a result of the default. In case of criminal fines, there is no direct co-

relation in respect of any kind of default even if it is one of the four categories for which penalties have a direct co-relation to profit. As in loss quantification, similar issues arise in respect of quantification of profit when quantifying for each and every individual involved.

- v. Quantification may not be required where the penalty is sufficiently large enough to negate any gains that the defaulter may have otherwise made. This can be done in cases where the default is repetitive by taking into account the relevant principles indicated in the Settlement Regulations.
- vi. Further, disgorgement is a remedy which is linked to gains made, hence loss quantification is not always relevant. Since the securities laws violations are not always a 'zero' sum game, there usually arises a difference between disgorgement of the unjust enrichment resulting from the default and compensation for the legal damages caused. An investor may be liable to receive monies in case of unjust enrichment through the remedy of disgorgement<sup>84</sup> or receive compensation in case of legal damages. Where the two remedies are not commensurate to each other, the Board's power is limited to restitution of the unjust enrichment through the remedy of disgorgement made rather than directing compensation of loss. The Committee has explained the difference between restitution and compensation in the draft Regulation 138 of the proposed Recovery Regulations.
- vii. Quantification of loss to investors may not be required where the default is a victim less default<sup>85</sup> (such as *pure vanilla*<sup>86</sup> insider trading where there is no

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<sup>84</sup> *Banque Financière de la Cité v Parc (Battersea) Ltd and Ors*; House of Lords, [1998] 1 All ER 737, [1998] 2 WLR 475, [1998] UKHL 7, [1999] AC 221; available at <<https://www.bailii.org/uk/cases/UKHL/1998/7.html>>; per Lord Steyn "*unjust enrichment ranks next to contract and tort as part of the law of obligations. It is an independent source of rights and obligations.*"

<sup>85</sup> *United States v Rajat Gupta*, 904 F.Supp.2d 349 (2012), available at <<https://www.leagle.com/decision/inadvfdco130826000031>>:

"While insider trading may work a huge unfairness on innocent investors, Congress has never treated it as a fraud on investors, the Securities Exchange Commission has explicitly opposed any such legislation, and the Supreme Court has rejected any attempt to extend coverage of the securities fraud laws on such a theory.

proximate and directly harmed person who suffers legal damages) or has no direct co-relation with the default (where there is break in causation).

**RECOMMENDATION:** In view of the above, the Committee makes the following recommendations, -

- i. Quantification of profit wherever possible should be done on the basis of the composite default and liability should generally be imposed on a joint and several basis;
- ii. When imposing liability on an individual basis, quantification may not be required where the penalty otherwise imposed is sufficient;
- iii. When imposing penalties, quantification of loss is generally appropriate in cases of joint and several liability or in case of the main accused noticee(s) rather than for 'victimless defaults' or for each and every individual involved in the default since apportioning loss between multiple defaulters may be even more difficult than apportioning illegal gains. Further, there is no equity between defaulters at time of directing joint disgorgement or joint penalties. It is also relevant for considering the amount of penalty to be levied within the range provided by law;

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See, e.g., *Chiarella v. United States*, 445 U.S. 222, 232-235, 100 S.Ct. 1108, 63 L.Ed.2d 348 (1980). Prosecution of insider trading therefore proceeds, as in this case, on one or more theories of defrauding the institution (or its shareholders) that owned the information. See, e.g., *Dirks v. SEC*, 463 U.S. 646, 660-64, 103 S.Ct. 3255, 77 L.Ed.2d 911 (1983); *Carpenter v. U.S.*, 484 U.S. 19, 25-27, 108 S.Ct. 316, 98 L.Ed.2d 275 (1987). In the eye of the law, Gupta's crime was to breach his fiduciary duty of confidentiality to Goldman Sachs; or to put it another way, Goldman Sachs, not the marketplace, was the victim of Gupta's crimes as charged."

<sup>86</sup> Only where insider trading is combined with other delinquent conduct investors may be able to show loss as a result of such conduct and claim restitution on the lines of disgorgement. See *United States v. Skowron*, 839 F. Supp. 2d 740, 752 (S.D.N.Y. 2012), available at <<https://casetext.com/case/united-states-v-skowron>>, consisting of an insider trading scheme and an ensuing cover-up which actively frustrated its employer's Morgan Stanley's efforts to co-operate with the SEC; *United States v. Kline*, 199 F.Supp.2d 922 (2002), available at <<https://www.leagle.com/decision/20021121199fsupp2d92211044>>, restitution was awarded to investors in a thinly-traded stock where insider trading defendant actively encouraged victims to sell shares to him based on insider trading information known only to him.

- iv. Further, in cases where it appears that the loss to the investors and profit made out of the default are more or less same, then either profit made or loss caused may be calculated using any available methodology.

### **3. WHAT IS THE 'STANDARD' TO BE ADOPTED FOR QUANTIFICATION?**

Quantification of 'profits made' and 'losses caused' requires the Board to examine the behaviour of the defaulter as well as the investors who may have suffered as a consequence of the default.

**STANDARD OF THE COMPLIANT MAN:** The defaulter's behaviour has to be compared vis-à-vis the behaviour of a person who complies with securities laws. The monetary and non-monetary benefits received by a defaulter has to be compared with the benefits received by the compliant man. *Prima facie*, the excess represents the unlawful gains of the defaulter. However, this simple formulation can sometimes require some complex computation to quantify the gains. In cases involving sale of securities, it matters whether the securities were purchased during the course of (or immediately before) the violation or sometime before. In the former case, it is easy to identify the gains using the difference in price, since the gains are directly tied to the unlawful activity. Whereas in the latter case, pre-existing gains that are legal need to be separated from the gains tied to the period of the unlawful activity. Similar issues arise when securities which have been manipulated are susceptible to movement on account of general market movement. Such movements affect all persons equally. Such movements may inflate or depress the profit of the defaulter in the same way as they would affect any investor. In order to estimate the profit resulting from a default, it may at times be important to differentiate, wherever possible, the profit resulting from general market movements and those resulting from the default. When the monies involved are large, then it is beneficial to use complex statistical methods such as those used by securities regulators world-wide to differentiate between legal gains and unlawful gains as the legal gains

may be appreciably large enough to be estimated, provided the defaulter supplies the necessary information.

**STANDARD OF THE REASONABLE INVESTOR:** Securities markets operate differently from the markets of other goods and services. India follows a disclosure based regime similar to that of many developed jurisdictions. These markets are presumed to function on the lines of an *efficient market* hypothesis where the market assimilates all available information into the price of the security. An investor who trades securities at the price set by an impersonal market does so by relying on the integrity of that price. Since most publicly available information is reflected in the market price, an investor's reliance on any public material misrepresentations may be presumed for various purposes. Securities market jurisprudence is built around the concept of 'fraud-on-the-market' i.e. in an open and developed securities market, the price of a company's securities are determined by the available material information regarding the company and its business. Misleading statements will therefore defraud the investors of securities even if the investors do not directly rely on the misstatements. The misstatements affect the price of the security, and thus defraud investors who rely on the price which is an indication of the security's value and all relevant information relating to that security. The causal connection between the defaulter's fraud and the investors' purchase of a security in such a case is no less significant than in case of direct reliance on misrepresentations. In both cases, defaulter's fraudulent statements or omissions cause investors to purchase securities which they would not have purchased absent defaulter's misstatements and/or omissions. Thus in securities laws cases SEBI is not required to prove direct reliance by investors on defaulter's misrepresentations but can satisfy its burden of proof on the element of causation by showing that the defaulter made material misrepresentations and it will be presumed that the misrepresentations occasioned an increase in the security's value that, in turn, induced the investors to purchase a security, though it may very well be that the investors never bothered to take note of the disclosures made on the exchange or the bulky prospectuses or that they were guided by astrological considerations or were just investing at a whim. The investors are presumed to have behaved in a reasonable way. The standard of a

reasonable investor was recognised by the US Supreme Court in several matters.<sup>87</sup> This has been applied in the context of Indian securities litigation as well<sup>88</sup> and relied upon by SEBI also.<sup>89</sup>

While considering the above standards, a few other factors also need to be kept in mind, such as cases which revolve around an omission(s), such as failure to give an advertisement in respect of changes between the draft offer documents and the RHP, failure to give an open offer, etc. In order to impart seriousness to compliance of laws, it is important to consider the 'cost of compliance' avoided instead of imposing base penalties of a few lakhs or thousands. In such cases, the defaulter avoids 'fixed' costs such as the cost of giving the advertisement or making the open offer. These 'fixed costs' can be estimated based on the prevailing practices by comparison with similarly placed compliant market participants. To these 'fixed' benefits, there may also be 'variable' benefits. In particular, in the case of an open offer, it may be possible that the open offer, even if it had been made, it would not have evinced any interest from the investors

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<sup>87</sup> *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 96 S.Ct. 2126, 48 L.Ed.2d 757 (1976), available at <<https://casetext.com/case/tsc-industries-inc-v-northway-inc?q=426%20U.S.%20438%20&p=1&tab=keyword&jxs=&sort=relevance&type=case>> (An omitted fact is material if there is a substantial likelihood that a *reasonable shareholder* would consider it important in deciding how to vote. It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote, but contemplates a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the reasonable shareholder's deliberations.); *Basic Incorporated, et al. v. Max L. Levinson, et al.*, 485 U.S. 224 (1988) (108 S.Ct. 978, 99 L.Ed.2d 194), available at <<https://casetext.com/case/basic-incorporated-v-levinson?q=485%20U.S.%20224%20&p=1&tab=keyword&jxs=&sort=relevance&type=case>> (“We face here the narrow question whether information concerning the existence and status of preliminary merger discussions is significant to the *reasonable investor's* trading decision.... We therefore find no valid justification for artificially excluding from the definition of materiality information concerning merger discussions, which would otherwise be considered significant to the trading decision of a *reasonable investor*, merely because agreement-in-principle as to price and structure has not yet been reached by the parties or their representatives”).

<sup>88</sup> See *In re Pharma Pharmaceuticals Products of India Ltd.*, (2006) 131 Comp Cas 747 (Bom). (2006) 5 CompLJ 282 Bom; 2006 70 SCL 93 Bom; *Maneck-chowk and Ahmedabad Manufacturing Co. Ltd., In re*, [1970] 40 Comp Cas 819. (The petitioner must *prima facie* show that the scheme is preeminently fair and reasonable as a prudent and reasonable shareholder would approve of and not object to.) Also See *Miheer H. Mafatlal v Mafatlal Industries Ltd*, JT 1996 (8) 205 (SC).

<sup>89</sup> SEBI Discussion Paper on review of Clause 36 and related clauses of the equity listing agreement, available at <[https://www.sebi.gov.in/sebi\\_data/attachdocs/1408444809721.pdf](https://www.sebi.gov.in/sebi_data/attachdocs/1408444809721.pdf)>; Also see *Hindustan Lever Ltd. v SEBI*, 1998 (18) SCL 311 (AA), detailing SEBI's order dated 11.03.1998. (SEBI *inter alia* held that, since information about merger would have affected the price of securities and any reasonable investor would have attached importance to such an information, non-disclosure of this information to UTI put UTI to distinct disadvantage and prevented it from taking an informed decision.)

or it may have been partly or fully subscribed; however, it is clear that the intent behind evading the open offer obligation was the probability of it being subscribed. Since the standard of proof in civil and administrative proceedings is the test of preponderance of probability<sup>90</sup>, quantification can be based on assumptions that match the intent. Quantification of gains becomes difficult in such cases but not impossible. In such cases, law permits that a presumption may be made in respect of *the 'common course of natural events, human conduct and public and private business'*<sup>91</sup>, having regard to *the facts of the particular scrip* by comparing with similar scrips and open offers, etc. made in the past a probable cost may be determined and the noticee may be given an opportunity to show why such assumptions adopted may not be correct and some other amount may be arrived at, e.g. on these very lines Table VI of the Schedule-II of the Settlement Regulations *inter alia* already provide for the Board to consider the *'probable cost of open offer as recommended by the Corporate Finance Department.'* Just as independent valuers are used for valuation of properties, costs may be called from independent merchant bankers using relevant information sought from the noticee to determine the probable cost of an open offer.

Similarly, there are omissions where the monies of clients are mixed with own funds to satisfy some margin or net-worth requirements. In these cases, the time value of the funds so taken or provided, needs to be taken into account with any other attendant profit.

There are also instances where a benefit may be drawn in respect of legal and illegal activities, such as salary, bonuses, etc. These issues have also been dealt with in the Report.

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<sup>90</sup> *Adjudicating Officer, SEBI v Bhavesh Pabari*, 2019 (3) SCALE 447, available at <[https://www.supremecourtindia.nic.in/supremecourt/2013/36291/36291\\_2013\\_Judgement\\_28-Feb-2019.pdf](https://www.supremecourtindia.nic.in/supremecourt/2013/36291/36291_2013_Judgement_28-Feb-2019.pdf)>.

<sup>91</sup> See Section 114 of the Indian Evidence Act, 1872, which has been held to be relevant and applicable to proceedings under securities laws and applied by the Supreme Court in *SIRECL & Ors v SEBI & Anr.*, order dated 31.08.2012 available at <[https://www.sebi.gov.in/enforcement/orders/aug-2012/order-in-the-matter-of-sahara-india-real-estate-corporation-limited-and-ors-\\_23665.html](https://www.sebi.gov.in/enforcement/orders/aug-2012/order-in-the-matter-of-sahara-india-real-estate-corporation-limited-and-ors-_23665.html)>.



To the extent possible, the Board should attempt to quantify the fixed and variable benefits and losses, though the exact amounts may never be ascertainable with certainty, since uncertainty is a necessary feature of any dynamic securities market and investors and defaulters are subject to it alike; it is not an advantage or a disadvantage for either. Investors and defaulters are willing to subject themselves to market uncertainties while making trading decisions for making profits, they must therefore be subjected to the same uncertainties when being adjudicated for unlawful activities.

**INVESTOR’S RIGHT OF RESTITUTION v LOSS COMPENSATION:** The standards are relevant for determining *inter alia* losses by investors, which is only used as a measure for guidance for determining penalty to be levied rather than for grant of compensation. For the purpose of computation of losses to the investors while levying penalties, the investors are assumed to have acted in a reasonable manner and thus suffered in a similar manner allowing the determination to be made in an approximate manner instead of involving the regulator in a never ending inquiry involving millions of investors in every other proceeding. However, it is quite possible that investors may have suffered higher or lower losses or even the number of investors affected may be larger since the securities may change several hands during the default period. Since the uncertainty is a result of the misconduct of the defaulter he bears the risk of uncertainty and cannot object to the approximation method for quantification of loss. Hence, the methods of loss quantification recommended in this report are used only to provide guidance in levy of penalty in India (or to determine terms of imprisonment and quantum of fines in the USA) and not for providing compensation to the investors since that power is anyways not vested with SEBI but with the civil court (or commercial courts) and the NCLT in certain instances. Investors must independently discharge their burden in the proceedings brought by them.<sup>92</sup>

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<sup>92</sup> *S.E.C. v. Tambone*, 597 F.3d 436, 461 (1st Cir. 2010), available at <<https://casetext.com/case/sec-exch-commn-v-tambone>> ([P]rivate litigants face multiple burdens in pleading securities claims. Not only must they meet the standard requirement that allegations of fraud be pleaded with particularity, but — unlike the SEC — they also must prove reliance on the alleged misrepresentations, economic loss, and loss causation).

#### 4. QUANTIFICATION OF LOSS TO INVESTORS

Quantification of loss to investors in respect of a closed group (a PMS, MF, AIF or an InVIT, etc.) is easier since the investors partake in a common scheme fund and the details of the investment values and subsequent values are easily available. The funds are required to calculate NAV on a regular basis and the same can be used.

The issue of multiple causation commonly arises when a defaulter's conduct has apparently caused some actual loss to the victim, but the defaulter alleges that but for the intervention of unforeseen factors, the loss would have been smaller or would not have occurred at all. Consider, for example, a victim who purchased stock based on a defaulter's fraudulent misrepresentations about its value, and then sees the stock price decrease still further because of an unforeseen downturn in the stock market after the purchase. From one point of view, the only loss directly caused by the defendant in this case is the difference between price the victim paid for the stock based on the misrepresentations by the defendant and the *intrinsic* market value of the stock at the time of purchase. On the other hand, *but for* the defaulter's blandishments, the victim would not have been holding the stock to begin with and thus would not have suffered the additional harm caused by the market decline which lowered the realisable value below the *intrinsic* market value of the stock at the time of purchase.<sup>93</sup> Therefore, even in case of multiple causation except for what can be assessed and separated based on the facts available to the Board, the defaulter bears the responsibility for the default created by the uncertainty of his default as his default is the proximate cause.

**The need for asserting the importance of disclosures:** The year 1992 is important because that is the year when the Indian stock market moved towards a disclosure based regime. By a disclosure based regime, we mean a regime where the issue of capital and trading thereof are considered to be vital and the basis of an

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<sup>93</sup> Frank O. Bowman, *Coping with "Loss": A Re-Examination of Sentencing Federal Economic Crimes under the Guidelines*, 1998 (3) Vol. 51 Vanderbilt Law Review 461, p 524, available at <https://scholarship.law.missouri.edu/cgi/viewcontent.cgi?article=1077&context=facpubs>.

‘efficient securities markets’. However, the Committee is of the view that we have not really acknowledged the importance of true and fair disclosures. Even now the violation of disclosure requirements is considered ‘technical’ by the regulator as well as the Tribunal in several of their orders and pronouncements. Section 34 of the Companies Act, 2013 declares liability for fraud for misstatements in prospectus for issue of shares, but there is no such clarity in SEBI regulations which governs the issue of various kinds of securities and offer documents.

The Committee is of the view that unless the importance is given to disclosures, overall governance cannot improve. Similarly, giving importance to the quality and timing of disclosures and non-disclosures (other than those contained in offer documents) will also enable the regulator to focus on the various modes through which illegitimate profit is made by various delinquents. The Committee notes that in the USA, wherefrom the disgorgement remedy in the securities market has been adopted has been used for a plethora of violations and not just fraud, because no person can be permitted to profit for money had and received on account of any kind of violation of law, in particular,-

- i. Trading done after disclosure violations. Eg. The SEC requires that purchasers of more than 5% of the stock of a publicly traded company file a Schedule 13D within 10 business days after crossing the 5% threshold. A filer must promptly update the Schedule 13D filing to reflect any material change in the facts disclosed, including, among other things, the acquisition or disposition of 1% or more of the class of securities that are the subject of the filing. A late Schedule 13D filing results in disgorgement because it enables the purchaser to buy subsequent shares more cheaply than had he purchased them after the stock price reflected the disclosure;<sup>94</sup>
- ii. Negligence without fraudulent intent. E.g. corporate raider selling stock without disclosure after having announced an acquisition and before completion

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<sup>94</sup> Mark L. Mitchell and Jeffrey M. Netter, *The Role of Financial Economics in Securities Fraud Cases: Applications at the Securities and Exchange Commission*, *The Business Lawyer*, Vol. 49, No. 2 (February 1994), 545, 554-556 &579-582 available at <https://www.jstor.org/stable/40687469>.

thereof.<sup>95</sup> Negligent failure to adopt and implement policies and procedures reasonably designed to prevent violations of securities laws.<sup>96</sup>

- iii. Failure to comply with business norms not amounting to fraud. E.g. Rating surveillance fees for 3 years were directed to be disgorged due to *inter alia* credit rating agency failing to disclose changes to certain surveillance assumptions as the methodology stated that the firm would do, misrepresenting its surveillance methodology for ratings of certain complex financial instruments during a three-year period, etc.<sup>97</sup>

Once greater attention is paid to disclosures requirements, any trading around the relevant period will allow the Board to compute the undue profits made and the losses caused to investors who were denied similar opportunity. Similarly, when a stock exchange purports to provide services to market participants, where market participants are lead to believe that they are all receiving similar kind of services from the exchange for similar fees when in fact they were not, the stock exchange may be asked to disgorge the monies earned in breach of law and of its fiduciary duty to the various market participants who traded on the stock exchange.

Disclosures are important from the perspective of the investors also. Merely because the disclosure that was not made indicates ‘no change’, especially ownership and financial information, compared to past disclosure does not mean it is technical. Infact, information disclosed on a stock exchange including that which reflects ‘no growth’ or ‘no change’ may be a key driver for timely divestment by investors to invest in some other scrip where growth is more probable. While large acquirers undertake their own additional due-diligences, the regulatory disclosures are the key drivers of price movement for investors. Investor wealth grows if the company grows, investors choose to invest, stay invested or divest based on the price outlook which depends on the disclosed information, even if it is no information. After all, the efficient market concept

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<sup>95</sup> Mark L. Mitchell and Jeffrey M. Netter, *The Role of Financial Economics in Securities Fraud Cases: Applications at the Securities and Exchange Commission*, *The Business Lawyer*, Vol. 49, No. 2 (February 1994), 545, 583-584 available at <https://www.jstor.org/stable/40687469>.

<sup>96</sup> SEC Administrative Order in the matter of *TPG Capital Advisors LLC* dated 21.12.2017, available at <https://www.sec.gov/litigation/admin/2017/ia-4830.pdf>.

<sup>97</sup> SEC order against *DBRS Inc.* available at <https://www.sec.gov/litigation/admin/2015/34-76261.pdf>.

implies that all available, or lack of information, is reflected in the price of the listed stock.

The importance of disclosures is also crucial in financial economics (discussed later in this Report) which uses *inter alia* event study methodologies that focus on the study of the effect of disclosures on price of the securities markets. A focus on the effect of disclosures/non-disclosures and ‘follow the money (or securities or assets)’ are the key foundation of investigation in securities laws. These statistical techniques in conjunction with focus on disclosures will enhance the ability of the regulator to quantify profit made due to failure from disclosures and the loss caused to investors.

**RECOMMENDATION:** The Committee is of the view that,-

- i. The SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003 may be amended on the lines of Section 34 of the Companies Act, 2013 to clarify that misstatements of any kind in an offer document, placement memorandum, or any other document calling for subscription to securities amounts to fraud;
- ii. The period of investigation, inquiry, audit or examination should ideally encompass the trading around the period the disclosures were required to be made or have been made and also encompass any delinquent who may be the recipient of the unlawful proceeds or securities/assets. An internal Circular may be issued in respect of this guideline.

**AT-LEAST BASIS:** Loss calculation is not easy and in certain cases can reflect the nature of the complexity of the scam. Especially in cases where a fraud has been perpetrated over a period of time, the amount of loss though not entirely quantifiable, still an attempt can be made on ‘at least’ basis. In *U.S. v Ebbbers*,<sup>98</sup> the Court of Appeals

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<sup>98</sup> 458 F.3d 110 (2<sup>nd</sup> Cir. 2006), available at <<https://www.leagle.com/decision/2006568458f3d1101558>>.

estimated a loss to the investors of at least US \$ one billion and *inter alia* held as follows:

“Determining this amount is no easy task. One version of the so-called market capitalization test would, in its simplest form, take the share price on the date of a fraudulent statement—X-day, we shall call it—subtract from it the share price on the day after the fraud is revealed—Y-day— and multiply that amount by the number of outstanding shares.

There is a problem, however, with this simplistic analysis. If the truth had been told on X-day, shareholder A would have suffered an immediate loss commensurate with the fraud loss because potential buyers at the earlier price would have immediately disappeared upon the bad news. When perpetrated, therefore, the fraud would not damage A anymore than the truth, at least immediately. However, were investor B to buy the stock after the fraudulent statement and in reliance upon the integrity of the market price, B would suffer a loss in the amount of the price paid less the intrinsic value, which, under the market capitalization test, would usually be deemed to be the price after the disclosure of the fraud on Y-day.

While shareholder A is as damaged by the truth as by the fraud on X-day, many frauds are ongoing, and, contrary to the testimony of Ebbers' expert, shareholder A may suffer a loss over time in being misled in assessing whether to hold or sell the stock. While A can be said not to have lost anything as a result of the fraud on X-day —assuming no prior disclosure obligation on the defendant's part—if new fraudulent statements are issued on X +1, X +2, etc., and the company's true value has further diminished on each occasion, the succeeding X-day frauds would have the effect of preventing A from making an informed judgment about holding the stock.

The securities laws are intended to allow investors to buy, sell, or hold based on accurate information. An investor who buys securities before an

extended fraud begins, and holds them during the period of the fraud, may therefore be little different from one who buys in mid-fraud.

For example, the ongoing fraud here involved a series of periodic, fraudulent financial reports that systematically inflated WorldCom's operating profits. If the first report had been accurate, some decrease in fundamental value would have been revealed, but the decrease would have been far less than that revealed in June 2002 after several more fraudulent reports. Investors who held their stock throughout the fraud period were therefore denied the opportunity to reassess and perhaps sell according to their own informed estimates of the declining performance.

The loss to investors who hold during the period of an ongoing fraud is not easily quantifiable because we cannot accurately assess what their conduct would have been had they known the truth. However, some estimate must be made for Guidelines' purposes, or perpetrators of fraud would get a windfall. (*emphasis supplied*) Moreover, revelation of an extended period of fraudulent financial statements may cause losses beyond that resulting from the restatement of financial circumstances because confidence in management and in even the truthful portions of a financial statement will be lost. ...

To be sure, this calculation is flawed. Ebbers' expert testified that at least some of the decline in WorldCom's stock price immediately after June 25, 2002, was attributable to factors other than accounting fraud, ... Even so, the loss amount is still well above \$1 billion, or ten times greater than the \$100 million dollar threshold for the 26-level enhancement... Even a loss calculation of \$1 billion is therefore almost certainly too low, and there is no reasonable calculation of loss to investors that would call for a remand.”

Further, since there is no direct relation between the loss to investors and the penalty or fine to be levied or the term of imprisonment to be ordered, the strictness with which the loss needs to be calculated, is not found in Indian securities laws.

#### **A. DIFFICULTY IN RESPECT OF AN UNREGISTERED OR FRAUDULENT SCHEME FUNDS.**

In securities schemes where money has been raised without the required approvals under law e.g. certificate of registration, the person raising the funds without registration (and his creditors acquire no right to such funds<sup>99</sup>) hold the monies in trust and must refund them. The Hon'ble Supreme Court in *PGF Limited & Ors. v Union of India & Anr.*<sup>100</sup> has noted that '*The investors virtually by signing on the dotted lines of those stereotyped blank documents would never be aware of the nature of constraints created in the document, which would virtually wipe out whatever investment made by them in course of time and ultimately having regard to the legal tangles in which such investors would have to undergo by spending further monies on litigations, ultimately prefer to ignore their investments cursing themselves of their fate. More than 90 per cent of such investors would prefer to forget such investments than making any attempt to secure their money back. Thereby, the promoters put to unlawful gain who always thrive on other peoples money.*' Thus in such cases it is safe to say that, unless refunded the monies raised amount to unlawful gain.

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<sup>99</sup> See *G. R. Deo, Liquidator, C.P. and Berar Government Clerks' Mutual benefit Fund, Nagpur v F Karim and Anr*, AIR 1946 Nag 196, wherein the High Court *inter alia* held as follows:

"The question is whether these sums, however paid, and however received, and into whatever account they were paid, can be claimed by the liquidator as part of the company's assets. In our opinion, they cannot. Section 3 (l), Insurance Act of 1938, contains an express prohibition. It states that:

No insurer carrying on any class of insurance business in British India shall, after the expiry of three months from the commencement of this Act, continue to carry on such business, unless he has obtained from the Superintendent of Insurance a certificate of registration.

8. As the certificate was not obtained, the company was prevented by law from carrying on its business. Part of its business was to obtain contributions from its members. Therefore, it was prohibited from receiving these contributions. Accordingly, if it continued to receive these moneys in spite of this prohibition, it could not, in our opinion, claim the moneys as its own.."

<sup>100</sup> Civil Appeal No. 6572 of 2004, Judgment dated 12.03.2013, Para 41.



Similarly, the loss computation arises in the context of the monies raised and the monies available for refund. Also since the person (or the liquidator thereof and his creditors) has no title to the funds, the monies in excess must go to the IEPF<sup>101</sup> or the IPEF<sup>102</sup>, as the case may be.

**RECOMMENDATION:** In this respect some of the principles that may be used for quantifying the losses to investors are as follows, -

- i. In case of an investment scheme requiring registration under securities laws, loss to an investor shall not be reduced by the money or the value of the property transferred to any individual investor in the scheme in excess of that investor's principal investment (*i.e.*, the gain to an individual investor in the scheme shall not be used to offset the loss to another individual investor in the scheme);<sup>103</sup>
- ii. In a case involving a scheme in which - (I) services were fraudulently rendered to the victim by persons falsely posing as licensed/registered professionals; (II) services were falsely represented as approved by SEBI or a governmental regulatory agency; or (III) services for which regulatory approval by SEBI or a government agency was required but not obtained, or was obtained by fraud, - loss shall include the amount paid for the property or services transferred, rendered, or misrepresented, with no credit provided for the value of those items or services;<sup>104</sup> and
- iii. The losses equal the unreturned amounts originally invested by the investors and the earnings re-invested in such schemes (promised returns which are not re-invested are not part of the loss calculation), even though those earnings accrued

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<sup>101</sup> See Section 125 of the Companies Act, 2013.

<sup>102</sup> See SEBI (Investor Protection and Education Fund) Regulations, 2009.

<sup>103</sup> US Sentencing Guidelines p 98, available at <<https://www.ussc.gov/sites/default/files/pdf/guidelines-manual/2016/GLMFull.pdf>>.

<sup>104</sup> *Ibid.*

as a result of such schemes. However, the most recent promised or reported earnings are excluded.<sup>105</sup>

**B. LOSS TO INVESTORS DUE TO DEFLATION OR INFLATION BY DEFAULTS SUCH AS FRAUDULENT TRADING, FALSE OR MISLEADING INFORMATION, ETC.**

Generally, there is no loss attributable to a fraud unless and until the truth (by truth we mean any *information* which breaks the veneer of falsehood and thus discloses the fraud, since the whole truth may never come to the knowledge of the market) is subsequently revealed and the price of the stock is adversely affected. Where the value of a security declines for other reasons, however, such decline, or component of the decline, is not a "loss" attributable to the fraud<sup>106</sup> and where such 'attributable' loss is mixed with 'un-attributable' loss it may be distinguished from attributable loss to the extent possible.

**RECOMMENDATION:** In case of frauds where a large number of investors get affected the loss may be calculated on the affected shares using the methods indicated by the US

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<sup>105</sup> Primer Loss Calculations under §2B1.1(b)(1) of the US Sentencing Guidelines p 23, available at <[https://www.ussc.gov/sites/default/files/pdf/training/primers/2016\\_Primer\\_Loss.pdf](https://www.ussc.gov/sites/default/files/pdf/training/primers/2016_Primer_Loss.pdf)>. See *United States v Hsu*, 669 F.3d 112 (2d Cir. 2012), available at <<https://www.courtlistener.com/opinion/623036/united-states-v-hsu/>>:

“The guidelines provide that when an investor puts money into a fraudster's hands, and ultimately receives nothing of value in return, his loss is measured by the amount of principal invested, not by the principal amount plus the promised interest or return that was never received. The situation is different, however, in a case in which an investor is told not simply that his investment will grow, but that it has grown, and that the total of his original investment and the accrued interest or other gain is now available to be withdrawn or reinvested in the scheme, depending on the investor's preference. (*emphasis supplied*) ... The task in Hsu's case, however, is straightforward. Hsu's victims frequently returned post-dated checks to him for reinvestment, thereby relinquishing the opportunity to cash those checks and withdraw from the scheme. When this occurred, the reinvested checks- including the previously promised returns- became part of their principal investment, and therefore constitute the very losses that Hsu intended to inflict upon his victims. The fact that such money may never have "existed," or that the scheme may have collapsed sooner if all investors had attempted to withdraw their purported gains at once, does not affect the loss calculation. On the facts of this case, the investors were given a clear opportunity to withdraw the total amount of their principal and accrued interest, and were induced not to do so by fraudulent promises of continued gain. The reinvestments were thus appropriately counted as loss. (*emphasis supplied*) Hsu's argument that the "gains" did not exist, and that there was no money to pay the investors, reduces to the claim that the victims' losses do not count because he was unable to pay them back.”

<sup>106</sup> See *United States v. Olis*, 429 F.3d 540, 546 (5th Cir. 2005), available at <<https://www.leagle.com/decision/2005969429f3d5401966>>.

Sentencing Commission and those used in securities litigations, with suitable modifications as follows, -

**“Inflation or Deflation in Value of Securities.**—In a case involving the fraudulent inflation or deflation in the value of securities, *the Board in determining loss may use any method including the following that is appropriate and practicable under the circumstances,* -

- i. **MODIFIED RESCISSORY METHOD<sup>107</sup>:** the actual loss attributable to the change in value of the security is the amount determined by—
  - (I) calculating the difference between the average price of the security during the period that the fraud occurred and the average price of the security during the relevant<sup>108</sup> period after the fraud was disclosed to the market or after the misconduct ended, as may be applicable, and
  - (II) multiplying the difference in average price by the number of securities out-standing after excluding those held by the defaulters themselves (if they amount to substantial holdings) throughout the period of the default, if available.

*Explanation 1.* – Average price may be calculated by using the closing price of each trading day of the time period selected or by using any other relevant price, including weighted average price or other method. It is not necessary that the relevant period may refer

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<sup>107</sup> *United States v. Bakhit*, 218 F. Supp. 2d 1232 (C.D. Cal. 2002), available at <<https://www.courtlistener.com/opinion/2360321/united-states-v-bakhit/>>; *United States v. Grabske*, 260 F.Supp.2d 866 (2002), available at <<https://www.courtlistener.com/opinion/2578802/united-states-v-grabske/>>:

“It is thus appropriate to compute the loss based on the average purchase price during the fraud and the average price during a relevant period after the fraud. Second, the rescissory method eliminates, or at least reduces, the complexity, uncertainty, and expense inherent in attempting to determine out-of-pocket losses.”

<sup>108</sup> **Suitable period:** choice of appropriate time period may be made to *inter alia* consider the time when the market could be said to have absorbed the information and reflect the same in the price of the security. There may be delay with which the market may start correcting itself or extended periods for the market to correct itself. This depends on individual stock and market conditions as seen in *Trojan & Co. Ltd v R. M. N. N. Nagappa Chettiar*, AIR 1953 SC 235: 1953SCR780, it need not begin immediately.

to the entire period from which the default occurred and the fraud came to a stop, the 'relevant' period may refer to a sub-period during which substantial trades took place or which was immediately connected to the fraud.

*Explanation 2. – 'relevant' period for averaging: In case of illiquid securities* [including related exchange traded derivatives and debt instruments]: the price on the day (or the next trading day, whichever is appropriate) the true and fair information/fraud has been become publicly disseminated/stopped may be selected or the average price for a period not exceeding seven trading days, to the extent possible, after the true and fair information/fraud has been become publicly disseminated/stopped may be selected, as may be deemed fit.

*Explanation 3. – 'relevant' period for averaging: In case of liquid securities* [including related exchange traded derivatives and debt instruments]: the period may be a multiple<sup>109</sup> of fifteen trading days to be selected after the true and fair information/fraud has been become publicly disseminated/stopped provided that it shall not exceed ninety days, to the extent possible, especially in relation to securities which are part of any index [including related exchange traded derivatives and debt instruments]. Shorter periods may be selected in case extraneous factors demonstrably affect the price.

In determining whether the amount so determined is a reasonable estimate of the actual loss attributable to the change in value of the security, the Board may consider, among other factors, the extent to

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<sup>109</sup> The deeper the market for a security the longer the period, with maximum possible period in case of a main indices such as BSE SENSEX or NIFTY 50.

which the amount so determined includes ‘significant changes’ in value not resulting from the default (*e.g.*, changes caused by external market forces, such as changed economic circumstances, changed investor expectations, and new industry- specific or firm-specific facts, conditions, or events that appear to impact the price movement by more than 20%) by fixing if possible, a suitable percentage of the amount determined above.

ii. **MARKET CAPITALIZATION METHOD<sup>110</sup>**: the actual loss attributable to the change in value of the security is the amount determined by—

- (I) calculating the difference between the immediate price of the security during a suitable period prior to the disclosure/stoppage of the fraud (usually the closing price the day before the disclosure/stoppage) and the immediate price of the security after the fraud was disclosed to the market/stopped (usually the closing price after the disclosure/stoppage) (or next day price), and
- (II) multiplying the difference by the number of shares outstanding after excluding those held by the defaulters themselves (if they amount to substantial holdings) throughout the period of the default, if available.

In determining whether the amount so determined is a reasonable estimate of the actual loss attributable to the change in value of the security<sup>111</sup>, the Board may consider, among other factors, the

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<sup>110</sup> (Suitable for instances where the stock valuation falls substantially after the fraud *e.g.* WorldCom, Enron, Satyam, etc.) *United States v. Olis*, 429 F.3d 540, 546 (5th Cir. 2005), available at <<https://www.leagle.com/decision/2005969429f3d5401966>>; *United States v. Moskowitz*, 215 F.3d 265 (2d Cir.2000), available at <<https://law.justia.com/cases/federal/appellate-courts/F3/215/265/608045/>>; and *United States v. Hedges*, 175 F.3d 1312 (11th Cir.1999), available at <<https://www.leagle.com/decision/19991487175f3d131211334>>. See also *United States v. Bakhit*, 218 F. Supp. 2d 1232 (C.D. Cal. 2002), available at <<https://www.courtlistener.com/opinion/2360321/united-states-v-bakhit/>>.

<sup>111</sup> See *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005) (S.C.), available at <<https://supreme.justia.com/cases/federal/us/544/336/>>.

extent to which the amount so determined includes ‘significant changes’ in value not resulting from the default (*e.g.*, changes caused by external market forces, such as changed economic circumstances, changed investor expectations, and new industry-specific or firm-specific facts, conditions, or events that appear to impact the price movement by more than 20%) by fixing if possible, a suitable percentage on the amount determined above: Provided that in case of companies which become entirely worthless after the default, i.e. If the company whose securities is sold has no activities, assets, facilities, or any other source of value, so that "company" has no underlying equity; in such cases instead of taking the difference take the entire value of stock prior to the fraud coming to light.<sup>112</sup>

*Explanation.* – The fact that the stock cannot be traded at all after the fraudulent scheme came to light or the stock has been traded only by “insiders” in the fraudulent scheme shall be relevant to decide if the stock was worthless.

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“For one thing, as a matter of pure logic, at the moment the transaction takes place, the plaintiff has suffered no loss; the inflated purchase payment is offset by ownership of a share that at that instant possesses equivalent value. Moreover, the logical link between the inflated share purchase price and any later economic loss is not invariably strong. Shares are normally purchased with an eye toward a later sale. But if, say, the purchaser sells the shares quickly before the relevant truth begins to leak out, the misrepresentation will not have led to any loss. If the purchaser sells later after the truth makes its way into the marketplace, an initially inflated purchase price might mean a later loss. But that is far from inevitably so. When the purchaser subsequently resells such shares, even at a lower price, that lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price. (The same is true in respect to a claim that a share's higher price is lower than it would otherwise have been, a claim we do not consider here.) Other things being equal, the longer the time between purchase and sale, the more likely that this is so, i.e., the more likely that other factors caused the loss.”

<sup>112</sup> *U.S. v. Zolp*, 479 F.3d 715 (9th Cir. 2007), available at <https://law.resource.org/pub/us/case/reporter/F3/479/479.F3d.715.05-50822.html>.

- iii. **MODIFIED MARKET CAPITALIZATION METHOD<sup>113</sup>**: comparing the change in stock value of other, stock of similarly placed but unaffiliated companies after irregularities in those companies were disclosed to the market. The average depreciation may be taken as loss caused.
- iv. **SIMPLE RECESSIONARY METHOD<sup>114</sup>**: the actual loss attributable to the change in value of the security is the amount determined by calculating the difference between the price paid by the affected set of investors and the price existing after the fraud was disclosed to the market/stopped.
- v. **AVERAGE LOSS TO VICTIM<sup>115</sup>**: the number of shares held by holders who are aggrieved and average loss based on the difference between the average price during the fraud (or relevant period selected) and average price during the averaging period selected after the fraud.”

The reasons for doing so are as follows, -

- i. Since there are several ways of calculating loss to investors due to the default, therefore only the most approximate calculation in a given set of facts and circumstances may be adopted, otherwise estimation of loss will be an endless inquiry;
- ii. Calculating loss based on depressed stock price on the date trading resumed following disclosure of fraud may result in an inflated loss

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<sup>113</sup> *U.S. v. Berger*, 587 F.3d 1038 (9th Cir. 2009), available at <<https://www.courtlistener.com/opinion/1345996/united-states-v-berger/>>.

<sup>114</sup> Suitable for a loss calculation for a limited set of investors. See *United States v. Grabske*, 260 F. Supp. 2d 866, 872–73 (N.D. Cal. 2002), available at <<https://www.courtlistener.com/opinion/2578802/united-states-v-grabske/>> (loss is based upon the price that the victim paid for the security and the price of the security as it existed after the fraud was disclosed).

<sup>115</sup> Suitable for a loss calculation for a limited set of investors where the entire period small, max is a few weeks. See *United States v. Snyder*, 291 F. 3d 1291 (11th Cir 2002), available at <<https://www.courtlistener.com/opinion/75836/united-states-v-harry-w-snyder-jr/>>.

adjustment because initial price drop may be temporary and an anomaly which could be an extreme reaction to the announcement of the fraud, hence a bounce-back period for averaging out anomalies has to be considered;<sup>116</sup>

- iii. Though the statute requires that the loss to investors as a result of the default to be calculated, no detailed empirical study is required to be done to consider the effect of every conceivable variable, which can affect the profit or loss. Unrelated market events are material only insofar as they could be identified and assessed;<sup>117</sup>
- iv. The aforesaid methods are neutral to the exact *modus operandi* which cause the price to rise or fall, whether it be false news or circular trading or something else, the aforesaid methods can be used;
- v. Investors have a right to recover exact damages under civil laws but not under securities laws proceedings where they serve only as a guidance tool, because compensating investors are not within SEBI's remit.<sup>118</sup> Hence methods to approximate loss are sufficient;
- vi. The direct losses caused are limited to only those investors who may trade with the fraudster; whereas indirect losses are between investors, some have lost money but their losses translate into profit of another sub-set of investors with whom they traded, and not that

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<sup>116</sup> *United States v. Bakhit*, 218 F. Supp. 2d 1232 (C.D. Cal. 2002), available at <<https://www.courtlistener.com/opinion/2360321/united-states-v-bakhit/>>.

<sup>117</sup> *United States v. Gordon*, 710 F. 3d 1124 (10<sup>th</sup> Cir. 2013), available at <<https://www.leagle.com/decision/infc020130315045>>.

<sup>118</sup> *Rakesh Agarwal v SEBI*, [2004] 49 SCL 351 (SAT) (Further, the disgorgement of alleged profits is always directed as a measure of deterrence and not compensation. Also authority for the point that Civil Court jurisdiction is preserved with regard to matters which the Board is not empowered to pass orders by or under the SEBI Act), , available at <[https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi\\_data/attachdocs/1299749902889.pdf](https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi_data/attachdocs/1299749902889.pdf)>.



of the fraudster. In such cases, it is an impossible task to differentiate between the investors who have lost and who have unwittingly profited. Also several persons may have traded multiple times and some may not have traded at all but lost money merely on account of holding it during the period of fraud. Hence a general approximation is made in respect of all the outstanding shares, as if they have been affected at least once. By its very nature, it is not meant to be an exact determination of loss caused for making compensation or restitution. Restitution is tied to the concept of profits made by the fraudster(s) and not the victim's losses, under the garb of restitution directing the fraudster(s) to make good the profits not received by him/them but by another set of trading investors, - would amount to compensation;

- vii. Investors buy and sell at different prices, some at great loss and some at a profit and the trades may be concentrated during a particular period and thereafter market forces may have resulted in a higher price notwithstanding the fraud thereby creating the perception of having diminished the effect of the fraud. Averaging and focusing on particular period around the relevant default, enables the loss to be calculated even in cases where price after the disclosure of the fraud was higher than the average price during the fraud.<sup>119</sup>

**DIFFERENTIATING IMPACT FROM MARKET MOVEMENTS AND THE DEFAULT:** There are many statistical techniques to understand the impact of information on price- some simple some complex depending on the nature of information. The Board as a specialised body regulating the securities market should become adept in using these techniques. Macroeconomic events— such as changes in interest rates, government spending, monetary policy, and oil prices just to name a few—affect almost all companies and the returns on almost all stocks. These changes have nothing to do with

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<sup>119</sup> *United States v. Snyder*, 291 F. 3d 1291 (11th Cir 2002), available at <<https://www.courtlistener.com/opinion/75836/united-states-v-harry-w-snyder-jr/>>.

company-specific news. Some stocks are more (or less) affected than others by such market fluctuations and the sensitivity of a stock's returns to gyrations in market returns is called a stock's beta. Stocks with a beta ( $\beta$ ) greater than 1.0 typically respond more than one-for-one to changes in the return of the overall market. Stocks with a beta ( $\beta$ ) less than 1.0 typically vary less than one-for-one with market returns. A stock with a beta ( $\beta$ ) of 2.0 would therefore fall by twice the percentage as the market, on average, absent any company-specific news because that stock is twice as sensitive as the average stock to market movements. Stock returns can be broken down into two parts: (i) the part explained by market returns and the firm's beta ( $\beta$ ); and (ii) the part affected by company-specific news. These two parts are additive. Suppose that the broader market is down by 2% and a company with a beta ( $\beta$ ) of 2.0 releases a negative earnings announcement that would result in a precipitous decline of 10% solely related to the earnings announcement. Holding everything else constant, the stock should be down by 4% because of the market decline, plus another 10% because of the company specific news, for a total decline of 14%.<sup>120</sup>

Thus using statistical methods (the *Beta* ( $\beta$ ) and *Delta* ( $\Delta$ ) of securities are statistical aspects which are used for predicting behaviour of securities by investment managers, exchanges and other financial advisors) it may<sup>121</sup> be possible to even distinguish between impact caused by a default and impact caused by market forces acting on a scrip at the same time, since the impact from the market forces can be estimated and deducted from the actual movement.

**RECOMMENDATION:** Where the information mix includes information, which affects the market (it may be the entire securities market or sector-specific) it may be possible to use the *beta* ( $\beta$ ) of a scrip and *delta* ( $\Delta$ ) in case of options, if reliable, to arrive at the

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<sup>120</sup> For beta cases see, J Duncan, *Recalculating "Loss" in Securities Fraud*, (2013) 3 Harvard Business Law Review 257, pp 268-269 available at <[http://www.hblr.org/wp-content/uploads/2013/10/HLB202\\_crop.pdf](http://www.hblr.org/wp-content/uploads/2013/10/HLB202_crop.pdf)>.

<sup>121</sup> Like all statistical methods, it has drawbacks such as, -a *low correlation*, another statistical aspect, may make Beta unreliable. Also, given the nature of securities markets, *past results are no guarantee for future results*, hence the predictions may not always be spot on. However, Delta which is used for options trading is more highly predictive. The difference between predicted return and actual return can give the loss caused to investors as a result of the default.

difference between projected change based on market data and actual change in addition to advanced statistical methods.

**C. SPECIAL CASE: LOSS TO INVESTORS MAY ARISE WITHOUT FALL IN PRICE OF SECURITY OR IN SPITE OF RECOVERY IN PRICE.**

This is a special case of loss to investors where positive and negative information is mixed. Shareholders may experience an actionable loss if stock does not appreciate as it would have absent the fraudulent conduct.<sup>122</sup> A recovery in share price after the fraud was disclosed to the purchasers does not automatically defeat an inference of economic loss.<sup>123</sup> The inflation in price attributable to fraud could be reduced or eliminated even if

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<sup>122</sup> See *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005) (S.C.), available at <<https://supreme.justia.com/cases/federal/us/544/336/>>.

<sup>123</sup> See *In re Columbia Sec. Litig.*, 155 F.R.D. 466, 483 (S.D.N.Y. 1994); *Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824, 832 (8<sup>th</sup> Cir. 2003), available at <<https://openjurist.org/335/f3d/824/gebhardt-v-conagra-foods-inc-c-p-w-d>>:

“ConAgra argues that since its stock's value increased in the weeks after the May announcement the plaintiffs can show no connection between the misrepresentations and any loss. However, stockholders can be damaged in ways other than seeing their stocks decline. If a stock does not appreciate, as it would have absent the fraudulent conduct, investors have suffered harm. (*emphasis supplied*) Therefore, we decline to attach dispositive significance to the stock's price movements absent sufficient facts and expert testimony, which cannot be considered at this procedural juncture, to put this information in its proper context.”

*Acticon AG v. China North East Petroleum Holdings Ltd.*, 692 F.3d 34 (2d Cir. 2012), available at <<https://www.leagle.com/decision/infc020120801053>>. Acticon alleged that NEP misled investors about its reported earnings, oil reserves, and internal controls. It further alleged that NEP revealed this information through a series of corrective disclosures and that in the trading days after each disclosure was made, NEP's stock price dropped. NEP argued that these allegations are not sufficient to allege economic loss because its share price rebounded on certain days after the final disclosure to the point that Acticon could have sold its holdings and avoided a loss. The Court disagreed with NEP and *inter alia* held that, -

“[A] share of stock that has regained its value after a period of decline is not functionally equivalent to an inflated share that has never lost value. This analysis takes two snapshots of the plaintiff's economic situation and equates them without taking into account anything that happened in between; it assumes that if there are any intervening losses, they can be offset by intervening gains. But it is improper to offset gains that the plaintiff recovers after the fraud becomes known against losses caused by the revelation of the fraud if the stock recovers value for completely unrelated reasons. Such a holding would place the plaintiff in a worse position than he would have been absent the fraud. (*emphasis supplied*) Subject to the bounce-back limitation imposed by the PSLRA, a securities fraud action attempts to make a plaintiff whole by allowing him to recover his out-of-pocket damages, that is, the difference between what he paid for a security and the uninflated price. See *Levine*, 439 F.2d at 334. In the absence of fraud, the plaintiff would have purchased the security at an uninflated price and would have also benefitted from the unrelated gain in stock price. If we credit an unrelated gain against the plaintiff's recovery for the inflated purchase price, he has not been brought to the same position as a plaintiff who was not defrauded because he does not have the opportunity to profit (or suffer losses) from ‘a second investment decision unrelated to his initial decision to purchase the stock.’”) (*emphasis supplied*)

there were a net increase in price. That could happen, for example, if the company corrected the false information and at the same time issued unrelated positive information. “A firm that lies about some assets cannot defeat liability by showing that other parts of its business did better than expected, counter-balancing the loss.”<sup>124</sup> Suppose a mining corporation makes a market announcement that it has found gold and the price moves up from Rs. 10 to Rs. 100/- a share, and investors purchase shares of the corporation. After a few months the corporation announces that they have found platinum but not gold. The stock price rockets to Rs. 1000, in this case the corporation may still have caused loss to investors as the price could have been higher by Rs. 90 had the company found both gold and platinum.<sup>125</sup>

**RECOMMENDATION:** In cases where price is affected by positive and negative news relating to the company examination of loss may be possible by examining their separate and cumulative effect.

## **5. PRINCIPLES RELATING TO QUANTIFICATION OF DISPROPORTIONATE GAIN MADE IN INSIDER TRADING MATTERS**

In respect of insider trading, the Committee proposes to discuss quantification in respect of disgorgement and in respect of penalties separately, due to the unique nature of disgorgement and for ensuring a sound enforcement regime against insider trading apart from just quantification.

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<sup>124</sup> *Goldberg v. Household Bank, F.S.B.*, 890 F.2d 965, 966 (7th Cir. 1989), available at <<https://openjurist.org/890/f2d/965>> (in relation to earnings re-statement by a bank).

<sup>125</sup> This example is adapted from the U.S. Supreme Court’s oral proceedings in *Dura Pharmaceuticals, Inc. v. Broudo*. Transcript of Oral Argument, *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 2005 WL 236546, (Jan. 12, 2005) available at <[https://www.supremecourt.gov/oral\\_arguments/argument\\_transcripts/2004/03-932.pdf](https://www.supremecourt.gov/oral_arguments/argument_transcripts/2004/03-932.pdf)>. Also See Elizabeth Chamblee Burch, *Reassessing Damages in Securities Fraud Class Actions*, available at <<https://core.ac.uk/download/pdf/76623384.pdf>>:

‘If the gold-platinum scenario sounds too hypothetical, consider a pharmaceutical company that announces higher than expected profits to create a market frenzy and later issues both a revised filing revealing its past financial woes and announces that it received regulatory approval for a new cancer-fighting drug.’

The prevention of insider trading is dependent on fixing a suitable deterrent on the insiders who engage in 'tipping.' When directors and other insiders within the company directly engage in tipping, the profits made by such insiders who themselves trade are easy to figure out and therefore easier to subject to deterrent penalties and disgorgement. However, even insiders know this and that is why this form of insider trading is rare. Instead, such company insiders 'tip' off outsiders including their relatives, who then trade. There are several advantages to such modus operandi, -

- i. It may be difficult to prove the link between such persons;
- ii. Even if the link is proven, the person who actually commits insider trading may be a person of little consequence propped up to bear the blame of insider trading. Further, the profits made may have been withdrawn from their bank accounts without leaving a trace, thus even before the crime is detected, the entire proceeds become irrecoverable from such propped up persons. Hence imposing a penalty or debarment on such a person may have no deterrent effect since he was selected because he has no real association with the securities markets and the monies would be irrecoverable; and
- iii. The inside tipper can always claim to not have 'benefitted' from the whole event even though insider trading could not have been possible without him breaching his fiduciary duties to the company and the shareholders in the first place. Though the company insider's liability is the greatest, he tries to appear as the most 'innocent' of the lot by claiming he has not benefitted- if this were true there is no reason for such defaults to happen in the first place. Unless joint liability is considered it will be difficult to justify levy of deterrent penalty and debarment on such delinquent insiders when their cases are considered individually.

The unfortunate result of the present state of law is that insider trading continues unabated, without material deterrent to company insiders who are the first line of defence against insider trading.

## A. DISGORGEMENT FOR INSIDER TRADING.

It is the view of the Committee that, the joint penal provision of the SEBI Act is clear in respect of tippers link with the profit of the tippee<sup>126</sup>, however there is little clarity in respect of disgorgement.

In this respect an analysis of the law of disgorgement is essential. SEBI initially attempted to develop an equitable tool for disgorgement similar to that found in developed jurisdictions. It however failed in its initial attempts since the remedy of disgorgement was framed as tool of compensation rather than as an anti-unjust enrichment mechanism.<sup>127</sup> Disgorgement depends on the profits made. Subsequently, in *Karvy Stock Broking Ltd. v SEBI*<sup>128</sup>, which is the foundational case of disgorgement law in India<sup>129</sup>, the Board had,<sup>130</sup> ordered disgorgement and imposed joint and several liability while doing so.

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<sup>126</sup> See 5.B below.

<sup>127</sup> *Rakesh Agarwal v SEBI*, [2004] 49 SCL 351 (SAT), available at <[https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi\\_data/attachdocs/1299749902889.pdf](https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi_data/attachdocs/1299749902889.pdf)> and *Hindustan Lever v. SEBI*, [1998] 18 SCL 311 (Appellate Authority); the remedy never had a compensatory nature to begin with even in the USA, see *Federal Trade Commission v. Bronson Partners, LLC*, 654 F.3d 359 (2d Cir. 2011), available at <<https://www.courtlistener.com/opinion/223605/ftc-v-bronson-partners-llc/>>:

“Nor, having obtained a disgorgement award, are public entities required to make any particular effort to compensate the victims that they can identify. See *Fischbach*, 133 F.3d at 176; see also *SEC v. Wang*, 944 F.2d 80, 88 (2d Cir.1991) (affirming a distribution plan that engaged in "line-drawing[,] which inevitably leaves out some potential claimants"). While agencies may, as a matter of grace, attempt to return as much of the disgorgement proceeds as possible, the remedy is not, strictly speaking, restitutionary at all, in that the award runs in favor of the Treasury, not of the victims.”

<sup>128</sup> [2008] 84 SCL 208 (SAT), available at <<https://indiacorplaw.in/wp-content/uploads/2008/05/karvystock.pdf>>.

<sup>129</sup> Though *NSDL v SEBI*, Appeal No. 147/2006, SAT Order dated 22.11.2007, available at <[https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi\\_data/attachdocs/1291962820302.pdf](https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi_data/attachdocs/1291962820302.pdf)> was decided before *Karvy Stock Broking Ltd. v SEBI*, both were related cases and the Tribunal was of the view that ‘*We are further of the view ‘that all these issues should have been determined only after the passing of the final order holding the appellants guilty of the alleged wrong doings for which proceedings are still pending.’* The law relating to disgorgement was explained and laid down in the subsequent case of *Karvy Stock Broking Ltd. v SEBI*.

<sup>130</sup> *Ibid*:

“The liability of all the 10 entities to disgorge the aforesaid amount was made joint and several as, according to the Board, they were a party to one large fraud where they either deliberately closed their eyes when the wrong doers perpetrated their illegality or were actively involved in the transactions. Quite interestingly, the Board observed that the exact apportionment of the liability between various parties could be decided by them inter se either by settlement or by suits of indemnity/contribution between each other and from all persons including financiers, key operators and other violators. (*emphasis supplied*) It was further observed that “It is not in the interest of the public that the regulator should spend its time in deciding private disputes between various perpetrators of the IPO fraud/cornering of shares” (*emphasis supplied*). It is against this order that the present appeal has been filed.”

On appeal the Securities Appellate Tribunal *inter alia* held as follows, -

“5. Before we deal with the contentions of the parties, it is necessary to understand what disgorgement is. It is a common term in developed markets across the world though it is new to the securities market in India. Black’s Law Dictionary defines disgorgement as “The act of giving up something (such as profits illegally obtained) on demand or by legal compulsion.” (*emphasis supplied*) In commercial terms, disgorgement is the forced giving up of profits obtained by illegal or unethical acts. It is a repayment of ill-gotten gains that is imposed on wrongdoers by the courts. Disgorgement is a monetary equitable remedy that is designed to prevent a wrongdoer from unjustly enriching himself as a result of his illegal conduct. It is not a punishment nor is it concerned with the damages sustained by the victims of the unlawful conduct. Disgorgement of ill- gotten gains may be ordered against one who has violated the securities laws/regulations but it is not every violator who could be asked to disgorge. Only such wrongdoers who have made gains as a result of their illegal act(s) could be asked to do so. (*emphasis supplied*) Since the chief purpose of ordering disgorgement is to make sure that the wrongdoers do not profit from their wrongdoing, it would follow that the disgorgement amount should not exceed the total profits realized as the result of the unlawful activity. In a disgorgement action, the burden of showing that the amount sought to be disgorged reasonably approximates the amount of unjust enrichment is on the Board.”

Thus the foundational case-law of the equitable remedy of disgorgement in India, though trying to draw an analogy from more developed jurisdictions (like the Board’s earlier attempt) was based on the dictionary meaning of the term rather than on a legal examination of case-laws of developed jurisdictions in respect of disgorgement, which were not placed before the Tribunal. Even existing Indian jurisprudence in respect of

joint and several liability was not explored by either litigant.<sup>131</sup> What is interesting to note is even US federal Courts initially floundered on a key aspect of disgorgement but subsequently corrected themselves once the inequity came to the fore.<sup>132</sup>

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<sup>131</sup> See *Dharni Dhar and Ors v Chandra Shekhar & Ors*, AIR 1951 All 774, discussing contribution by joint tortfeasors and its applicability in India depending on the facts and circumstances of each case:

“The rule [of *Merrywhether v Nixon* (1799) 8 T. R. 186; 16 R. R. 810 : 101 E. R. 1337] (*supplied*) was thus modified and came to be stated in these words :

“No person who has been guilty of fraud or any other form of wilful wrong-doing, and has been made liable in damages, has any right of contribution or indemnity against any other person who was a joint wrong-doer with him....”

66. Where a civil wrong is committed jointly by certain persons as against another, they purge themselves of the consequences of the wrong when they repair the damage caused to that person. It cannot, therefore, be said that the hands of tort-feasor who has repaired the damage are unclean. Indeed the hands of the person who has not yet contributed his share of the loss are unclean and there is no justice in denying the relief to the person who has repaired the whole of the damage caused by the action of both of them.”

Also see *Kushro S. Gandhi & Ors v N.A. Gajdar & Ors*, 1970 (SC) AIR 1468, 1969 SCR (2) 959, holding that the recovery of the entire liability could be made from all or any of the persons jointly liable before they rely on accord and satisfaction without going into the correctness of *Dharni Dhar and Ors v Chandra Shekhar & Ors*, AIR 1951 All 774.

<sup>132</sup> See *SEC v Lauer & Ors.*, 445 F. Supp. 2d 1362 (S.D. Fla. 2006), available at <<https://www.courtlistener.com/opinion/2499896/sec-v-lauer/>>, wherein the court inter alia observed the development of requirement of tracing in respect of disgorgement,-

“Lauer cites, among other cases, *S.E.C. v. First City Financial Corp., Ltd.*, 890 F.2d 1215, 1230 (D.C.Cir.1989) (“First City”) which states that because “disgorgement primarily serves to prevent unjust enrichment, the court may exercise its equitable power only over property causally related to the wrongdoing.” Several cases have cited First City for this proposition, most notably for our purposes, *CFTC v. Sidoti*, 178 F.3d 1132, 1138 (11th Cir.1999), and *SEC v. Gane*, 2005 WL 90154, \*19 (S.D.Fla. 2005) (Gonzales, J.). The Eleventh Circuit, relying upon First City, held that “the district court may not disgorge profits obtained without the aid of any wrongdoing.” *Sidoti*, 178 F.3d at 1138. The Sidoti Court went on to find that the district court had abused its discretion for ordering disgorgement of profits for a period during which there was no record evidence of fraud.

Subsequent to First City, the Court of Appeals for the District of Columbia reviewed the narrow interpretation Lauer proposes for the holding in First City and held to do so conflicts with longstanding precedent and would lead to a monstrous doctrine that would perpetuate rather than correct an inequity. In *SEC v. Banner Fund Int'l, et al.*, 211 F.3d 602, 617 (D.C.Cir.2000), the Court of Appeals explained: (emphasis supplied)

“Because disgorgement is an equitable obligation to return a sum equal to the amount wrongfully obtained, rather than a requirement to replevy a specific asset, we reject Blackwell's challenge and affirm the district court.

. . . As the SEC points out, the requirement of a causal relationship between a wrongful act and the property to be disgorged does not imply that a court may order a malefactor to disgorge only the actual property obtained by means of his wrongful act. Rather, the causal connection required is between the amount by which the defendant was unjustly enriched and the amount



Pursuant to a detailed enquiry into the foundations of the equitable nature of disgorgement the Committee is of the view that the aforesaid decision (whereby disgorgement in India is limited to only those persons who have received the proceeds of default and only to the extent of the proceeds received) is *per incuriam*.

The Committee has examined the case laws surrounding disgorgement in USA, which is the foremost securities market in the world where this remedy has been prominently applied<sup>133</sup> and several Anglo-American principles of equity and law in common with

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he can be required to disgorge. To hold, as Blackwell maintains, that a court may order a defendant to disgorge only the actual assets unjustly received would lead to absurd results. Under Blackwell's approach, for example, a defendant who was careful to spend all the proceeds of his fraudulent scheme, while husbanding his other assets, would be immune from an order of disgorgement. Blackwell's would be a monstrous doctrine for it would perpetuate rather than correct an inequity. (emphasis supplied)"

Many district courts faced with this argument agree that "[t]here is no requirement that frozen assets be traceable to the fraudulent activity underlying a lawsuit." *SEC v. Dennis Crowley*, Case No. 0480354-Civ-Middlebrooks, Slip. Op. (S.D.Fla.2004) (order by consent by Magistrate Judge Johnson) [DE 1368, Ex. I]; see also *SEC v. A.B. Financing and Inv., Inc.*, Case No. 02-23487-Civ-Ungaro-Benages, Slip. Op. at 2-3. (S.D.Fla.2003) ("a district court may freeze assets not specifically traced to illegal activity" quoting *Levi Strauss & Co. v. Sunrise Int'l Trading Inc.*, 51 F.3d 982 (11th Cir.1995)) [DE 1368, Ex. J]; *SEC v. Belmonte*, No. 88 6557, 1991 WL 214252 (S.D.Fla.1991) (Roettger, J.) (refusing to release funds from sale of home, even though home had been acquired prior to alleged fraud, because there had been no showing that ill-gotten funds had not been used to subsidize mortgage payments or improve home); *SEC v. Current Financial Svcs.*, 62 F. Supp. 2d 66, 68 (D.D.Cir.1999) (refusing to release personal funds not traceable to the fraud because defendant's liability exceeded total funds frozen); *SEC v. Grossman*, 887 F. Supp. 649, 661 (S.D.N.Y.1995) ("it is irrelevant whether the funds affected by the Asset Freeze are traceable to the illegal activity") (aff'd, 101 F.3d 109 (2d Cir. 1996)); *SEC v. Roor*, No. 99-3372, 1999 WL 553823 at \*2 (S.D.N.Y.1999) (denying motion to release so-called "untainted" funds from mortgage of property that preexisted alleged fraud); *SEC v. Glauberman*, No. 90-5205, 1992 WL 175270 at \*1 (S.D.N.Y.1992) (rejecting defendant's argument that funds subject to disgorgement must be traced "dollar for dollar" to the illegal activity). (emphasis supplied)

....The amount of assets to be frozen, prior to the finding of liability, is determined not by whether the funds themselves are traceable to the fraudulent activity underlying the lawsuit, but by showing a reasonable approximation of the amount, with interest, the defendant was unjustly enriched. *Id.*; *SEC v. Blatt* 583 F.2d 1325, 1335 (5th Cir.1978). (emphasis supplied)"

<sup>133</sup> *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (directing the district court to consider the remedy of restitution), available at <<https://law.justia.com/cases/federal/appellate-courts/F2/401/833/324140/>>; *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (district court directing restitution), available at <<https://law.justia.com/cases/federal/district-courts/FSupp/312/77/1468753/>> and *SEC v. Texas Gulf Sulphur Co.*,

those and our jurisdiction. No statute governs the disgorgement of ill-gotten profits—rather, the principles of equity provide the foundation for this remedy.<sup>134</sup>

While the equity foundation of disgorgement is correct and disgorgement is generally limited to the extent of the illegal gains made by a particular defaulter, however equity provides for an important exception: joint defaulters. In case of joint defaulters, the disgorgement remedy has always been on the basis of joint and several liability. It is not limited to the amount of monies received by a particular defaulter. The latest landmark ruling in respect of joint and several liability is *SEC v. Contorinis*,<sup>135</sup> wherein the US Court of Appeals examined the entire case law relating to disgorgement and *inter alia* held as follows, -

“The primary issue presented is whether an insider trader who trades on behalf of another person or entity using funds he does not own, and thus produces illegal profits that he does not personally realize, can nevertheless be required to disgorge the full amount of illicit profit he generates from his illegal and fraudulent actions. Because our cases have established that tippers can be required to disgorge profits realized by their tippees’ illegal insider trading, and this case is distinguishable only insofar as Contorinis himself executed the fraudulent trades rather than leave that task to a tippee, we conclude that the district court was empowered to enter the disgorgement order, and did not abuse its discretion in doing so.

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446 F.2d 1301 (2d Cir. 1971) (upholding district court order of restitution), available at <<https://law.justia.com/cases/federal/appellate-courts/F2/446/1301/140482/>>.

<sup>134</sup> See *Janigan v. Taylor*, 344 F.2d 781, 786 (1st Cir.1965), available at <<https://www.leagle.com/decision/19651125344f2d7811934>>.

<sup>135</sup> 2014 U.S. App. LEXIS 2927 (2d Cir. Feb. 18, 2014), available at <<https://cases.justia.com/federal/appellate-courts/ca2/12-1723/12-1723-2014-02-18.pdf?ts=1410919262>>. Also see, *SEC v. Great Lakes Equities Co.*, 775 F. Supp. 211, 214 (E.D. Mich. 1991), available at <<https://law.justia.com/cases/federal/district-courts/FSupp/775/211/1555222/>>, wherein the court *inter alia* held that,-

*"[t]he benefit or unjust enrichment of a defendant includes not only what it gets to keep in its pocket after the fraud, but also the value of the other benefits the wrongdoer receives through the scheme. Thus, in insider trading cases, a tipper must disgorge not only his own profits but also any profits made by his tippees, even if the tipper did not receive any tangible kickback from those tippees."*

Contorinis argues that because he never personally controlled the profits that accrued to the Paragon Fund – although he could make investment decisions, he did not control disbursement of the proceeds – ordering him to disgorge the entire amount gained through his insider trading is a misapplication of the disgorgement principle. The argument identifies an ambiguity in the concept of disgorgement.

...

Contorinis argues, in effect, that one can only “disgorge” what one has personally “swallowed”; the SEC argues that a fraudster should be compelled to return not only those profits from the fraud that he has reserved for his own use, but also those that he has bestowed on others.

...

In resolving this dispute, we do not write on a clean slate. Our prior cases indicate that an insider trader may be ordered to disgorge not only the unlawful gains that accrue to the wrongdoer directly, but also the benefit that accrues to third parties whose gains can be attributed to the wrongdoer’s conduct. We have long applied that principle in the tipper-tippee context. Thus, in *SEC v. Warde* we held that, in the determination of a disgorgement amount, “[a] tippee’s gains are attributable to the tipper, regardless whether benefit accrues to the tipper.” 151 F.3d 42, 49 (2d Cir. 1998). That principle has deep roots in parallel civil remedial structures. For example, in *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 165 (2d Cir. 1980), we concluded that “[t]rades by tippees are attributed to the tipper” in determining liability for damages, and in *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1308 (2d Cir. 1971), the foundational case for insider trading liability, we required a tipper to make common-law civil restitution “for the profits derived by his tippees. That rule makes perfect sense. A potential tipper in possession of inside information who seeks to confer a benefit on a friend or to curry favor with someone who can confer reciprocal benefits in the future can do so either by trading on this information himself and passing the *profit* on to the intended beneficiary, or by passing the *information* to the beneficiary and thus allowing the tippee to realize the profit himself. In

the former case, the insider would unquestionably be liable to disgorge the profit; disgorgement is required whether the insider trader has put his profits into a bank account, dissipated them on transient pleasures, or given them away to others. It would make little sense to allow the insider to escape disgorgement when he gives away not the proceeds of a trade predicated on his insider knowledge, but rather the knowledge itself to others who he knows will spin the information into gold by trading on it themselves. (*emphasis supplied*)

...

There is no injustice, therefore, in making him responsible for the profits he made for others, as well as for himself, through his fraudulent insider trades.

...

As we said in *Warde*, in the absence of the discretion to allocate liability to wrongdoers, “[t]he value of the rule in preventing misuse of inside information would be virtually nullified [because] those in possession of such information, although prohibited from trading for their own accounts, [would be] free to use the inside information on trades to benefit their families, friends, and business associates.” 151 F.3d at 49. See also *Tex. Gulf Sulphur*, 446 F.2d at 1308 (“[W]ithout such a remedy, insiders could easily evade their duty to refrain from trading on the basis of inside information. Either the transactions so traded could be concluded by a relative or an acquaintance of the insider, or implied understandings could arise under which reciprocal tips between insiders in different corporations could be given.”). (*emphasis supplied*)

...

We do not conclude that district courts *must* impose disgorgement liability for insider trading upon wrongdoers when the gains accrue to innocent third parties, but rather that the district courts *may* elect to do so in appropriate circumstances. (*emphasis supplied*)

...

As our consideration of the tipper context demonstrates, to so limit the power of courts to order disgorgement would permit evasion of the prohibition on insider trading by allowing the direction of benefits to acquaintances.

...

As our case law has indicated (and as our opinion here confirms), when third parties have benefitted from illegal activity, it is possible to seek disgorgement from the violator, even if that violator never controlled the funds. The logic of this, as more fully articulated *supra*, is that to fail to impose disgorgement on such violators would allow them to unjustly enrich their affiliates. Thus, ordering a violator to disgorge gain the violator never possessed does not operate to magnify penalties or offer an alternative to fines, but serves disgorgement's core remedial function of preventing unjust enrichment. (*emphasis supplied*) District courts possess the equitable discretion to determine whether disgorgement liability should fall upon third parties or violators, a responsibility concordant with the district courts' broad discretion to assay disgorgement more generally."

Also see *SEC v. Hughes Capital Corp.*,<sup>136</sup> wherein the Court *inter alia* explained the principles of the law of torts underpinning disgorgement and held as follows, -

"Disgorgement is an equitable remedy designed to deprive a wrongdoer of his unjust enrichment and to deter others from violating securities laws." *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1230 (D.C. Cir. 1989). When apportioning liability among multiple tortfeasors, it is appropriate to hold all tortfeasors jointly and severally liable for the full amount of the damage unless the liability is reasonably apportioned. "Where joint tortfeasors cause a single and indivisible harm for which there is no reasonable basis for division according to the contribution of each, each tortfeasor is subject to liability for the entire harm." (*emphasis supplied*) *United States v. Alcan Aluminum Corp.*, 964 F.2d 252, 268-69 (3d Cir. 1992).<sup>137</sup>

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<sup>136</sup> 124 F.3d 449, 455 (3d Cir. 1997), available at <<https://casetext.com/case/securities-and-exchange-v-hughes-capital>>.

<sup>137</sup> See *United States v. Alcan Aluminum Corp.*, 964 F.2d 252 (3d Cir. 1992), available at <<https://www.leagle.com/decision/19921216964f2d25211183>>:

"Obviously, of critical importance in this analysis is whether a harm is divisible and reasonably capable of apportionment, or indivisible, thereby subjecting the tortfeasor to potentially far-reaching liability. Under the Restatement, where a joint tortfeasor seeks to apportion the full amount of a plaintiff's damages

Courts have held that joint-and-several liability is appropriate in securities cases when two or more individuals or entities collaborate or have close relationships in engaging in the illegal conduct. (*emphasis supplied*) See *First Jersey Securities*, 101 F.3d at 1475; *Hateley v. SEC*, 8 F.3d 653, 656 (9th Cir. 1993). In the instant case, the defendants all collaborated in a single scheme to defraud Hughes' investors through the bogus initial public offering and the subsequent sale of warrants. They enjoyed a "close relationship" with each other through their connection to Hughes, the other corporations used in the scheme, and the nominee accounts used to perpetuate the scheme."

Thus, the elective nature of imposing joint and several liability for fraud and insider trading by drawing upon the common law principles of tort and equity is well laid down in US law. For a long time, in USA disgorgement was a remedy available only through Federal Courts; in 1990 the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisors Act of 1940 and the Investment Company Act of 1940 were amended by the Securities Enforcement Remedies and Penny Stock Reform Act<sup>138</sup> and the SEC has been authorised to seek disgorgement in its own proceedings.

Indian jurisprudence while trying to frame a remedy of disgorgement on the lines of developed jurisdictions actually fell short of imposing joint and several liability on defaulters, as our Anglo-Indian tort jurisprudence of joint and several liability was not examined, thus allowing defaulters to arrange their affairs in a manner to defeat the enforcement of securities laws.

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according to that tortfeasor's own contribution to the harm, it is the tortfeasor's burden to establish that the damages are capable of such apportionment. As the comments concerning this issue explain, the burden of proving that the harm is capable of apportionment is placed on the tortfeasor to avoid."

**It is not the profit to be disgorged that has to be apportioned, but the harm. If the harm caused is an indivisible whole like a scheme to defraud investors, the profit may be disgorged, jointly and severally.**

<sup>138</sup> Available at <<https://www.gpo.gov/fdsys/pkg/STATUTE-104/pdf/STATUTE-104-Pg931.pdf>>.

The Securities Laws (Amendment) Act, 2014, inserted the following Explanation in Section 11B of the SEBI Act, Section 19 of the Depositories Act and Section 12A of the SCRA, -

“Explanation. —For the removal of doubts, it is hereby declared that power to issue directions under this section shall include and always be deemed to have been included the power to direct any person, who made profit or averted loss by indulging in any transaction or activity in contravention of the provisions of this Act or regulations made thereunder, to disgorge an amount equivalent to the wrongful gain made or loss averted by such contravention.”

The Explanation gives the impression that the disgorgement can be done ‘only’ from a person who has made illegal gains by indulging in a contravention of securities laws and such disgorgement shall be equal to the amount gained. As such the Explanation gives an impression by converse reasoning that disgorgement can only be done from a person who has received monies. However, a deeming provision is not to be extended to what it does not say, it is to be applied only to what it says. A legal fiction cannot be carried further than what it says.<sup>139</sup> The Explanation does not use the word ‘only’ nor does it actually prohibit the levy of joint and several liability. The Explanation was introduced only for the removal of certain doubts rather than creating new ones. Hence, it is the view of the Committee that Section 32 which permits the application of other laws is an important source by which securities laws jurisprudence can be developed and remedies shaped to deal with different kinds of situations. Hence, the Committee is of the view that notwithstanding the present Explanation, it is permissible for the Board to rely upon Section 32 of the SEBI Act and direct disgorgement on joint and several liability basis whether or not all such persons have actually received monies, since the delinquent act is *joint*, the receipt of illegal proceeds by anyone in furtherance of such an act is receipt by all.

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<sup>139</sup> See *K. S. Dharmadatan vs Central Government And Ors*, 1979 AIR SC 1495, 1979 SCR (3) 832; *Commissioner of Sales Tax, Uttar Pradesh v. The Modi Sugar Mills Ltd.*, 1961 AIR SC 1047, 1961 SCR (2) 189; *Braithwaite & Co. (India) Ltd. v. Employees' State Insurance Corporation*, 1968 AIR SC 413, 1968 SCR (1) 771; *Commissioner of Income Tax Bombay City v. Elphinstone Spinning and Weaving Mills Co. Ltd.*, 1960 AIR SC 1016.

In this respect it must be considered that the concept of fraud in securities laws is wider than the concept of common law fraud, which is too restrictive to deal with the complexities of the securities markets.<sup>140</sup> While the restrictions may not be applicable vis a vis the Board, several of the broader concepts relating to common law fraud are equally applicable to securities laws and are definitely applicable, in view of section 32 of the SEBI Act, 1992. Thus, the Supreme Court has considered the American caselaw (including cases relating to insider trading) surrounding their *pari materia* anti-fraud provision in securities laws, which also covers insider trading without specifically mentioning it, and has held that in cases of fraud, joint liability can be imposed on the delinquents (including the one who initiates) and those who aid and abet.<sup>141</sup>

**ALTERNATIVE RECOMMENDATION:** Though an amendment for the purpose of clarifying the joint and several liability is not required, however for sake of clarity it may be considered.

- i. If required, the existing explanation in respect of disgorgement in securities laws be amended for the sake of clarifying any doubts in respect of joint and several liability, as follows, -

“Explanation.—For the removal of doubts, it is hereby declared that the power to issue directions under this section shall include and always be deemed to have been included the power to direct **jointly and severally, all or any of the persons**, who ~~made profit or averted loss by indulging~~ in any transaction or activity in contravention of the provisions of this Act or regulations made thereunder, to disgorge an amount equivalent to the wrongful gain made or loss averted by such contravention.”

**SPECIAL CASE: DISGORGEMENT ACTION TAKEN BY EMPLOYERS AGAINST THEIR EMPLOYEES:** It is seen that various companies and other entities take action in the

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<sup>140</sup> *SEBI v Kanaiyalal Baldevbhai Patel*, 2017 (15) SCC 1 : 2017 SCC Online SC 1148.

<sup>141</sup> *Ibid.*



nature of disgorgement against their employees. But there is no clarity as to where the monies disgorged by such companies and entities from their employees go. Some have complied with the spirit of the securities laws and deposited the monies with the SEBI IPEF while some have taken advantage of the situation and kept the monies with themselves. Further, there is no clarity in this respect as not all companies and entities report in detail the nature of action taken against delinquent employees, since no standardised reporting format has been provided.

Objectively seen, there is already a situation where insider trading is difficult to prove and even in cases where violations are found they are not adequately reported to the Board. The entire insider trading regime is open to misuse where unscrupulous employers can use 'employees' as front men to undertake trading and then use their powers to 'penalise' or 'sanction' such employees under the Code of Conduct to fill their own coffers by taking advantage of lack of clarity in law. Even the reporting of such violations by the employer to the Board was inadequate or incomplete and only recently a detailed reporting format has been specified by the Board vide Circular dated July 19, 2019. It is interesting to note that this situation has continued since 2002 when the Code of Conduct was first mandated in the 1992 Regulations relating to insider trading.

Hence a detailed examination of the power of disgorgement, if any, of the powers vested in employers under securities laws has been undertaken in this Report. The SEBI (Prohibition of Insider Trading) Regulations, 1992 *inter alia* provided as follows,-

**“Penalty for contravention of code of conduct**

**.1** Any employee/officer/director/partner who trades in securities or communicates any information for trading in securities in contravention of the code of conduct may be penalised and appropriate action may be taken by the company/organisation/firm.

**.2** Employees/officers/directors/partners of the company who violate the code of conduct shall also be subject to disciplinary action by the company, which may include wage freeze, suspension, ineligible for future participation in employee stock option plans, etc.

**.3** The action by the company/organisation/firm shall not preclude SEBI from taking any action in case of violation of SEBI (Prohibition of Insider Trading) Regulations, 1992.”

The open ended language pertaining to the ‘penalties’ that the employer may impose has given rise to this issue. In the first instance, it must be noted that ‘penalties’ imposed by an employer are not ‘penalties’ imposed by the Board under securities laws. Sanctions and penalties by employers are essentially disciplinary in nature and form the terms of employment of every employee-employer contract, and are not ‘delegated’ by the Board. Further, the provision makes clear that the action taken by the employer is not supposed to prejudice any action by the Board. In cases where illegal trading take place and disgorgement is done by the employer who then keeps the monies with himself instead of depositing them in the IPEF, not only does such employer prejudice the disgorgement action which would otherwise have been taken by the Board and the monies deposited in the IPEF, but it is also not in line with the ‘equitable’ nature of disgorgement. Insider trading violations which result in unlawful gains do not create any ‘equities’ between the employer and employee which need to be adjusted between them, it is generally considered to be a victim-less crime. It is not in the nature of an excess remuneration or incentive that is later recovered or clawed back from the employee.

The SEBI (Prohibition of Insider Trading) Regulation, 2015 *inter alia* provides that ‘*Without prejudice to the power of the Board under the Act, the code of conduct shall stipulate the sanctions and disciplinary actions, including wage freeze, suspension, recovery, clawback, etc.*’ Though the new regulations remove the confusion in respect of employer disciplinary action being ‘penalties under securities laws’ as well as lay down that in case of contra trades the monies should be deposited in the IPEF, there is still no clarity in respect of disgorgement taken by the employer for other violations including insider trading. Hence, the aforesaid reasoning applies with equal force to other violations and the employer cannot recover or clawback or disgorge the unlawful profits from non-contra trade violations and keep them with himself, thereby ‘unjustly enriching’ himself under the guise of enforcement of the Code of Conduct. Clawback and

recovery are provisions designed to take 'back' the amounts that the employer may have given to the employee in the first place. Unlawful profits accruing from trading are not monies that the employee has *made from or on behalf of or given by* the employer which the employer may recover or clawback under these provisions.

**RECOMMENDATION:** The Board may consider issuing a circular to all employers who are required to frame a code of conduct under the 1992 or 2015 regulations relating to insider trading, to, in case of sanctions have been imposed by an employer in the nature of disgorgement under the 1992 or 2015 regulations relating to insider trading prior to the issue of the Circular, the monies so disgorged shall be deposited in the SEBI IPEF within 30 working days; and

**RECOMMENDATION:** The Board may consider amending the 2015 insider trading regulations to clarify that the employer cannot impose a sanction against an employee, if such sanction would amount to disgorgement of profit resulting from insider trading.

## **B. PENALTY IN RESPECT OF INSIDER TRADING.**

Penalty for insider trading is levied under Section 15G of the SEBI Act which reads as follows, -

### **“Section 15G. Penalty for insider trading.-**

If any insider who,—

- (i) either on his own behalf or on behalf of any other person, deals in securities of a body corporate listed on any stock exchange on the basis of any unpublished price-sensitive information; or
- (ii) communicates any unpublished price-sensitive information to any person, with or without his request for such information except as required in the ordinary course of business or under any law; or
- (iii) counsels, or procures for any other person to deal in any securities of any body corporate on the basis of unpublished price-sensitive information,

shall be liable to a penalty which shall not be less than ten lakh rupees but which may extend to twenty-five crore rupees or three times **the amount of profits made out of insider trading**, whichever is higher.”

Section 15G covers different kinds of default and only clause (i) is actual *insider trading*.<sup>142</sup>

Clause (iii) is *linked* to insider trading, it is sufficient for an insider to only ‘counsel’ another to deal in securities, though actual trading may not happen.

Clause (ii) is *linked* to insider trading, it is the act of ‘tipping’ and does not require actual trading by the ‘tippee’ for the tipper to be punishable.

However, under 15G whenever, trading does happens as a result of clause (ii) and (iii), the persons liable under (ii) and (iii) are liable to the extent of three times the amount of profits made by the act of insider trading [clause (i)], even it is not done by them- and not from the act of communication or procurement for which they are charged with under clauses (ii) and (iii).

Section 15G is to a large extent a condensed version of Sections 20(a) & (b),<sup>143</sup> 20A and 21A of the Securities Exchange Act, 1934<sup>144</sup> which imposes penalty on a person, who passes unpublished price sensitive information, equal to the profits made by insider trading. Thus, the intent of Indian securities law is to impose a form of joint and several penal liability on the ‘tipper-tippee’ relating to the profits made from the act of insider

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<sup>142</sup> Insider trading is the act of trading while in possession of unpublished price sensitive information, See Regulation 4 of SEBI (Prevention of Insider Trading) Regulations, 2015.

<sup>143</sup> *Sec Dirks v. SEC*, 463 U. S. 646 (1983), available at <<https://supreme.justia.com/cases/federal/us/463/646/case.html>> (tipper liability is based on Section 20(b) of the Securities Exchange Act, 1934), inter alia holding that:

“The conclusion that recipients of inside information do not invariably acquire a duty to disclose or abstain does not mean that such tippees always are free to trade on the information. The need for a ban on some tippee trading is clear. Not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they also may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain. See 15 U.S.C. § 78t(b) (i.e. Section 20(b) of the Securities Exchange Act, 1934-supplied) (making it unlawful to do indirectly "by means of any other person" any act made unlawful by the federal securities laws).” (*emphasis supplied*)

<sup>144</sup> Available at <<http://legcounsel.house.gov/Comps/Securities%20Exchange%20Act%20of%201934.pdf>> and codified at U. S. Code, Title 15, Chapter 2B, §78a-78qq, available at <<http://uscode.house.gov/view.xhtml?path=/prelim@title15/chapter2B&edition=prelim>>.

trading *per se*, rather than to penalize the each person only to the extent of the money that he may receive.

Disgorgement is a very important remedy in securities laws. When a defaulter makes an unlawful gain he enriches himself unjustly so the penalty imposed on him should not be allowed to be paid using such ill-gotten gains, else the penalty loses its deterrent effect. Hence, in cases where disgorgement is not made, the penalty should be higher than the ill-gotten gains. This is an important barometer to decide which multiple of profit should be selected while imposing penalty in insider trading matters (as well as under Section 15HA of the SEBI Act). It is important to expand upon the liability of insiders to ensure proper control mechanisms are put in place to avoid the possibility of insider trading.

**RECOMMENDATION:** Securities laws may be amended as follows,-

- i. A new provision should be introduced regarding ‘controlling person liability’ similar to that found in USA. Employers and intermediaries who fail to put in place reasonable systems that can control and limit the violations of securities laws must be held liable for the defaults that they allow to occur due to their recklessness. Further, the provision should also clarify the liability of joint persons, i.e. (i) persons who employ other persons to assist such persons in the violation of securities laws; and (ii) those who provide substantial assistance to such person. The following amendment to securities laws may be considered, -

“Section....

(1) Every person who, directly or indirectly, controls any person liable under any provision of this Act or of any rule or regulation made thereunder, shall also be liable jointly and severally with and to the same extent as such controlled person in any action brought under this Act or any rule or regulation made thereunder, unless the controlling person acted in good

faith and did not directly or indirectly induce or enable the act or omission constituting the violation or cause of action.

*Explanation 1.* - No person shall be liable as a controlling person solely by reason of employing another person, but the liability of such employer may be subject to sub-section (1) where he is under a duty to control but intentionally or by gross negligence fails to exercise control.

*Explanation 2.* – In this section ‘control’ includes direct and indirect positive acts or omissions that amount to control.

(2) It is hereby clarified that it shall be and always has been unlawful for any person, directly or indirectly, to do any act or thing which would be unlawful for such person to do under the provisions of this Act or any rule or regulation made thereunder, through or by means of any other person.

(3) Any person who knowingly or in absence of good faith provides substantial assistance to another person in violation of a provision of this Act, or of any rule or regulation made thereunder, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.

*Explanation.* - For the purpose of this section, nothing is said to be done in “good faith” which is done without due care and attention.

(4) The Board may proceed against all or any of the persons who may be liable jointly for the violation of securities laws and non-initiation of proceedings under securities laws against any particular person shall not by itself amount to discharge or acquittal of such person and such person shall remain liable to be proceeded against in appropriate proceedings, if the Board so deems fit.”

The recommended provision is neutral and applies to all kinds of violations, not just insider trading. Further, it does not declare that trivial abettors are not liable,

but rather focuses on imposing the liability of such persons ‘on’ the person who controlled them. The Board would then be free to concentrate its enforcement action against the main persons- persons who employed others and those who provided substantial assistance i.e. the ‘smart’ enforcement through action on the main accused and enforce securities laws in a time bound manner to protect the interest of investors rather than expend its limited resources and time on pursuing the entire chain of defaulters.

## **6. GENERAL PRINCIPLES RELATING TO QUANTIFICATION OF DISPROPORTIONATE GAIN AND LOSS CAUSED TO INVESTORS AS A RESULT OF THE DEFAULT**

- I. The statutory position in USA and India is the same. The gain and loss quantification is limited only to that amount which is as a result of the default. *Indeed, simply to take the definition of “gain” without limiting it to gain “resulting from the default” would lead to absurd results. It is not all the defaulter(s) stock gains-over an entire lifetime of stock trading, but only the stock gains “resulting from the default.”*<sup>145</sup>
  
- II. Defaults by company personnel throw up some interesting issues for the purpose of quantification. Given the competitive nature of capitalistic markets wherein the corporate insiders may indulge in such activities to ensure that they can continue in their corporations and/or obtain higher compensation in the present or future. In this respect the issue of quantification of profit made by the corporate insider may not be clear, as it may be in the form of salary, bonuses and stock options. In this respect the Committee notes the global practice of disgorging such compensation or a relevant part thereof. [*The right of an employer to dismiss for cause and cancel or claw-back compensation already*

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<sup>145</sup> See *United States v Mooney*, (2005) (8th Cir.) 425 F.3d 1093, available at < <https://casetext.com/case/us-v-mooney-10>>; *United States v. Nacchio* (2009) (10th Cir.) 573 F.3d 1062, available at <<https://casetext.com/case/us-v-nacchio-11>>.

*given or promised is different from the right of the Board to quantify relevant gain and disgorge, though both arise only after the violation has come to light. Clawback undertaken by the employer will not completely nullify disgorgement (as the possibility of overlap is limited to situations where the salary and bonuses paid by the employer amounts to the illegal gain) by the Board and vice versa as neither is a voluntary or self-remedial process rather a contentious one which the defaulter is made to comply unwillingly nor are they a replacement for each other, the jurisprudence surrounding both is different]. Bonus which are dependent on earnings can be recalculated on restated financials after the fraudulent information is out and compared with the bonuses paid out on the original reported financials. However in case of multiple financial years this is calculated on a percentage basis as such fraudulent information can have cumulative effect.<sup>146</sup> In other cases where no such clear linkage exists, an approximation may be adopted.*

In cases where executive compensation includes acquisition of securities under any options or grants, if there is a corrective disclosure before the executive liquidates his position, then the grant generates a loss measured using the Black Scholes method of valuation<sup>147</sup> (to take account for possibility of early exercise) caused by the fraud that should be offset with other gains, if any, from the fraud. In case there is an increase in price due to disclosure before the position is liquidated, the gain would have to be measured by using the difference in

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<sup>146</sup> See, Elaine Buckberg and Frederick G. Dunbar, *Disgorgement: Punitive Demands and Remedial Offers*, *The Business Lawyer* Vol. 63, No. 2 (February 2008), 347, 362-369, available at <<https://www.jstor.org/stable/40688470>> for example based on the SEC methodology for calculating bonuses to be disgorged.

<sup>147</sup> This is the most common method of valuation of employee stock options in India and consistent with Ind AS 102. The other methods known as the Monte Carlo method and Binomial methods are not in much use in india for valuation of securities. See, <<https://numeraconsulting.com/blog/3-methods-for-valuation-of-employee-stock-options/>>. Also see, Ministry of Corporate Affairs: Ind AS 102 including the principles for valuation of share options to employees available at <[http://mca.gov.in/Ministry/pdf/Ind\\_AS102.pdf](http://mca.gov.in/Ministry/pdf/Ind_AS102.pdf)>.



inflation per share between grant and sale.<sup>148</sup> In case of other employee benefits such as retirement schemes, restrictive stock grants, etc. experts use analyses similar to those used for bonus and option compensation.<sup>149</sup>

The issue of loss caused by corporate insiders is far more complex. Where corporate insiders, including promoters misuse corporate facilities for self-profit, their liability for secret profits is well settled in law. This is not limited to just the corporate insider who makes the secret profit but a contribution claim could succeed against another corporate insider who took no steps to prevent a misapplication of the company's property by its director.<sup>150</sup> Where a concealment of interest in another organization, directly or indirectly controlled by the insider or its related parties is made, who benefits from such transactions, the liability extends to all transactions, unless proven to be independent by the corporate insider; and the corporate entity which benefits from the same is also liable to the full extent.<sup>151</sup> When the related party transaction results in a loss, the Companies

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<sup>148</sup> See, Elaine Buckberg and Frederick G. Dunbar, *Disgorgement: Punitive Demands and Remedial Offers*, *The Business Lawyer* Vol. 63, No. 2 (February 2008), 347, 372-, available at <<https://www.jstor.org/stable/40688470>> for example based disgorgement based on employee stock options.

<sup>149</sup> *Ibid.*

<sup>150</sup> *Clegg v Pache (Deceased)*, [2017] EWCA Civ 256 (UK Court of Appeals); available at <<http://www.bailii.org/ew/cases/EWCA/Civ/2017/256.html>>. (Also see *N Narayanan v Adjudicating Officer of the Securities and Exchange Board of India*, AIR 2013 SC 3191, available at <[https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi\\_data/attachdocs/1413521982829.pdf](https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi_data/attachdocs/1413521982829.pdf)>; See *MSI v Raven*, [2013] EWHC 3147 (Comm), available at <<https://www.bailii.org/ew/cases/EWHC/Comm/2013/3147.html>> : "It has long been established that a trustee who knowingly permits a co-trustee to commit a breach of trust is also in breach of trust. A director who has knowledge of his fellow director's misapplication of company property and stands idly by, taking no steps to prevent it, will thus not only breach the duty of reasonable care and skill (which is not fiduciary in character): *Ultraframe v Fielding* [2005] EHC 1638 (Ch), [1300]-[1302]), but will himself be treated as party to the breach of fiduciary duty by his fellow director in respect of that misapplication by having authorised or permitted it: *Walker v Stones* [2001] QB 902, 921D-E; *Gidman v Barron and Moore* [2003] EWHC 153 (Ch) at [131]; *Neville v Krikorian* [2006] EWCA Civ 943, [49]-[51] and *Lexi Holdings v Luqman* (No. 1) [2007] EWHC 2652 (Ch) at [201]-[205].")

<sup>151</sup> *Ibid.*

"Mr Dagnall relied upon conventional, long established, legal principles for this part of his appeal. ... In relation to the burden of proof, he submitted that the present case fell well within the "*Armory v Delamirie*" principle [Armory was awarded the maximum value that a jewel of that form which was stolen could have as the original could not be examined (under the principle that a wrongdoer should not be able to derive gain from the effects of his wrongdoing due to uncertainty of damages)] (*supplied*), as applied by Longmore LJ in *Keefe v The Isle of Man Steam Packet Company Limited*[2010] EWCA Civ 683 at paragraph 19, namely that a defendant who has in breach of duty made it difficult or impossible

Act, 2013 expressly provides under Section 188 (4) & (5) requiring the corporate insider to indemnify the losses to the company.<sup>152</sup> In some cases, the profits made may be insignificant to the losses caused by a related party transaction, which goes sour. If any loss or depreciation results as a result of a related party transaction, no question of any foreseeability or remoteness arises and the corporate insider is automatically liable for the loss caused to the investors.<sup>153</sup>

III. In case of illegal activities, credit for the monies/assets returned to avoid detection or after detection of the illegal activity is not to be considered for levy of penalty<sup>154</sup> or if payments are made in respect of initial investments to entice additional investments and conceal the default.<sup>155</sup> However, the same may be considered while taking into account any disgorgement obligation.

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for a claimant to adduce relevant evidence must run the risk of adverse factual findings. ...it should have been directed on the basis of a starting point that all FPL's (beneficiary company) (*supplied*) profits during the relevant period should be accountable, subject to the exclusion of such transactions or profits as the defendants could show were independently undertaken or earned, (*emphasis supplied*)... Mr Dagnall satisfied me that the case was also put in that much simpler, more general and legally principled way (as he presented it on appeal), at least in the closing written submissions to which the parties and the court had recourse on the final day of the trial, headed "Summary of the case in law against first and third defendants"”

<sup>152</sup> Also see, *Mahesan v. Malaysian Govt. Officers Co-operative Housing Society Ltd* [1978] 1 MLJ 149; [1979] AC 374, [1978] 2 All ER 405 (Privy Council) (The appellant was a director and secretary of the respondent co-operative society. He brought land for the society at overvalue. The appellant knew of the land being overvalued however he failed to inform the society. The society discovered the fact only after the sale was done and discovered the appellant had received a secret commission from the vendor. As a result, the Privy Council held that the respondent could recover either bribe or the amount of the actual loss suffered by it as a consequence of entering into the contract).

<sup>153</sup> *Duckwari plc (No. 2) Re:* (1998) 2 BCLC 315; (1998) 3 WLR 913 (CA). See also, *Duckwari plc (No. 3) Re:* (1999) 1 BCLC 168; (1999) 2 WLR 1059 (CA). (The position of a director is fiduciary in nature and similar where a trustee makes an unauthorized investment).

<sup>154</sup> See *US Sentencing Guidelines* p 97, available at <<https://www.ussc.gov/sites/default/files/pdf/guidelines-manual/2016/GLMFull.pdf>>; and Primer Loss Calculations under §2B1.1(b)(1) of the US Sentencing Guidelines pp 27-32, available at <[https://www.ussc.gov/sites/default/files/pdf/training/primers/2016\\_Primer\\_Loss.pdf](https://www.ussc.gov/sites/default/files/pdf/training/primers/2016_Primer_Loss.pdf)>

<sup>155</sup> The US Sentencing Guidelines take into account ‘intended’ loss as well as ‘actual’ loss, whereas Indian securities laws explicitly refer only to actual loss to investors. However, securities laws do not exclude the application of any other relevant factor for consideration. [See *Siddharth Chaturvedi v SEBI*, (SC) (Civil Appeal No. 14730 of 2015 decided on March 14, 2016); *Adjudicating Officer, SEBI v Bhavesh Pabari*, 2019 (3) SCALE 447, available at <[https://www.supremecourtindia.nic.in/supremecourt/2013/36291/36291\\_2013\\_Judgement\\_28-Feb-2019.pdf](https://www.supremecourtindia.nic.in/supremecourt/2013/36291/36291_2013_Judgement_28-Feb-2019.pdf)> and Finance Act, 2017] This principle for not giving credit to certain repayments is based on the two grounds, namely (i) ‘intended loss’ (ii) the payments are essentially part of the fraudulent scheme. Both grounds hold good in respect of Indian securities laws and hence the recommendation, since intended loss is loss that is foreseen by the defaulter or hence foreseeable and relevant. See *United States v. Dobish*, 102 F.3d 760 (6th Cir. 1996), available at

IV. In case of costs incurred for running an illegal activity, no benefit is required to be given for such costs, including fixed costs.<sup>156</sup> However, direct trading costs (including securities transaction tax) may be deductible depending on the facts and circumstances of each case, as direct transaction-specific costs.<sup>157</sup> In disgorgement cases where illicit profits are used for payment of income taxes unrelated to such profits no such credit is required to be given, however if profits are used for payment of taxes related to such profits then it is discretionary to grant such credit for taxes paid, i.e. in cases where the restitution is possible to identified investors no such tax credit should be allowed and in case the

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<https://www.courtlistener.com/opinion/731240/united-states-v-michael-dobish/> (An investment manager normally occupies a position of trust. Mr. Dobish constructively held such a position, based on his own representations, and he abused that position to defraud his victims. The court also found that money was returned only as a means of perpetuating the fraud, and that the scheme would have been continued indefinitely had the victims not discovered what was going on.); *United States v. Mucciante*, 21 F.3d 1228 (2d Cir. 1994), available at <https://law.justia.com/cases/federal/appellate-courts/F3/21/1228/622994/> (Mucciante's sentence was properly enhanced. Although he returned some of Berger's money, and repaid Yohay and Horowitz, he did so as part of a meretricious effort to maintain their confidences. He is therefore not entitled to credit for sums returned, or for sums spent for Berger's benefit. Finally, it is of course irrelevant that Mucciante took the money to impress people, rather than for a more sinister purpose).

<sup>156</sup> See *Federal Trade Commission v. Bronson Partners, LLC*, 654 F.3d 359 (2d Cir. 2011), available at <https://www.courtlistener.com/opinion/223605/ftc-v-bronson-partners-llc/>:

“We need not dwell long on this argument, as it is well established that defendants in a disgorgement action are “not entitled to deduct costs associated with committing their illegal acts.” *SEC v. Cavanagh*, No. 98-Civ.-1818-DLC, 2004 WL 1594818, at 30 (S.D.N.Y. July 16, 2004), *aff’d*, 445 F.3d 105 (2d Cir.2006). Although we sometimes refer casually to the power of district courts to “require wrongdoers to disgorge fraudulently obtained profits,” *Official Comm. of Unsecured Creditors of WorldCom, Inc. v. SEC*, 467 F.3d 73, 81 (2d Cir.2006) (emphasis added), that is because in many securities fraud cases the wrongdoer receives no direct monetary transfer from his victims. Where that is true, the defendant's ill-gotten gains are equal to the profits of his unlawful trading. But where the profits from fraud and the defendant's ill-gotten gains diverge, the district court may award the larger sum. In *SEC v. DiBella*, for example, we rejected an argument that “disgorgement is limited to profits reaped through [the defendant's] securities law violations,” such that a defendant who was paid to assist another's violation of Section 10(b) could not be required to disgorge his fees. 587 F.3d 553, 572 (2d Cir.2009) (internal quotation marks omitted). And in *Verity*, we explained that although the defendants-appellants were not liable for consumer payments that never reached them, “the district court should determine the amount of the ... total billings that the defendants-appellants received ..., without deducting monies paid by the defendants-appellants to other parties.” 443 F.3d at 68. Likewise, at least three other circuits measure unjust gains in FTC actions by revenues instead of profits. See *FTC v. Direct Mktg. Concepts, Inc.*, 624 F.3d 1, 14-16 (1st Cir.2010); *FTC v. Kuykendall*, 371 F.3d 745, 765-67 (10th Cir. 2004) (holding that unjust gains should be calculated based on a defendant's “gross receipts”); *Febre*, 128 F.3d at 536.”

<sup>157</sup> See *SEC Administrative Decision in the matter of Curtis A Peterson*, pp 6-7, discussing several authorities in respect of discretionary deduction for transaction specific costs and denying others, available at <https://www.sec.gov/alj/aljdec/2017/id1124jsp.pdf>.

disgorgement is due to the Board's Investor Protection and Education Fund, the defaulter may be allowed credit if such taxes can be computed easily and information is provided or else in all such cases the defaulter must approach the Income Tax authorities for relief instead of the Board.<sup>158</sup> In case of penalty calculation, profit made is only a barometer for assessing penalty rather than for the purpose of refund/restitution or recovery of the disproportionate profit, hence taxes and other costs incurred after the default are of no relevance and no credit is required.

- V. Where the investors' property is destroyed or lost e.g. in case of share certificates, the fair market value when the default was detected by the investor or the authority, whichever is earlier can be considered or the cost of replacement can be considered.<sup>159</sup> In this respect the Hon'ble Supreme Court of India in its recent judgment in *63 Moons Technologies Ltd. v U.O.I & Ors.*<sup>160</sup> has *inter alia* noted various methods of valuation of shares as follows,-

“71. In *Miheer H. Mafatlal v. Mafatlal Industries Ltd.*, (1997) 1 SCC 579, in the context of a voluntary amalgamation made under Sections 391 to 394 of the Companies Act, this Court went into share valuation. This Court held:

“40. .... It must at once be stated that valuation of shares is a technical and complex problem which can be appropriately left to the consideration of experts in the field of accountancy. Pennington in his *Principles of Company Law* mentions four factors which had to be kept in mind in the valuation of shares:

“(1) Capital Cover,

(2) Yield,

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<sup>158</sup> See SEC *Administrative Decision in the matter of Curtis A Peterson*, pp 5-8, discussing several authorities in respect of non-deductibility of taxes, available at <<https://www.sec.gov/alj/aljdec/2017/id1124jsp.pdf>>. Also see, Elaine Buckberg and Frederick G. Dunbar, *Disgorgement: Punitive Demands and Remedial Offers*, *The Business Lawyer* Vol. 63, No. 2 (February 2008), 347, at 381, available at <<https://www.jstor.org/stable/40688470>>.

<sup>159</sup> See *US Sentencing Guidelines* p 96, available at <<https://www.uscc.gov/sites/default/files/pdf/guidelines-manual/2016/GLMFull.pdf>>.

<sup>160</sup> Judgment dated 30.04.2019 available at <[https://www.sci.gov.in/supremecourt/2018/4493/4493\\_2018\\_Judgement\\_30-Apr-2019.pdf](https://www.sci.gov.in/supremecourt/2018/4493/4493_2018_Judgement_30-Apr-2019.pdf)>.

- (3) Earning Capacity, and
- (4) Marketability.

For arriving at the fair value of share, three well-known methods are applied:

- (1) The manageable profit-basis method (the Earning Per Share Method)
- (2) The networth method or the break value method, and
- (3) The market value method.”

What is clear from the various methods of valuation of shares, when it comes to such valuation qua the transferor and transferee company, is that the market value method is one method in which shares can be valued so that their equivalent can then be provided for in the amalgamated company. This would be nothing other than what those shares were worth in the market on a particular day or an average taken within a certain period. What is important to note is that the market value of shares is market value of shares reflective of their economic value, being an interest measured by a sum of money, is not something that is completely alien to determining the rights of or interest of a shareholder in the transferor or transferee company, as the case may be.”

- VI. In some cases the estimate of loss may be more or less equal to the illegal gains derived, even though such monies available for disgorgement may have dwindled or lost in value by the time the default is detected or recovery initiated. E.g. in case of unauthorized investment schemes.
- VII. In case of activities requiring registration, recognition or any other authorization by the Board are conducted without requisite approvals, the fees due to the regulator which would otherwise be payable and have not been paid shall amount to loss avoided and counted towards illegal gains.

VIII. Technological firms nowadays seek to issue securities to the public to raise cheap capital. Such firms have trade secrets or other proprietary information in the nature of unpublished price sensitive information, which needs to be protected. Loss of such information can result in substantial loss of stock valuation. In case of misuse of such information, an estimate of illegal gains or loss caused may be based on the estimate of the fair market value of such information<sup>161</sup> failing which the cost of developing that information may be used, if available with the victim company, and where the company suffers a loss of business, including loss of business opportunity.<sup>162</sup> The principles for calculation of loss of profit including loss of business are well understood and may be applied in such instances.<sup>163</sup> Some such methods are,-

- i. When the harm is for a finite period of time and is related to a separately identifiable cash flow, a lost profits approach is preferred due to the finite period of damages. This approach represents the difference between profits the victim would have attained, “but for” the harmful event, and profits actually attained. Profits can be defined variously depending on the venue, facts and circumstances of the underlying engagement. The calculated lost profits are then adjusted for mitigation, if any. A lost profits analysis is commonly employed in breach of contract, intellectual property and general commercial litigation cases. It may be done using,-
  - a. *The sales projection method* which compares forecasted profits before the harmful event to actual profits after the harmful event;
  - b. The *before-and-after method*, which compares profits before the harmful event to profits after the harmful event, is appropriate for many businesses;
  - c. The *accounting for profits method* is based on incremental sales or profits achieved by the defaulter as the result of the harmful event. It

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<sup>161</sup> See International Accounting Standards Board standard 38 (IAS 38) read with International Financial Reporting Standard 3 (Business Combinations) and Indian Accounting Standard (Ind AS) 38 (Intangible Assets).

<sup>162</sup> See *US Sentencing Guidelines* p 97, available at <<https://www.uscc.gov/sites/default/files/pdf/guidelines-manual/2016/GLMFull.pdf>>.

<sup>163</sup> See <<https://www.alvarezandmarsal.com/ar/insights/damages-measured-lost-profits-or-lost-business-value>>

should be reasonably certain that the victim would have attained the same amount of sales or profits as the defaulter, “but for” the harmful event;

- d. The *yardstick method* compares profits to a quantifiable yardstick, before and after the harmful event. This method is typically used in industries where profit margins are closely tied to a measurable yardstick such as the price of raw material;
  - e. The *market share method* is based on the market share the plaintiff would have attained, “but for” the harmful event. This method may be suitable for industries where reliable data regarding the overall market is readily available.
- ii. In circumstances where the loss of earnings is considered or assumed to be permanent and into perpetuity, or where a business is destroyed completely, a lost business value approach is generally appropriate. This approach is commonly applied in business destruction, shareholder oppression, dissenting shareholder and tax matters. A business valuation is performed before the date of harm and after the date of harm, with the resulting difference regarded as the lost business value, this may be done using the following methods,-
- a. The *asset-based approach* involves analyzing the plaintiff’s tangible and intangible assets net of liabilities. This approach does not directly address the operating earnings of the business and, as such, is useful in estimating the value of a non-operating business where cash flows are nominal, such as a holding company or an asset-intensive business;
  - b. The *market approach* uses pricing multiples taken from guideline companies or transactions and applies these multiples to the appropriate performance measure of the company being valued;
  - c. The *income approach* calculates a business’s value by applying a discount or capitalization rate to a measure of its expected future

earnings to arrive at a present value of the future benefit streams. This approach is commonly used in estimating the value of both publicly-traded and closely-held businesses.

In any event, these losses are generally relevant only when a particular company is targeted, causing indirect loss to share-holders. The losses may be calculated using the assistance of the person impacted.

- IX. Technology has changed the way transactions are done and has created newer modes of committing plain vanilla defaults. Front-running is essentially the placing of trades ahead of another trade order based on prior knowledge of such subsequent order to take advantage of the price change on account of such subsequent order vis-à-vis other traders. The US SEC views co-location services as a material aspect of the operation of the facilities of an exchange.<sup>164</sup> Co-location enables access to legalized data feed in a way that counters geographical disadvantages where the trader is allowed to access stock prices a split second before the general market by being ‘closer’ to the exchange.<sup>165</sup> However, when exchange officials, actively or passively, provide preferential access to a particular person where trade data is actually received before others in a discriminatory and unfair manner, trading on such preferential information may result in trading ahead of the market. In such cases, the advantage does not arise from the server being co-located at the exchange, rather the advantage arises from prior dissemination of the information to a particular person who has been given preferential access to the co-location server vis-à-vis others.

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<sup>164</sup> See Exchange Act Release No. 34-61358, 75 Fed. Reg. 3594, 3610 & fn. 76 (Jan. 21, 2010), available at <<https://www.sec.gov/rules/concept/2010/34-61358.pdf>>.

<sup>165</sup> *In Re: Barclays Liquidity Cross and High Frequency Trading Litigation* (Opinion and Order, SDNY, 14-md-02589, August 25, 2015), pp 8-9, available at <[http://securities.stanford.edu/filings-documents/1052/NA00\\_01/2015826\\_o01x\\_14MD02589.pdf](http://securities.stanford.edu/filings-documents/1052/NA00_01/2015826_o01x_14MD02589.pdf)>.



X. Where securities are purchased and sold during the default period it is easy to calculate the realized profit. Quantification of profit includes notional loss.<sup>166</sup> However complexity arises in the cases of notional profit<sup>167</sup> or where the acquisition price is not available or in cases where the illegal profit may be mixed with legal profit. Further, trading need not result in net cash positive transaction. Gain in the form of undue advantage (loss avoided) will also arise in cases where the default was done to lower the possible losses than would have otherwise resulted from market conditions, e.g. if the historical cost price was much higher than the prevailing price at the beginning of the default period. In such cases a variation of the averaging period may be used to arrive at a suitable fair notional price (acquisition or sale) to arrive at the difference between cost and purchase value.

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<sup>166</sup> *Dushyant N. Dalal & Anr v SEBI*, SAT Appeal No. 182 of 2009 decided on 12.11.2010, p 9, available at <<https://www.sebi.gov.in/satorders/dalal.pdf>>:

“The next argument of the learned senior counsel is that the Board was in error in taking into account the unrealized gains for the shares which are still being held by the appellants and the said amount should be omitted for calculating the gains. It is true that the appellants did not sell all the shares that were cornered by them through the key operators and that some of them are still lying in their demat accounts. The whole time member in the impugned order has worked out the notional gain with reference to the closing price of the shares on the first day of listing and deducted the issue price therefrom. As at present advised, we can think of no better way of calculating the notional gain made by the appellants. Even if there is a better method of calculating the notional gains, we do not think that the method adopted by the whole time member is in any way arbitrary or unfair calling for our interference. Surely the appellants cornered the shares through illegal means and they cannot be heard to say that notional profits should not be worked out merely because they continue to hold some of them. They cannot be allowed to unjustly enrich themselves. We, therefore, reject this argument of the appellants as well.”

<sup>167</sup> See *SEC v. Shapiro*, 494 F.2d 1301 (2d Cir. 1974), available at <<https://casetext.com/case/securities-and-exchange-commission-v-shapiro>>, the defendant continued to hold stock he had fraudulently obtained after the inside information on which he had acquired the stock became public. The district court ordered the defendant to disgorge his profits computed as of the day the inside information was publicly disclosed. The defendant argued that such a disgorgement constituted a penalty because he would be forced to give up more than the stock was actually worth when it was sold, as its value had dropped after the inside information became public. The Court of Appeals disagreed with defendant's logic, noting that:

“[Defendant's] additional losses resulted not from any penalty imposed by the court but from his unwise investment decision to keep the stock after February 18 [the date the inside information became public].

...

[A] contrary holding would create a serious anomaly that might encourage insider trading. To require disgorgement only of actual profits in cases where the price of the stock subsequently fell would create a heads-I-win-tails-you-lose opportunity for the violator: he could keep subsequent profits but not suffer subsequent losses.”

XI. **TAX EVASION AND GAIN QUANTIFICATION:** Cases where the primary purpose of a scheme is tax evasion, rather than defrauding investors in securities markets is a particular case. In such cases the securities regulator may have to deal with concerns that are unrelated to securities markets. Such transactions if continued unabated, risks the misuse of securities markets for defrauding other authorities. In 2014 the US SEC succeeded in disgorging the profits of a fraudulent scheme [setting up foreign trust accounts to hide beneficial ownership and trade in securities] *inter alia* on the basis that federal taxes were avoided even when the US Internal Revenue Services had not sought to recover the unpaid taxes and in spite of there being no statutory basis or precedent of using unpaid taxes as a measure of disgorgement.<sup>168</sup>

In *SEC v Wyly*,<sup>169</sup> the court *inter alia* held as follows, -

“The SEC arrives at its proposed measure of disgorgement by 1) calculating the total profits earned on the sale of the Issuer securities by the IOM trusts, and 2) approximating the amount of taxes that... would have been paid on those profits had the Wylys accurately disclosed beneficial ownership of the securities. For the following reasons, I conclude that this is an appropriate measure.... On June 13, 2013, I held that the SEC was not foreclosed, as a matter of law, from seeking disgorgement in an amount equivalent to the federal income taxes the Wylys would have been required to pay if they properly disclosed beneficial ownership over the Issuer securities. "There is no explicit prohibition, either in the Tax Code or in the Exchange Act, on using tax benefits as a measure of unjust enrichment in other contexts" and no "express limitation on the SEC's authority to calculate and disgorge any "reasonable approximation of profits causally connected to the violation." (*emphasis supplied*) ....

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<sup>168</sup> See <<https://www.jdsupra.com/legalnews/sdny-judge-permits-novel-theory-and-86626/>>.

<sup>169</sup> *S.E.C. v. Wyly*, 56 F.Supp.3d 394 (2014) 1:10-cv-05760-SAS, ECF 476 at 67 n.218 (S.D.N.Y. Sept. 25, 2014) available at <<https://www.leagle.com/decision/infcco20140925e94>>.

Congress has granted exclusive authority to the Secretary of the Treasury to assess and "collect the taxes imposed by the internal revenue laws," who has, in turn, delegated that authority to the IRS. Section 7401 of the Tax Code states that "[n]o civil action for the collection or recovery of taxes, or of any fine, penalty or forfeiture, shall be commenced unless the Secretary authorizes or sanctions the proceedings and the Attorney General [of the United States] or his delegates directs that the action be commenced."

As I previously held, "this is *not* a civil action for the collection or recovery of taxes. . . . Rather, this is a civil action for securities law violations, the *remedy* for which is measured by the amount of taxes avoided" as a result of the defendants' securities violations." [A] tax is an enforced contribution to provide for the support of the government. "Disgorgement is a discretionary and equitable remedy aimed at preventing unjust enrichment. Measuring unjust enrichment by approximating avoided taxes does not transform an order of disgorgement into an assessment of tax liability.... Thus, unlawful gains may be measured in any number of different ways. For example, courts commonly order defendants to disgorge not only the proceeds of a fraud or the profits of an unlawful trade, but also salary and bonuses earned during the period of a fraud, and amounts equivalent to losses avoided as a result of the securities violations. (*emphasis supplied*) Disgorgement "is a remedy that gives courts flexibility" to determine the appropriate remedy "to fit the wrongful conduct."...

The SEC is not seeking disgorgement equivalent to the unpaid taxes for *all* profits earned by the IOM trusts. Rather, the SEC's disgorgement amount pertains specifically to the taxes avoided on profits relating to the exercise of options and sale of stock in four companies in which the Wyllys were influential insiders. The jury found that the Wyllys were beneficial owners of all of the Issuer securities—from the time the options were transferred to the trusts to the time the trusts exercised the options or

otherwise acquired stock to the time they were sold. The jury also found that the Wyllys' pervasive failure to disclose beneficial ownership constituted securities fraud. There is no evidence in the record that the purpose of this fraud was to manipulate or distort the market. (*emphasis supplied*) There is ample evidence, however, that the driving purpose of the securities fraud was to conceal the Wyllys' relationship to the IOM trusts and preserve the preferential tax treatment on secret offshore profits for as long as possible. ...

This measure of disgorgement reflects the unique circumstances of this case. The Wyllys engaged in securities fraud to conceal their relationship to and control of the IOM trusts in order to maintain the secrecy of the offshore system and preserve their tax benefits. The unlawful gains causally related to the securities violations found by the jury, is an amount equivalent to the taxes avoided on the profits the Wyllys realized on the sale of Issuer securities. (*emphasis supplied*)”

On appeal, the aforesaid ruling of the District Court was upheld by the US Court of Appeals<sup>170</sup>, *inter alia* holding as follows, -

“In its September opinion explaining its disgorgement order, the District Court emphasized that “this is not a civil action for the collection or recovery of taxes. Rather, this is a civil action for securities law violations, the remedy for which is measured by the amount of taxes avoided as a result of the defendants' securities violations.” The Court made clear that “[m]easuring unjust enrichment by approximating avoided taxes does not transform an order of disgorgement into an assessment of tax liability.”

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<sup>170</sup> *SEC v Donald R Miller, Executor and Ors*, No. 14-4261-cv (2d Cir. Dec. 18, 2015), available at <<https://caselaw.findlaw.com/us-2nd-circuit/1720954.html>>.

Since the tax avoidance sum merely served the purpose of quantifying the disgorgement remedy, rather than forming the basis for liability itself, it is irrelevant that—or whether—tax liability is non-transferable. What matters is that the gains received were ill-gotten in violation of securities laws, a determination that has already been made by the jury at trial. (*emphasis supplied*) That conclusion is not disturbed by the particular measure used by the District Court to order equitable relief. Here, the District Court's adoption of two alternative measures of disgorgement in its September and December opinions makes the point even more salient. The Relief Defendants challenge only the tax measure set forth in the September opinion. In fact, the particular method of measurement used is immaterial.”

Similar issue arose in India, in the case of *Rakhi Trading*, The Hon'ble Supreme Court of India<sup>171</sup> did not determine the issue of tax evasion as the show cause notice was silent on that aspect but the following observations are noteworthy:

“Per Kurian, J:

SAT held that these trades were for the purpose of tax planning which is not violative of any regulation. We are not inclined to get in to the issue of tax planning as it was not mentioned in the show cause notices. (*emphasis supplied*)

We find it difficult to appreciate the stand taken by the SAT which is endorsed by the learned senior counsel appearing for the respondents. Mr. Chidambaram, learned senior counsel appearing for Rakhi Trading argues that the SAT decision is valid and proper. Reliance is also placed on the case of Ketan Parekh (*supra*) in which SAT held that synchronised trades are not per se illegal. As far as reversal of trades is concerned, the senior counsel has

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<sup>171</sup> *SEBI v Rakhi Trading Pvt. Ltd.*, C.A. 3174-3177 & 3180/2011. Order dated 08.02.2018, available on <[https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi\\_data/attachdocs/feb-2018/1518429932105.pdf](https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi_data/attachdocs/feb-2018/1518429932105.pdf)>.

sought to distinguish Ketan Parekh (supra) as it pertained to dealings in the cash segment whereas the present case deals with the F&O segment. The learned senior counsel has strenuously argued that no rules of the game have been violated.

...

In the instant case, one party booked gains and the other party booked a loss. Nobody intentionally trades for loss. An intentional trading for loss per se, is not a genuine dealing in securities. The platform of the stock exchange has been used for a non-genuine trade. Trading is always with the aim to make profits. But if one party consistently makes loss and that too in pre-planned and rapid reverse trades, it is not genuine; it is an unfair trade practice. (*emphasis supplied*)

...

According to SAT, only if there is market impact on account of sham transactions, could there be violation of the PFUTP Regulations. We find it extremely difficult to agree with the proposition. (*emphasis supplied*)

...

The traders thus having engaged in a fraudulent and unfair trade practice while dealing in securities, are hence liable to be proceeded against for violation of Regulations 3(a), 4(1) and 4(2)(a) of PFUTP Regulations. Appeal Nos.1969/2011, 3175/2011 and 3180/2011 are hence allowed. The orders of the Securities Appellate Tribunal are set aside and that of the SEBI are restored to the extent indicated above.

Per R. Bhanumathi, J (concurring):

When there were no other transactions in the market affecting the price of the underlying shares or F&O Segment and the price in both the segments had remained static, then there was no reasonable ground to get apprehensive and panic. Therefore, squaring off the position appears to adjust the financial results with a view to avoid the tax incidence through an unfair trade practice or for some ulterior purpose. (*emphasis supplied*)

...

An act to fall within Regulation 4(2)(a), it is not necessary that the transactions entered into by the party was with intention to manipulate the market and that the market was in fact manipulated. Market manipulation is a deliberate attempt to interfere with the free and fair operation of the market and create artificial, false or misleading appearances with respect to the price, market, product, security and currency.

...

In the quasi-judicial proceeding before SEBI, the standard of proof is preponderance of probability. (*emphasis supplied*)

...

The market, as already observed, is so widespread that it may not be humanly possible for the Board to track the persons who were actually induced to buy or sell securities as a result of manipulation and the Board cannot be imposed with a burden which is impossible to be discharged. (*emphasis supplied*)

...

Intense supervision might distort the path of securities market development; but SEBI cannot be a silent spectator to unfair trade practices/manipulative market for some ulterior purpose like tax evasion etc. (*emphasis supplied*) To find the right balance between market forces and Regulatory body's intervention, SEBI has to deal sternly with those who indulge in manipulative trading and deceptive devices to misuse the market and at the same time ensuring the development of the market.

...

Before I conclude, it is necessary to refer to the findings of SAT on 'tax planning'. SAT held that even assuming that non-genuine synchronized trades have been entered into for the purposes of tax planning, such trade could be held objectionable only if they have resulted in influencing the market in one way or other. For its finding that every person is entitled to arrange his affairs as to avoid taxation. SAT relied upon *Viram Investment*

*Pvt. Ltd. and Ors. v. SEBI* (MANU/SB/0046/2005) decided on 11.02.2005. Contention of the respondents is that transactions which have been entered into with a view to achieve tax planning are not illegal and respondents placed reliance upon *Viram Investment Pvt. Ltd.* case. The learned counsel for SEBI contended that the market cannot be manipulated by fictitious transactions either for tax planning or for some ulterior purposes like money laundering etc. (*emphasis supplied*)

No grounds have been raised in the show cause notice alleging that the impugned fictitious transactions have been entered into with a view to avoid payment of tax and was an act of tax planning. Adjudicating officer also has not gone into this aspect. Hence, I am not inclined to go into this aspect, whether the impugned transactions were intended to reduce the brunt of taxation and an act of tax planning. The correctness of findings of SAT in the case of *Viram Investment Pvt. Ltd.* is left open. (*emphasis supplied*)

...

The impugned transactions are manipulative/deceptive device to create a desired loss and/or profit. Such synchronized trading is violative of transparent norms of trading in securities. If the findings of SAT are to be sustained, it would have serious repercussions undermining the integrity of the market and the impugned order of SAT is liable to be set aside. (*emphasis supplied*)”

The judgement of the Hon’ble Supreme Court is noteworthy for the following reasons:

- i. The issue of tax planning/evasion arose only because the transactions were defended *inter alia* on those grounds. It became relevant to do so since there was no other logical explanation for the noticees to knowingly engage in structured loss making transactions;



- ii. Though the issue of tax planning through non-genuine trades was kept open the Court has laid down the principle that for a transaction to be a fraudulent and unfair trade practice actual impact on the market is not necessary. A fraudulent trade is a fraud, whether or not a particular identifiable individual or the market is affected in a demonstrable way. To that extent the law in India and USA are similar;
- iii. In respect of tax planning, though the correctness of SAT's judgment in *Viram Investment Pvt. Ltd.* was kept open, the validity of underlying transactions through which desired losses are knowingly bought and sold stands eroded and in effect *Viram Investment Pvt Ltd. (SAT)*<sup>172</sup> may no longer be good law;
- iv. The concurring judgment is clear that SEBI cannot be a silent spectator to unfair trade practices/manipulative market for some ulterior purpose like tax evasion, etc. This leaves the door open for further developments in Indian jurisprudence on the lines of USA SEC where disgorgement was successfully obtained on the basis of taxes avoided by a fraudulent scheme.

In cases where a few persons create a scheme for their own benefit it may be possible to disgorge benefits linked to unpaid taxes avoided due to such a scheme. In cases where a brokers run investment schemes primarily designed for tax evasion and attract several clients offering their 'services' for such purposes, it may cast an impossible burden on the enforcement mechanism of the Board to prosecute each and every investor. In such cases, the joint and several liability may be appropriate and the intermediaries may be made liable for the entire scheme profits, including those of their clients (based on taxes avoided) and not

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<sup>172</sup> *Viram Investment Pvt. Ltd. v SEBI*, SAT Appeal no. 160/2004, decided on 11.02.2005, available at <[https://www.sebi.gov.in/enforcement/orders/feb-2005/in-the-matter-of-viram-investment-pvt-ltd\\_11029.html](https://www.sebi.gov.in/enforcement/orders/feb-2005/in-the-matter-of-viram-investment-pvt-ltd_11029.html)>.

just their own, since such large scale structured transactions cannot be done without their active participation.<sup>173</sup>

## 7. FINANCIAL ECONOMICS

A discussion on advanced mathematical methods is necessary as violations in securities markets now involve 100's or 1000's of crores. Notably, the magnitude of securities laws violations has increased to such a level that they have been found fit to be included under the Fugitive Economic Offenders Act, 2018 which must necessarily involve violations of at least Rs. 100 crores.

Advanced mathematical methods are essentially statistical methods that are useful in instances where large sums are involved and simpler arithmetic and rule of thumb methods may have large divergences from the approximate values obtainable through statistical methods, which help to isolate the effect of market-related factors and default-related factors in calculating the disproportionate gains made.

However, statistical methods are not easily employed in low value matters. Experts may be needed, as is the practice in USA-SEC, to justify the particular method chosen, since within statistical methods there may be divergences based on the methods and the data set chosen. This is where SEBI's role as a regulator regulating a financially and technically complex market comes into play.

Statistical methods are used in all fields and not just the financial world, including weather forecasting, big data analysis, census data analysis and formed an important aspect of the Mandal Commission's classification which utilised extrapolation of caste

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<sup>173</sup> See *US v Royer and Anr*, 549 F.3d 886 (2d Cir. 2008) (US CA), available at <<https://caselaw.findlaw.com/us-2nd-circuit/1261811.html>>: The gains made by the defendant and by the subscribers of his investment website. The Court found that the investments scheme was a coordinated effort between the defendant who made the website and the subscribers.

census data from 1891 and 1931 censuses.<sup>174</sup> Statistical methods are often employed by asset management companies, fund managers to forecast returns on investment in order to take investment decisions. Statistical methods are used for all kinds of forecasts including investment returns, setting margin requirements. Take for example the statistical Black-Scholes Model<sup>175</sup> of option pricing and pricing of employee stock options<sup>176</sup> which has also been considered by some to be at the root of the financial crisis of 2008.<sup>177</sup> Though statistical methods seem complex, these methods are in fact commonly used in the securities markets by the large number of financial experts and economists the world over.<sup>178</sup> Several software exist for carrying out such calculations.<sup>179</sup>

The Board also hires a large number of financial experts (economists, statisticians, MBAs, CAs, etc.) like other global regulators and is thus well placed to adopt the best practices of global securities regulators. These methods of calculating return are not confined to securities regulators but are also used by market making investment decisions based on a mathematically anticipated return that the investment may generate.

### **CHASING THE ALPHA ( $\alpha$ ) OR THE ABNORMAL RETURNS OR EXCESS RETURN<sup>180</sup> OF INSIDERS/FRONT-RUNNERS:** Legal scholars<sup>181</sup> and other securities regulators have

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<sup>174</sup> See Nandini Sundar, Professor of Sociology at the Delhi School of Economics, ‘Will counting caste help to reduce inequality?’ <[http://censusindia.gov.in/Ad\\_Campaign/press/Will%20counting%20caste%20help%20to%20reduce%20inequality.pdf](http://censusindia.gov.in/Ad_Campaign/press/Will%20counting%20caste%20help%20to%20reduce%20inequality.pdf)>.

<sup>175</sup> <<https://economictimes.indiatimes.com/definition/black-scholes-model>>

<sup>176</sup> See Ministry of Corporate Affairs: Ind AS 102 including the principles for valuation of share options to employees available at <[http://mca.gov.in/Ministry/pdf/Ind\\_AS102.pdf](http://mca.gov.in/Ministry/pdf/Ind_AS102.pdf)>.

<sup>177</sup> See Ian Stewart, Emeritus professor of Mathematics at the University of Warwick, ‘The mathematical equation that caused the banks to crash’, available at <<https://www.theguardian.com/science/2012/feb/12/black-scholes-equation-credit-crunch>>; Also see, NSE-NCFM Options Trading (Advanced) Module, available at <<https://www.nseindia.com/learn/self-study-ncfm-modules-advanced-modules>> (explaining the various methods adopted for valuation of exchange-traded options in securities).

<sup>178</sup> <<https://www.motilaloswal.com/article.aspx/1625/What-do-we-mean-by-Alpha-from-a-fund-managers-perspective>>

<sup>179</sup> See <<https://wrds-www.wharton.upenn.edu/pages/analytics/>>; <<https://www.r-project.org/>>; <[https://www.sas.com/en\\_in/home.html](https://www.sas.com/en_in/home.html)>; <<https://www.stata.com/>> and <<https://www.eventstudytools.com/>>.

<sup>180</sup> See <<https://www.investopedia.com/terms/a/abnormalreturn.asp>>; <<https://investinganswers.com/financial-dictionary/stock-valuation/abnormal-rate-return-3105>>.

supported the use of financial economics in securities litigation, including disgorgement. Calculating the excess returns using an event study uses statistics to assess the impact of an event on the value of a firm's stock and the trading done. It enables determination of the abnormal returns generated in cases of informational advantage and it is the standard methodology used by the USA SEC in insider trading analysis, however it is not required in all cases.<sup>182</sup> It is 'abnormal' because it varies from the normal: 'expected rate of return'. It can be positive or negative. ('Ideally' a fund manager who can generate a positive alpha or positive abnormal returns beats the market and is highly sought after).

Statistical methods are usually employed in cases where the defaulter does not close his position and determination of profit is difficult or the illegal profit is mixed with legal gains. Event studies (econometric methodology) in conjunction with the abnormal rate of returns methods are useful to assess the returns of defaulters in comparison with the

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<sup>181</sup> Janet c Alexander, *The Value of Bad News in Securities Class Actions*, 41 UCLA L. Rev. 1421, 1433 (1994); Macey, Miller, Mitchell, Mitchell & Netter, *Lessons from Financial Economics: Materiality, Reliance, and Extending the Reach of Basic v Levinson*, 77 Va. L. Rev, 1017, 1021-28 (1991), available at <<https://www.jstor.org/stable/1073445>>; Fischel, *Use of Modern Finance Theory in Securities fraud Cases Involving Actively Traded Securities*, 38 Bus. Law, 1, 1-20 (1982), available at <<https://www.jstor.org/stable/40686405>>.

<sup>182</sup> *SEC v Wyly*, 71 F. Supp. 3d 399 (S.D.N.Y. 2014), available at <<https://casetext.com/case/sec-amp-exch-commn-v-wyly#N197547>>:

"Moreover, I do not agree that the SEC should have employed **the standard method used for measuring the ill-gotten gains in insider trading cases, i.e., performing an event study for each trade.** (*emphasis supplied*) First, this is not an insider trading case. Though the SEC alleges that the Wyllys used an informational advantage to trade opportunistically, they did this in the context of the offshore system where the Wyllys could choose between securities from four different Issuers where they had an informational advantage. In this context, the Wyllys could have information that while one Issuer stock was poised to rise moderately, another Issuer stock would rise more during the same period.

In this case, using an event study would not detect any use of informational advantage in a sale of the first stock, even though the decision to sell was motivated by an informational advantage.

Second, this approach is simply not feasible given the length of the fraud period here—thirteen years—and the hundreds of trades at issue. Because of the unique facts of this case, I credit Dr. Becker's testimony that the established methodologies for measuring the value of secrecy and informational advantage would not reasonably approximate the Wyllys' ill-gotten gains. Moreover, given the absence of an established methodology, I agree that Dr. Becker's method, that of comparing the Wyllys' profits to those of a buy-and-hold investor could reasonably approximate the profits causally connected to the Wyllys' violations.

Based on the unique facts here and the testimony of the experts, I conclude that Dr. Becker's choice of method was reasonable."

normal returns of market to assess the amount of profit to be disgorged. The Committee notes that existing methods adopted relating to profit calculation indicate an attempt to develop a simpler methodology vis-a-vis statistical methods. However in doing so there are several trade-offs which limit the application and reliability of current methods; the Committee notes that those methods are not in public domain and nor are they designed specifically for illiquid securities nor are they designed for eventualities where the defaulter has an open position at the end of the fraud or in line with the approach adopted by various Court nor do they help differentiate the legitimate gains from disproportionate gains as is the requirement under the securities laws. As such they are not really an alternative to statistical methods adopted by various securities regulators, courts and tribunals globally. Invariably, the Committee notes that the Board is a specialist organisation regulating a very complex financial market and its technical edge needs to be sharpened if the Board is to make a determined effort to maintain a cutting edge enforcement arm.

**‘α’ AS AN IMPORTANT RED FLAG:** Since it is difficult for any person to actually get a substantial ‘α’ without appropriate justification, calculating ‘α’ of trades by insiders and connected persons may be a very good indication of insider trading or front-running having taken place. The failure to substantiate the trade on the basis of actual access to reliable data (other than unpublished price sensitive information) which led to the investment decision, in comparison to the general market or even professional fund managers, is useful indicator of fraud especially if such persons were in a position to access unpublished price sensitive information. Statistics enables such analysis of fraudulent trades.

The exact formulae and methods are not discussed in this report as these methods are well understood in the financial world and are adopted and developed by different

securities regulators globally<sup>183</sup> as well as by market participants in making investment decisions. However, the Committee will briefly discuss the concepts underlying the Event Study methodology which is the most basic method used by securities regulators globally for cases relating to information advantage.

**EVENT STUDY MECHANISM<sup>184</sup>:** An event study is a statistical technique developed by economists that estimates the stock price impact of occurrences such as mergers, earning announcements, and so forth. The basic notion is to disentangle the effects of two types of information on stock prices- information that is specific to the firm under examination (e.g. dividend announcement) and information that is likely to affect stock prices market wide.

In securities investigation, the execution of an event study by an economist is quite simple. It involves the identification of an event that causes investors to change their expectations about the value of a firm. The Investigator compares a stock price movement contemporaneous with the event to the expected stock price if the event study had not taken place. There are three basic steps in conducting an event study: (i) define the event window; (ii) calculate the abnormal stock price performance around the event and (iii) test for statistical significance of the abnormal stock price performance.

(i) **THE EVENT WINDOW:** The first step in the event study is selecting an event window. The event window is the period when information about the event

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<sup>183</sup> For a detailed study of SEC methodology and how it may be adopted in the context of other markets see the study in respect of the Italian market by the *Italian Companies and Exchange Commission* using the event study analysis method and the probabilistic method used as an alternative method: Marcello Minenna, 'Insider Trading, Abnormal Return and Preferential Information: Supervising through a Probabilistic Model', 27 (2003) Journal of Banking & Finance, Issue 1, 59-86, available at <<https://nscpolteksby.ac.id/ebook/files/Ebook/Journal/2015/Banking%20and%20Finance/Vol.%2027/Volume%2027%20Issue%201/Page%2059-86/Insider%20trading-abnormal%20return%20and.pdf>>, <<https://www.sciencedirect.com/science/article/abs/pii/S0378426601002096>>. Also see <<http://marcello.minenna.it/wp-content/uploads/2015/08/riskeu2003.pdf>>.

<sup>184</sup> For details see Mark L. Mitchell and Jeffrey M. Netter, 'The Role of Financial Economics in Securities Fraud Cases: Applications at the Securities and Exchange Commission', *The Business Lawyer*, Vol. 49, No. 2 (February 1994), pp. 545-590, available at <[https://www.jstor.org/stable/40687469?seq=1#metadata\\_info\\_tab\\_contents](https://www.jstor.org/stable/40687469?seq=1#metadata_info_tab_contents)>; A. Craig Mackinlay, 'Event Studies in Economics and Finance', (1997) 35 *Journal of Economic Literature*, 13-39, available at <<https://pdfs.semanticscholar.org/aac6/83a678a12a3dcd73389aac7289868847ea73.pdf>>.

becomes available to the stock market and thus may affect the relevant company's stock price. For most publicly-traded corporations, the event is disseminated publicly by newswire sources or the stock exchange. Because the efficient markets hypothesis, supported by considerable empirical evidence, suggests that stock prices react quickly to the release of new information, in many cases the event window will be relatively short, sometimes as short as one trading day. In determining the length of an event window, an important trade off exists. The longer the event window, the more likely the window includes the period during which all new information about the event is released. The trade-off, however, is that long event windows may include noise and information from other events, making it difficult to isolate the impact of the relevant event. The extent of difficulty in defining the event window length varies across events. In those instances, where the release of new information is a complete surprise to the market, it is relatively easy to establish the beginning of the event period. Consider an airline crash, for example. Because airline crashes are unanticipated, the first day of the event period is either the day of the crash or the subsequent trading day if the crash occurred after the market close. Even when it is easy to identify the beginning of an event window, it can be difficult to establish an end of the event window. In the airline example, the end of the period would depend on when all of the relevant information regarding the crash was made available to market participants. For some crashes, it may take several days or perhaps even weeks before the market receives all the relevant information; in these cases, a longer event window is more necessary than for a crash in which all the information is available within a few hours following the crash. In most cases, however, the bulk of the information is released at the announcement of the event. Because the market processes information rapidly, it is conventional to expand the window for a short period after the announcement. It is standard to extend the event period to close of the trading on the day after the release of the pertinent information.

For those events that are subject to leakage, defining the beginning of the event window can be problematic. Consider the case of a merger in which the target

company is rumoured to be “in play” prior to the announcement. For such a case, the event window should begin prior to the actual merger announcement, perhaps as long as a week or two. Ideally, the first day of the event window corresponding to a merger would be the date on which investors began trading on news about the upcoming merger, regardless of whether the news was based on rumours, inside information, regulatory filing, or a public announcement that merger talks were in process. In practice, this date is difficult to define and some degree of judgment is required generally based on price and volume movements prior to the merger announcement. With respect to securities fraud cases, there is substantial variation in the complexity of determining the length of an event window. In some fraud cases, choosing the appropriate event window is straightforward. An example is an insider trading case where the information used by the investor is revealed subsequently in a single public announcement. On the other hand, in many securities fraud cases the relevant information is revealed slowly over time, while during the same period investors receive other, sometimes unrelated, information about the firm(s) in question. In the latter case, it is relatively difficult to choose an appropriate window. The main advice is to carefully identify the exact dates during which the information in question reached the market, and then restrict the window to a short period if possible, generally two or three days around each release of new information.

(ii) CALCULATING ABNORMAL STOCK PRICE PERFORMANCE: The question is whether the absolute value of the return is large enough so that the investigator can indicate with confidence that the return made by the defaulter is relatively unusual. The goal is to isolate the effect of the event on the contemporaneous stock price movement. Stated differently, the investigator attempts to determine whether the stock price behaviour around the event is abnormal. A large abnormal price movement occurring at the same time the market receives news about an event suggests that the event caused the abnormal price movement. Furthermore, the link between the event and the price movement is even stronger if there is no other new information reaching the market at the same time that could affect the stock



price. The degree to which the stock price movement is small or big depends not only on the absolute value of the movement but also on the movement relative to the historical patterns and to contemporaneous overall market movements.

It is important to account for market-wide movement in stock, especially during periods when the market is volatile. The basic method for accounting for market-wide factors subtracts the market-wide return from the individual stock's return. This estimate is called the net-of-market return. Several choices of market indices are available as proxies for a market wide return- wider the market index the better it is considered as representative of the market. There are several statistical models depending on stock behaviour that can be used to determine returns, such as (a) the Constant Mean Return Model which assumes that the mean return of a given security is constant through time and is perhaps the simplest model, (b) the Market Model which assumes a stable linear relation between the market return and the security return (c) restricted approaches in special cases such as the Market-Adjusted Abnormal Return which is a constrained model used in cases of underpricing of initial public offerings. There are also Economic Models which can be cast as restrictions on the statistical models to provide even more constrained models. The use of other models is dictated by data availability. An example of a normal performance return model implemented in situations with limited data is the market-adjusted return model. A general recommendation is to only use such restricted models if necessary, and if necessary, consider the possibility of biases arising from the imposition of the restrictions. The main potential gain from using a model based on the arbitrage pricing theory is to eliminate the biases introduced by using the CAPM. However, because the statistically motivated models also eliminate these biases, for event studies such models dominate.

Further, although net-of-market returns, in many cases, provide an appropriate estimate of stock price effects of new information, there are instances where computation of market adjusted returns requires a more refined analysis to account for the fact that not all stocks are affected identically by economy-wide

factors. This requires the investigator to use beta ( $\beta$ )-adjusted stock market performance. The difference between the predicted return and the actual return on a given date during the event window is known as 'abnormal return'. *Why abnormal? It is assumed that the unexplained part is due to some "abnormal" event that is not captured by the model.* Event windows can extend beyond one trading day. For these cases, the abnormal returns are cumulated to create 'cumulative abnormal returns'. Cumulative abnormal returns only measure the impact of company specific information. In a real sense, the value of the information to the trader is best represented by how the information would have affected the stock price in the absence of any other factors – the cumulative abnormal return.

(iii) TESTING FOR STATISTICAL SIGNIFICANCE: The question is whether the absolute value of the return is large enough so that the investigator can indicate with confidence that the return made by the defaulter is relatively unusual. The importance of historical average and standard deviation of the daily returns is highlighted in making the assertion that a given daily return is different from the typical daily return given the context of a normal-bell shaped- distribution. Statistical tests of significance are useful both in establishing materiality and in calculating disgorgement. A finding that a stock return associated with the release of information is large enough that it is unlikely that the return occurred by chance is strong evidence that the information was important. Therefore, if that information was used allegedly in securities fraud, the finding that the associated stock return is large enough to be statistically important implies that the information is material. Furthermore, a finding of statistical significance for stock returns data used in calculations of disgorgement is an indication that the estimates are accurate.

E.g. suppose a company's stock price increases 7 % on the day that management releases a favourable earnings announcement. Suppose, also, that the prior day a company insider purchased stock based on his knowledge of the forthcoming

announcement. The insider is subsequently charged with insider trading. A finding that the 7% return on the earnings announcement day is statistically significant is strong empirical evidence that the news was important. Stated differently, it is unlikely that the 7% increase in stock price occurred by chance. Furthermore, in calculating the profits for disgorgement based on stock price increase on the announcement day, if the return is statistically significant, then a more credible argument can be made that the 7% return represents the value of the insider's information. (This example does not imply that only positive increases in stock price are statistically significant, the historical and other contemporaneous factors need to be taken into account to determine what change in price is statistically significant.)

Thus, statistical methods not only enable the quantification of profits but also enable the adoption of a statistical method to test the materiality of any information.

The Board needs to develop new legal theories and adopt these statistical methods if the Board needs to maintain a cutting edge enforcement mechanism. Wherever difficulty is faced by the Board in using these methods the assistance of experts like fund managers, auditors, lawyers, mathematicians, economists can be taken.

Though there are several shortcomings in using each and every kind of statistical methods in all circumstances,<sup>185</sup> new methods<sup>186</sup> get developed over time, like other securities regulators, to enable a best judgment assessment, which is better than no assessment at all. These methods need to be assessed in detail, adopted and developed by the Board, since different methods can be used depending on the facts of each case and the shortcoming of each method, such as liquidity of stock, recently quoted stock, etc.

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<sup>185</sup> <<https://economictimes.indiatimes.com/mf/analysis/how-to-calculate-risk-adjusted-returns-on-funds/articleshow/12208746.cms>>

<sup>186</sup> See Jeng, Metrick and Zeckhauser, 'Estimating the Returns to Insider Trading: A Performance-Evaluation Perspective', Harvard University and MIT Press: The Review of Economics and Statistics, May 2003, 85(2): 453-471, available at <<https://sites.hks.harvard.edu/fs/rzeckhau/InsiderTrading.pdf>>.

## 8. GENERAL GUIDELINES

In view of the above, the Committee is of the view that non-mandatory public guidelines (based on globally acknowledged methods of quantification, accounting standards and principles applied by judicial bodies, etc.) applicable for all new cases for quantification of profit made and loss caused as a result of violation of securities laws may be issued for the technical authorities that undertake investigation, inspection or audit under securities laws. These authorities may quantify the approximate profit made or loss caused based on the aforesaid in their Reports which shall be relevant for the Board for initiating appropriate enforcement action as well as serve as a guide for the quasi-judicial authority while considering the appropriate penalty to be levied or the amount to be disgorged. In general, before doing a full calculation, a back of the envelope/rough estimation can be made by the investigation authorities to determine which mode is to be adopted. If the earlier methods are more appropriate to a particular matter, the same can be adopted after recording reasons. The selection of the final profit/loss amount is left to the exercise of judicial discretion of the quasi-judicial authority. The Board can seek information from any person, including the defaulter. If after reasonable time, the noticee does not provide the relevant information, the calculation made by SEBI at the highest value will be final. (See the principle established in *Armory v Delamirie*<sup>187</sup>). The guidelines have been framed after taking into account any foreseeable needs in the near future that the Board may have.

On comparison with global regulators, it becomes clear that the enforcement processes of the Board needs a major overhaul. The Committee takes notice of the practices of the Japanese Regulator<sup>188</sup> - the Securities and Exchange Surveillance Commission (SESC) - which issues a Recommendation for Administrative Monetary Penalty to the Prime Minister of Japan and the Commissioner of the Financial Services Agency (FSA), which

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<sup>187</sup> [1722] EWHC KB J94, (1722) 1 Strange 505, 93 ER 664 (KB), available at <<https://www.bailii.org/ew/cases/EWHC/1722/J94.htm>>

<sup>188</sup> See <<https://www.fsa.go.jp/sesc/english/aboutsesc/all.pdf>>.

is confirmed by the FSA. The Recommendations<sup>189</sup> made by the Securities and Exchange Surveillance Commission and the Orders<sup>190</sup> issued by the Financial Services Agency (which is part of the Prime Minister's Office) contain detailed calculations on how the penalty was levied, taking into account every transaction and ¥ as far as possible. This practice needs to be adopted by the Board in its investigation/inspection/audit reports to further transparency and clarify the basis of its penalty, disgorgement and refund orders.

**RECOMMENDATION:**

- i. The Board may consider issuing the following public Guidelines at the earliest (w.e.f. Oct 01, 2021) to enable advance notice to market participants, including the members of the bar and Bench:

**GUIDELINES FOR QUANTIFICATION OF THE AMOUNT OF DISPROPORTIONATE GAIN  
INCLUDING UNFAIR ADVANTAGE  
&  
AMOUNT OF LOSS CAUSED TO AN INVESTOR OR GROUP OF INVESTORS**

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**QUANTIFICATION OF AMOUNT OF DISPROPORTIONATE GAIN MADE AND LOSS CAUSED**

<sup>189</sup> See, Recommendation dated 02.02.2016 for administrative penalty for market manipulation by Evo Investment Advisors, available at <<https://www.fsa.go.jp/sesc/english/news/reco/20160202-1.htm>>; Recommendation dated 04.03.2016 for administrative penalty for market manipulation by Blue Sky Capital Management Pty Ltd, available at <<https://www.fsa.go.jp/sesc/english/news/reco/20160304-1.htm>>; Recommendation dated 06.12.2016 for administrative penalty for market manipulation by Morgan Stanley MUFJ Securities Co. Ltd., available at <<https://www.fsa.go.jp/sesc/english/news/reco/20161206-1.htm>>; Recommendation dated 17.03.2017 for administrative penalty for market manipulation by Caspian Trading Ltd., available at <<https://www.fsa.go.jp/sesc/english/news/reco/20170317-1.htm>>; Recommendation dated 26.06.2018 for administrative penalty for market manipulation in shares of Cocokara Fine Inc., available at <<https://www.fsa.go.jp/sesc/english/news/reco/20180626.htm>>.

<sup>190</sup> See, Order dated 24.04.2018 imposing Penalty Surcharge for market manipulation of stocks of Yurtec Co. Ltd and Maeda Road Construction Co. Ltd., available at <<https://www.fsa.go.jp/news/30/shouken/20180424-8.html>>; Order dated 24.04.2018 imposing penalty surcharge in case of insider trading relating to Misawa Home stock by officers of its subsidiary, available at <<https://www.fsa.go.jp/news/30/shouken/20180424-7.html>>; Order dated 24.04.2018 imposing penalty surcharge for insider trading by officer of Escrow Agent Japan Ltd, available at <<https://www.fsa.go.jp/news/30/shouken/20180424-6.html>>. (Translated from Japanese using Google Translate).

**CHAPTER I**

**INTRODUCTION**

The securities laws provide guidance to the adjudicating officer and the Board for the purpose of arriving at an appropriate penalty to be levied and enable the consideration of relevant factors, including the following factors, -

- (i) the amount of disproportionate gain or unfair advantage, wherever quantifiable, as a result of the default;
- (ii) the amount of loss caused to an investor or group of investors as a result of the default; and
- (iii) the repetitive nature of default.

Quantification of disproportionate gain is also relevant for the purpose of disgorgement from defaulters.

Whereas, Chapter VII of the Second Schedule to the Securities and Exchange Board of India (Settlement Proceedings) Regulations, 2018 read with Regulation 32 of those Regulations, provides guidance for consideration of the 'repetitive nature of the default'.

Whereas, the Board considers it necessary to provide the following guidance for quantification of the amount of disproportionate gain or unfair advantage and the amount of loss caused to an investor or group of investors as a result of the default,-

**CHAPTER II**

## GLOSSARY OF IMPORTANT TERMS

<u>SR. No.</u>	<u>TERM/ ABBREVIATION</u>	<u>EXPLANATION</u>
1.	<b>Accounting for profits method</b>	Based on incremental sales or profits achieved by the defaulter as the result of the harmful event.
2.	<b>Arbitrage</b>	The act of simultaneous buying and selling of securities, currency, or commodities in different markets or in derivative forms in order to take advantage of differing prices for the same asset.
3.	<b>Asset-based approach</b>	Involves analyzing the plaintiff's tangible and intangible assets net of liabilities.
4.	<b>Average loss to the victims method</b>	The number of shares held by holders who are aggrieved multiplied by the average loss [based on the difference between the average price during the fraud (or relevant period selected) and average price during the averaging period selected after the fraud]
5.	<b>Before-and-after method</b>	Compares profits before the default event to profits made after the default event.
6.	<b>Beta (<math>\beta</math>)</b>	Describes the movement in a stock's or a portfolio's returns in relation to that of the market returns. For all practical purposes, the market returns are measured by the returns on the indices, since an index is a good reflector of the market.
7.	<b>Board</b>	Securities and Exchange Board of India
8.	<b>Bucketing</b>	Promising a certain price in respect of buying or selling of a security to a client and waiting till a discrepancy arises in the price of such security
9.	<b>Capping and Pegging</b>	Capping is the practice of selling large amounts of a commodity or security close to the expiration date of its options in order to prevent a rise in the underlying's price. The writer or seller of an options contract has an interest in keeping the price of the underlying below the strike price in order for the options

		to expire worthless.  Pegging is the opposite practice of buying large amounts of a commodity or security close to the expiration date of its options in order to prevent a decline in its price
10.	<b>Churning and Burning</b>	Practice of an intermediary conducting excessive trading in a client's account mainly to generate commissions.
11.	<b>Correlation</b>	Is a statistic that measures the degree to which two securities (or stock exchange indices) move in relation to each other. Correlations are used in advanced portfolio management and calculated by various stock exchanges and intermediaries, computed as the correlation coefficient, which has a value that must fall between -1.0 and +1.0.
12.	<b>CTT (Commodity Transaction Tax)</b>	Commodities transaction tax (CTT) is a tax similar to Securities Transaction Tax (STT), levied in India, on transactions done on the domestic commodity derivatives exchanges.
13.	<b>Delta (<math>\Delta</math>)</b>	A ratio comparing the change in the price of an asset, usually a marketable security, to the corresponding change in the price of its derivative. Delta values can be positive or negative depending on the type of option.
14.	<b>ESOPS (Employee Stock Ownership Plan)</b>	An employee-owner program that provides a company's workforce with an ownership interest in the company.
15.	<b>IEPF (Investor Education and Protection Fund)</b>	A fund formed under the Companies Act, 2013 for promotion of investors' awareness and protection of the interests of investors.
	<b>Income approach</b>	Involves calculation of a business's value by applying a discount or capitalization rate to a measure of its expected future earnings to arrive at a present value of the future benefit streams.
16.	<b>Inter-positioning</b>	Illegal practice of employing a second intermediary in order to generate an additional commission and can take various forms. In one form, the broker purchases stock for the brokerage firm's proprietary account from the customer sell order; and then fills the customer buy order by selling from the brokerage firm's proprietary account



		<p>at a higher price — thus locking in a riskless profit for the brokerage firm's proprietary account.</p> <p>A second form of inter-positioning involves the broker selling stock into the customer buy order, and then filling the customer sell order by buying for the brokerage firm's proprietary account at a lower price — again, locking in a riskless profit for the brokerage firm's proprietary account. In both forms of inter-positioning, the broker participates on both sides of the trade, thereby capturing the spread between the purchase and sale prices, disadvantaging at least one of the parties to the transaction.</p>
17.	<b>IPEF (Investor Protection and Education Fund)</b>	A fund constituted by SEBI (Investor Protection and Education Fund) Regulations, 2009
18.	<b>IPR (Intellectual Property Rights)</b>	Legal rights that protect creations and/or inventions resulting from intellectual activity in the industrial, scientific, literary or artistic fields.
19.	<b>Market Approach</b>	Uses pricing multiples taken from guideline companies or transactions and applies these multiples to the appropriate performance measure of the company being valued
20.	<b>Market Capitalization</b>	The total market value of a company's outstanding shares.
21.	<b>Market Capitalization Method</b>	<p>The actual loss attributable to the change in value of the security is the amount determined by—</p> <p>(I) calculating the difference between the immediate price of the security during a suitable period prior to the disclosure/stoppage of the fraud (usually the closing price the day before the disclosure/stoppage) and the immediate price of the security after the fraud was disclosed to the market/stopped (usually the closing price after the disclosure/stoppage) (or next day price), and</p> <p>(II) multiplying the difference by the number of shares out-standing after excluding those</p>

		<p>held by the defaulters themselves (if they amount to substantial holdings) throughout the period of the default, if available.</p> <p>In determining whether the amount so determined is a reasonable estimate of the actual loss attributable to the change in value of the security, the Board may consider, among other factors, viz.- the extent to which the amount so determined includes 'significant changes' in value not resulting from the default (<i>e.g.</i>, changes caused by external market forces, such as changed economic circumstances, changed investor expectations, and new industry-specific or firm-specific facts, conditions, or events that appear to impact the price movement by more than 20%) by fixing if possible, a suitable percentage on the amount determined above: Provided that in case of companies which become entirely worthless after the default, i.e. If the company whose securities is sold has no activities, assets, facilities, or any other source of value, so that the "company" has no underlying equity; in such cases instead of taking the difference take the entire value of stock prior to the fraud coming to light.</p> <p>Explanation. – The fact that the stock cannot be traded at all after the fraudulent scheme came to light or the stock has been traded only by “insiders” in the fraudulent scheme shall be relevant to decide if the stock was worthless.</p>
22.	<b>Market Share Method</b>	The method is based on the market share the person would have attained, “but for” the default event.
23.	<b>Marking the Close</b>	Involves deliberately buying or selling securities or derivatives contracts at the close of the market in an effort to alter the closing price of the security or derivatives contract
24.	<b>Modified Market Capitalization Method</b>	Comparing the change in stock value of other, stock of similarly placed but unaffiliated companies after irregularities in those companies were disclosed to the market. The average depreciation may be taken as loss

		caused.
25.	<b>Modified Recessionary Method</b>	<p>The actual loss attributable to the change in value of the security is the amount determined by—</p> <p>(I) calculating the difference between the average price of the security during the period that the fraud occurred and the average price of the security during the relevant period (<i>choice of appropriate time period may be made to inter alia consider the time when the market could be said to have absorbed the information and reflect the same in the price of the security. There may be delay with which the market may start correcting itself or extended periods for the market to correct itself. This depends on individual stock and market conditions</i>) after the fraud was disclosed to the market or after the misconduct ended, as may be applicable, and</p> <p>(II) multiplying the difference in average price by the number of securities out-standing after excluding those held by the defaulters themselves (if they amount to substantial holdings) throughout the period of the default, if available.</p> <p><i>Explanation 1.</i> – Average price may be calculated by using the closing price of each trading day of the time period selected or by using any other relevant price, including weighted average price or other method. It is not necessary that the relevant period may refer to the entire period from which the default occurred and the fraud came to a stop, the ‘relevant’ period may refer to a sub-period during which substantial trades took place or which was immediately connected to the fraud.</p> <p><i>Explanation 2.</i> – <b>‘relevant’ period for averaging; In case of illiquid securities</b> [including related exchange traded derivatives and debt instruments]: the price on the day (or the next trading day, whichever is appropriate) the true and fair</p>

		<p>information/fraud has been become publicly disseminated/stopped may be selected or the average price for a period not exceeding seven trading days, to the extent possible, after the true and fair information/fraud has been become publicly disseminated/stopped may be selected, as may be deemed fit.</p> <p>Explanation 3. – <b>‘relevant’ period for averaging: In case of liquid securities</b> [including related exchange traded derivatives and debt instruments]: the period may be a multiple of fifteen trading days to be selected after the true and fair information/fraud has been become publicly disseminated/stopped provided that it shall not exceed ninety days, to the extent possible, especially in relation to securities which are part of any index [including related exchange traded derivatives and debt instruments]. Shorter periods may be selected in case extraneous factors demonstrably affect the price.</p> <p>In determining whether the amount so determined is a reasonable estimate of the actual loss attributable to the change in value of the security, the Board may consider, among other factors, the extent to which the amount so determined includes ‘significant changes’ in value not resulting from the default (<i>e.g.</i>, changes caused by external market forces, such as changed economic circumstances, changed investor expectations, and new industry- specific or firm-specific facts, conditions, or events that appear to impact the price movement by more than 20%) by fixing if possible, a suitable percentage of the amount determined above.</p>
26.	<b>Net Profit Approach</b>	The approach considers the total increase in value realized through trading in securities. Gain is the total profit actually made from a defendant’s illegal securities transactions.
27.	<b>Portfolio-pumping</b>	Bidding up the value of a fund's holdings right before the end of the period, when the fund's

		performance is measured. This is done by placing a large number of orders on existing holdings, which drives up the value of the securities within the fund portfolio.
28.	<b>Quasi-judicial Authority</b>	A Member of the Board or an Adjudicating Officer exercising quasi-judicial functions.
29.	<b>Relevant Authority</b>	Includes an investigating officer, designated authority, inspecting authority and a quasi-judicial authority.
30.	<b>Sales Projection Method</b>	The method compares forecasted profits before the harmful event to actual profits after the harmful event
31.	<b>Scalping</b>	Recommending a security for investment and selling it at a profit while making the recommendation
32.	<b>Securities Laws</b>	Includes all laws pertaining to securities market which are administered by the Board
33.	<b>Simple Recessionary Method</b>	the actual loss attributable to the change in value of the security is the amount determined by calculating the difference between the price paid by the affected set of investors and the price existing after the fraud was disclosed to the market/stopped
34.	<b>Standard of the Compliant Person</b>	The defaulter's behaviour has to be compared vis-à-vis the behaviour of a person who complies with securities laws. The monetary and non-monetary benefits received by a defaulter has to be compared with the costs incurred and benefits received by the compliant person to determine the illegal gain.
35.	<b>Standard of the Reasonable Investor</b>	In order to determine loss caused to investors or to determine the obligation of defaulters which is dependent on the prior exercise of any right associated with securities, etc., the investors are presumed to have behaved in a reasonable way.
36.	<b>Tailgating</b>	When a broker, financial advisor or another sort of investing agent buys or sells a security for a client, and then proceeds to make the same transaction for himself.
37.	<b>Touting</b>	To strongly encourage investors to buy a particular security. Touting means an intermediary recommending sale to the investors without disclosing that the person

		recommending has received any direct or indirect benefit from another for making such recommendation.
38.	<b>Uttering of Securities</b>	The issue of securities without proper approvals or continued holding of fraudulent or forged securities, exercise of corporate rights and acquisition of further securities on account of such securities.
39.	<b>Yardstick Method</b>	The method compares profits to a quantifiable yardstick, before and after the harmful event.
40.	<b>Zero-Sum Game</b>	<b>A mathematical representation of a situation in which each participant's gain or loss of utility is exactly balanced by the losses or gains of the utility of the other participants.</b> <b>In the context of securities market it means that the investors affected are the same as the investors from whom the gain has been derived from and the loss caused to such investors thereabouts equals the gain derived</b>

Words and expressions used but not defined in these Guidelines but defined in the Securities and Exchange Board of India Act, 1992 the Securities Contracts (Regulation) Act, 1956 the Depositories Act, 1996 the Companies Act, 2013 or any of the rules or regulations made thereunder, shall have the same meanings respectively assigned to them in those Acts, rules or regulations or any statutory modification or re-enactment thereto.

**CHAPTER III**

**GENERAL PRINCIPLES**

1. These Guidelines provide non-mandatory guidance and depending on the facts and circumstances of each case the relevant authority may deviate from or modify these guidelines as may be deemed fit or use any method not detailed in these guidelines or any combination or modification thereof, for reasons to be

recorded.

2. These Guidelines may be applied, to the extent possible, to all fact-finding inquiries such as investigations, inspections, inquiries, enquiries, audits initiated on or after October 01, 2021 and consequential legal proceedings.
3. **Application of Multiple methods:** The relevant fact-finding authority may use the available information and indicate in the relevant Report, all or any of the possible methods for calculating approximate disproportionate gain derived or loss caused to investors as deemed appropriate.

*Explanation.* - Where it is possible to apply more than one methodology for the purpose of quantification of a particular amount, it is not necessary for the relevant authority to apply all possible methods in its report/fact finding/examination instead any appropriate method(s) may be applied for the benefit of the quasi-judicial authority.

4. **Joint liability of offenders:** In cases of joint liability for any alleged default, generally, the relevant authority, may calculate the gain derived or loss caused holistically on a joint, several or 'joint and several liability basis', as may be deemed fit.
5. **Persons who may be charged jointly:** The following persons may be charged jointly and their gains and losses quantified jointly, namely, -

(a) persons accused of the same violation committed in the course of the same conduct;

Explanation 1. – Any person who is in charge of and responsible for the activities of any other person may be charged jointly with the person he is in charge of.

Explanation 2. – “in the course of the same conduct” means a group of facts so connected together by reason of continuity of action or purpose or cause

and effect, or as principal and subsidiary acts.

(b) persons accused of a non-compliance/violation of securities laws and persons accused of abetment of, or attempt to commit, such violation;

(c) persons accused of a non-compliance/violation of securities laws in the nature of breach of fiduciary obligation and persons accused of misappropriation of money or other property which was the subject of such fiduciary duty;

(d) persons accused of different violations of securities laws committed in the course of the same conduct;

(e) persons accused of a non-compliance/violation of securities laws in the nature of fraudulent and unfair trade practices, insider trading or misappropriation, and persons accused of receiving or retaining, or assisting in the disposal or concealment of, property possession of which is alleged to have been transferred by any such violation committed by the first-named persons, or of abetment of or attempting to commit any such last-named violation;

(f) an acquirer and persons acting in concert with such acquirer;

(g) in case of failure to make, or making of incorrect or false or misleading, disclosures, reports, filings, statements, offer documents, or information, the person which signs or issues such document along with persons who prepare such document (including experts involved) and persons who approve the same; and

(h) any other classes of persons, as may be deemed fit.

Explanation 1. – The classes of persons mentioned in this guideline may or may not be charged jointly depending on the facts and circumstances of each case.

Explanation 2. – Where there are multiple charges, it is not necessary that all persons to be heard jointly be charged together in respect of each and every charge.



6. **Quantification when not required:** Quantification may not be required, *inter alia*, in the following cases, -

- i. Where the relevant authority is satisfied that the penalty imposed would be higher than any possible disproportionate profit derived from the default or is the maximum imposable penalty under securities law; or
- ii. Where multiple defaulters are involved and one or more than one person but not all, have been held jointly or jointly and severally liable for a particular default(s), quantification may not be required for other defaulter(s) in respect of such default(s); or
- iii. In violations which are generally considered to be victim-less defaults, such as insider trading, loss caused to investors may not require quantification.

7. **Zero-sum game scenario:** Where loss to the investors and profit made out of the default are more or less same, then either profit made or loss caused may be calculated using any available methodology.

*Explanation.* – In cases where the default does not entail a ‘zero-sum game scenario’, the refund or disgorgement wherever permitted under law shall be based on the disproportionate gains made, jointly or severally, and not the loss caused to investors.

8. **Determination of gain or loss “as a result of the default”:** Wherever possible, gain derived or loss caused which is causally connected with the default should be segregated from gain derived or loss caused which is not so connected, in accordance with these Guidelines, to arrive at the disproportionate gain and loss caused to investors, as a result of the default.

*Explanation 1.* - Uncertainty is inherent in the act of the defaulter, hence the

defaulter shall bear the risk of uncertainty and be liable for any uncertainty in the estimation of disproportionate gain made (and loss caused to investors) since the defaulter's conduct has created the uncertainty in estimation of non-legitimate gain derived (or loss caused to investors).

*Explanation 2.* – Any gain derived or loss caused is said to be causally connected if such gain or loss is a direct or proximate result of, or such gain or loss was reasonably foreseeable as a result of the violation of securities laws.

*Explanation 3.* - Disproportionate gain could be direct or indirect, in cash or kind, and includes notional gain or unfair advantage of any kind, including any loss avoided.

*Explanation 4.* - “Loss to investors” for the purpose of these Guidelines does not include emotional distress, harm to reputation or other non-economic harm.

*Explanation 5.* -Where disproportionate gain or loss caused to investors, cannot be estimated with reasonable approximation, then quantification to the extent possible or on ‘at least’ basis may be done.

*Explanation 6.* – The following standards may be relied upon to determine the gains derived or losses caused as a result of the default, -

- i. Standard of the Compliant Person;
- ii. Standard of the Reasonable Investor; or
- iii. Any other standard that may suitably analyse the conduct of the defaulter and segregate and identify the gain made or loss caused by the defaulter as a result of the default.

9. **Application of the principle of *Armory v Delamirie*:** The defaulter shall be responsible to supply to the satisfaction of the Board, the necessary information required to calculate disproportionate gain made (or loss caused to investors), which is within his possession or that which he is in a position to obtain. On failure to provide the relevant information, the entire gain derived (or loss caused to investors) may be deemed to be as a result of the default and such calculation shall be final and any windfall accruing to investors on account of such uncertainty which is inherent in the misconduct of the defaulter may be made available to the investors in appropriate proceedings resulting from disgorgement.

10. **Application of average values:** (a) Average may be applied wherever considered appropriate and average includes weighted averages, mean, median or mode as may be considered appropriate.

(b) Wherever appropriate, actual price, average price, weighted average, closing prices or average of closing prices during the relevant period may be used;

11. **Averaging period:** Averaging period may be of a very short duration in case of illiquid securities or long (but not exceeding 90 days) in case of liquid securities. Averaging period may be used to calculate appropriate acquisition or sale price when no price is available or the price available is misleading or does not consider the market factors affecting price.

In *non-insider trading matters*, if in spite of averaging period, the price is affected by significant market factors (i.e. factors that appear to impact the price movement by more than 20%) an approximate deduction as deemed fit may be given.

12. Manipulation of securities may be done by fraudulent trading or dissemination of false information or any other fraudulent device designed to manipulate the

securities markets.

13. **Default period:** Default period means the period during which the default was committed and may also include any period during which the relevant prior events and acts or omissions that enabled the default took place, as well as any consequential events, acts or omissions; or any relevant sub-period thereof including the period under investigation, audit or inspection, etc.
14. **Application of multiple guidelines:** On account of the nature of the act or omission of the defaulter(s) the quantification of profit made or loss caused may include quantification under more than one guideline;
15. **Presumption against influence of extraneous factors:** For the purpose of quantification, the relevant authority may presume that the change in price of securities excludes any depression or inflation in the price of security caused by factors other than the misconduct, unless the defaulter proves the relevance thereof and such factors are capable of being assessed based on the record and as per these guidelines.
16. **Other Presumptions:** The following presumptions may be relied upon, -
  - i. The relevant authority may presume the existence of any fact which it thinks likely to have happened, due regard being had to the common course of natural events, human conduct and public and private business, in their relation to the facts of the particular case, including, -
    - a. That evidence which could be and is not produced would, if produced, be unfavorable to the person who withholds it (or any other related person);
    - b. That when a document creating an obligation is in the hands of the obligor, the obligation has been discharged, save in case where the circumstances of the case are such that he may have stolen it, or procured by duress or false representation; and
    - c. That the common course of business has been followed in

particular cases.

- ii. Where a document would *ex facie* be relevant to any inquiry, investigation, audit, examination or other proceeding and the defaulter knew or reasonably could have known that the violation of securities laws was detected or about to be detected by the Board, the non-production of such document on the ground of non-maintenance due to the mere lapse of a period longer than the period for which such document is required by law to be maintained shall be no defence.
- iii. Where there is a question as to the good faith of a transaction by one who is in a position of active confidence, the burden of proving the good faith of the transaction is on such person.  
*Explanation.* - The burden of proving that unpublished price sensitive transaction has been communicated for a lawful purpose shall be on the person so communicating.
- iv. When a person does an act with some purpose other than that which the character and circumstances of the act suggest, the burden of proving that purpose is upon him.  
*Explanation.* - The burden of proving that unpublished price sensitive information has not been communicated shall be on the person who enters into a communication with a person who trades or enables another to trade in a manner which is suggestive of have been done on the basis of such information.
- v. When any fact is especially within the knowledge of any person, the burden of proving that fact is upon him.
- vi. The burden of proving any fact necessary to be proved in order to admit any document as evidence or to enable any person to give evidence of any other fact is on the person who wishes to rely on such evidence.

vii. Fraudulent funding through transfers shown as 'loans' for the purpose of enabling a default or which arise as a consequence of such default, which a person receiving has no intention to repay or which are repaid from funds relating to such default, may be included as siphoned off funds or disproportionate gain or considered as his own funds, as the case may be.

*Explanation 1.* – Where a person repays a loan subsequent to the time of detection of misconduct, he shall be deemed to have no intention to repay unless he makes appropriate submissions indicating that such repayment, if any, was not on account of such detection.

*Explanation 2.* – Where a person submits that a particular transaction is a legitimate loan transaction or reversal thereof, it shall be necessary to give evidence indicating that the actual net transfers of money took place as well as admissible evidence (duly stamped, registered and disclosed wherever required by law) indicating the purpose for which the transfers were made at the relevant time.

17. Wherever, any information, including price is not available for the purpose of quantification, these guidelines may be applied to the extent possible.

*Explanation.* – In cases where data is not made available even after being sought, the data may be presumed as 'o' or not applicable or arrived at by extrapolation or by using another other means or reasonable assumptions may be made and the methodology modified appropriately.

**18. When UPSI comes into existence:** Where information relating to the contravention of securities laws is in the nature of unpublished price sensitive information, such unpublished price sensitive information shall deem to come into existence when the contravention was committed and concealed, and not when the contravention was detected.

*Explanation.* – Where the unpublished price sensitive information pertains to the existence of any investigation, inspection, audit or inquiry against a company the unpublished price sensitive information shall come into existence when such company or the persons in charge of such company first become aware of such investigation, inspection, audit or inquiry.

19. **Relevance of accounting standards:** The accounting standards required to be followed by the defaulter shall be relevant but not binding for the purpose of quantification and may be applied to the extent possible.
20. **Assumption of sale:** Where a security has not been sold during the default period, for the purpose of quantification, the security shall be deemed to have been sold and sale price shall be calculated as per these guidelines.
21. **Round-off:** The relevant authority may round-off the disproportionate gains or losses caused quantified to the next multiple of 1000.
22. Mere irregularity or error which is not substantial shall not affect, any approximation of disproportionate gains or losses caused.

## **CHAPTER IV**

### **GUIDELINES ON DEDUCTIONS**

1. **Deductions, if any, may be permitted in accordance with these guidelines.** The defaulter shall be responsible to provide to the satisfaction of the Board the necessary information required to determine the deduction claimed, failing which such claim shall be denied.
2. **Deduction of monies:** Where monies raised by issue of securities is

refundable,-

**In proceedings for levy of penalty:** No deduction may be given to the defaulters in case of monies/assets are returned/refunded/disgorged, -

- i. to avoid detection or to perpetuate ongoing contravention,
- ii. after detection of the contravention, or
- iii. payments made in respect of initial investments to entice additional investments or to conceal the contravention.

*Explanation.* – For the purpose of these guidelines, the time of detection of the contravention is the earliest of, -

- A. the time the misconduct was discovered by a Government Agency, including the Board or a securities market infrastructure institution or a self-regulatory organization, leading to an examination into the facts being directed by the relevant authority; *or*
- B. the time the defaulter knew or reasonably could have known that the violation was detected or about to be detected under (1).

**In proceedings for disgorgement/refund:** Deduction may be given in respect of the assets returned by the defaulters and duly reported to the Board before the issuance of any interim direction, cease and desist order or direction of disgorgement/refund, as the case may be.

*Explanation.* – Where a claim is made that monies have been duly refunded to investors, the defaulter shall be liable to prove, -

- A. the existence of sufficient funds from which monies were refunded; and
- B. the proof of refund through banking means or by way of direct



credit in the bank account through NEFT/RTGS/IMPS or any other mode allowed by RBI.

*Explanation.* – Where despite a refund opportunity being provided, monies have not been claimed by investors or where investors to whom monies are due cannot be found within reasonable time, such monies shall be deposited in the IEPF or IPEF as the case may be.

3. **Deduction for costs of illegal activity:** As a general principle, no deduction shall be given for costs incurred in respect of conducting the violation of securities laws.
4. **Deduction for costs directly related to the transaction and specifically for transaction:** Deduction in relation to costs incurred while doing the unlawful transaction in securities which are *direct and transaction-specific*, such as stamp duties, STT and CTT shall be allowed;  
*Explanation.* – General costs including costs incurred for employees' remuneration are not a transaction-specific cost.
5. **Deduction for costs incurred but which remain unpaid:** No deduction for costs (including taxes) which are due but which remain unpaid shall be allowed;
6. **Deduction for leveraged funds:** Wherever the trading is done on the basis of leveraged funds, no separate deduction shall be allowed for the cost of leveraging, beyond the price of acquisition;
7. **Deduction for taxes paid in refund matters:** Deduction for taxes paid (other than STT or CTT) shall not be allowed in case of refund obligations under securities laws;

**8. Deduction for taxes paid in disgorgement matters:** Deduction for taxes paid (other than STT or CTT) shall not be allowed in case of disgorgement obligations under securities laws where disbursement to identifiable investors may be possible;

*Explanation.* - Deduction under this guideline may be allowed where disgorgement is directed for victimless defaults such as insider trading.

**9. Deduction for taxes against different revenue streams:** No deduction shall be allowed for taxes paid from gross receipts based on the portion of receipts used for payment of taxes in respect of activities other than the activity under consideration;

*Explanation.* – Where the defaulter has paid taxes for more than one activity, including activities not connected to the default, the burden of proving which portion of taxes paid is relevant to the default shall be on the defaulter, failing which no deduction may be allowed.

**10. Deduction for taxes in penalty proceedings:** Deduction of taxes paid (other than STT or CTT) is not relevant for the purpose of quantifying gain derived while levying penalty.

**11. Fraudulently providing financial products and services without proper license or approval:** When the defaulter(s) poses as a registered/authorized financial service provider and *represents* that the financial products or services are authorized by the Board or any other Government Agency, including a securities market infrastructure institution or a self-regulatory organization even though they are not or fraudulently obtains such authorization for financial goods or services, the defaulter shall receive no deduction for the value of the financial products or services are misbranded or falsely represented regardless of the actual fitness or performance of those products.

12. **Deductions for taxes (other than STT or CTT) paid for unlawful activity:** Save as otherwise provided in this Chapter, deduction for taxes (other than STT or CTT) paid from gross receipts based on the portion of receipts used for payment of taxes in respect of unlawful activity may be allowed in cases, where the defaulter is able to compute and prove to the satisfaction of the Board, the co-relation of the relevant portion of taxes for which deduction is claimed with the activity under consideration.
13. Nothing in these guidelines shall affect any right of the defaulter, if any, to seek appropriate remedy before the relevant tax authority.

## CHAPTER V

### GENERAL GUIDELINES RELATING TO QUANTIFICATION OF DISPROPORTIONATE GAIN

1. **Disproportionate Gain quantification:** The quantification of disproportionate gain or unfair advantage under these guidelines is only an approximation, to the extent possible since uncertainty is inherent in the act of the defaulter, who shall bear the burden of the uncertainty.
2. **Misconduct affecting derivatives, arbitrages, etc.:** It is possible for the misconduct to involve manipulation of price and/or volume of a security in one segment or stock exchange and that the disproportionate gains accrue in a different segment or stock exchange in the same security or in a security related to such security and that it would amount to manipulation of the security where such disproportionate gains accrue.

*Explanation.* – It is not necessary for the disproportionate gain to only occur in the security of the listed company whose unpublished price sensitive information is disclosed. It may also be in relation to a security related to such security.

3. **Interest to avoid unjust enrichment from what would amount to an interest free loan from investors:** For the purpose of refund or disgorgement, unless otherwise provided by law, disproportionate gain, wherever quantified, shall include simple interest at the rate of 1% per month from the time when gain was accrued till the date of repayment to investors.

4. ***Zero Sum scenario in an unregistered investment scheme or fraudulent default.* - Disproportionate gains made or loss to investors as a result of unregistered investment schemes (PMS/AIF/CIS, etc.) or those investment schemes that fail by reason of a fraudulent or unfair trade practice, etc.:** Loss caused to investors equal the amounts originally invested by the investors and the earnings re-invested in such schemes, even though those earnings accrued as a result of such schemes. However, the most recent promised or reported earnings shall be excluded unless re-invested.

*Explanation.* – Investment schemes in these guidelines also include services of portfolio manager, an alternative investment fund and other pooled investment arrangements required to be registered with the Board.

5. **Fees earned in respect of any misconduct:** In case the defaulter's misconduct included the provision of services of an intermediary or securities market infrastructure institution or a professional, the ill-gotten gains shall include the *gross* fees, commissions, etc. earned in respect of the misconduct.

*Explanation 1.* - Where the gross fees are for unlawful as well as lawful activities, if the substantial nature of the services provided was in relation to unlawful activities, then the entire fees shall be considered as undue advantage. Else a fraction of such gross fees may be taken based on the clarification provided by the defaulter.

*Explanation 2.* - In these guidelines an '*intermediary or securities market*

*infrastructure institutions'* shall include any person required by securities laws to be registered or recognized by the Board.

6. **Regulatory charges avoided:** In case of any un-authorized or un-recognized or un-registered activity, including unauthorized issue of securities, the monies that would have been payable as fess, charges, etc., for conducting such activity including those payable to the Board, Government, stock exchange, depository or clearing corporation, but not paid, shall be included in the disproportionate gain made as losses avoided.
7. **Loss avoided while in possession of negative information:** Where front running or insider trading is done to avoid loss due while in possession of negative unpublished information, the loss avoided is the value of shares sold multiplied by the difference in price during the relevant period after the publication of such information.
8. **Gains made by the person in charge of a juridical person:** In case of a director, partner, employee or any other person in charge of the actions of a body corporate or firm, subject to appropriate quantification made by such defaulter, the disproportionate gains may include the entire remuneration, commission (including secret commissions), share of profits, bonuses, stock options, sweat equity, stock sales, any other corporate or pecuniary benefit is received by such person (or part thereof) during the relevant period, as may deemed fit after considering relevant factors:  
Provided that, where the default is such that it enables the defaulter to gain control of the body corporate or the compensation was substantially tied to the default or the body corporate is required to restate its accounts due to substantial non-compliance of securities laws due to the default, the entire such benefit may be considered to be due as disproportionate gains.
9. **Failure to comply with fiduciary duties:** In case of any auditor or other

professional who has failed to comply with the fiduciary duties under securities laws, the disproportionate gain may also include the gross remuneration received for conducting his duties or a portion thereof.

**Undisclosed profit:** Where a person under a fiduciary duty to investors makes an unauthorized secret commission, profit, etc. while managing the funds of investors such gains shall amount to disproportionate gains.

## CHAPTER VI

### GENERAL GUIDELINES RELATING TO QUANTIFICATION OF LOSS

1. **Loss quantification:** Loss quantification under these guidelines is only an approximation on a class basis and serves as a guide for considering the appropriate penalties to be levied within the range provided by law and does not vest in any particular person(s), the right to seek compensation from the Board;

*Explanation.* – In these guidelines, unless otherwise proved, loss calculation is for guidance only and not restitutory in nature, as direct co-relation with disproportionate gains made and loss caused to investors may not exist.

2. Loss to investors may accrue even when no trades are made by the defaulters, such as order log manipulation (which amounts to a fraudulent statement made to investors through the stock exchange mechanism by entering orders which create the impression of a false demand), false tips and messaging, etc.
3. **Loss in non-zero-sum cases:** In cases involving fraudulent and unfair trade practices cases, where the default does not entail a Zero-sum game scenario, in addition to the methods detailed in these guidelines, the loss to investors or group of investors may be calculated *inter alia* using the following methods:
  - i. Simple Recessionary method;

- ii. Modified Recessionary method;
- iii. Market Capitalization method;
- iv. Modified Market Capitalization method;
- v. Average loss to the victims method;
- vi. Any other method determined to be suitable in the given circumstances;  
or
- vii. A combination of the aforesaid.

## **CHAPTER VII**

### **GUIDELINES RELATING TO CONTRAVENTION INVOLVING UNPUBLISHED PRICE SENSITIVE INFORMATION, ETC.**

**1. Communication of unpublished price sensitive information related to Intellectual Property Rights (IPR):** In case of unlawful communication of unpublished price sensitive information related to any IPR which is not required to be disclosed at the time of communication and loss of such information may result in substantial loss of stock valuation, with or without any trading done by the defaulter,-

- i. the disproportionate gain shall include the fair market value of such information, failing which the gain shall equal the cost of developing such information;

Explanation. – Valuation of the information may be done based on the applicable accounting principles and cost of developing the information can be derived from the costs maintained by the relevant company.

- ii. loss caused may include loss of profit or loss of business value, as the case may be.

Explanation 1. – *Loss of business value* may be calculated through the

following methods, -

- d. The *asset-based approach*;
- e. The *market approach*;
- f. The *income approach*; or
- g. Any other suitable method or combination of methods.

Explanation 2. – *Loss of profit* may be calculated through the following methods, -

- a. The *sales projection method*;
- b. The *before-and-after method*;
- c. The *accounting for profits method*;
- d. The *yardstick method*;
- e. The *market share method*; or
- f. Any other suitable method or combination of methods.

**2. Special case of default involving unfair informational advantage:**

Where the conduct involves informational advantage which results in trading, including insider trading, trading while in possession of true information when false, incorrect or misleading information is circulated in securities market, front-running or tailgating by persons in fiduciary capacity, etc., to determine the gains from such default, the following methods may be employed, -

- i. Statistical methods (such as calculation of abnormal returns using event studies, probabilistic methods, etc., as may be considered fit) wherever appropriate, preferably if the monies involved exceed Rs. 3 crore;
- ii. Non-statistical and approximation methods as detailed in these guidelines for sale or purchase of securities or both, as the case may be; or
- iii. A combination of i. and ii.

**CHAPTER VIII**

**GUIDELINES RELATING TO CONTRAVENTION INVOLVING HOLDING NORMS AND**



## **FAILURE TO PROVIDE EXIT OPPORTUNITY**

1. **Contravention of holding norms:** In case of failure/delay to dilute the securities holding as per the required holding norms, the disproportionate gains may include the following, -
  - i. the gains based on the difference in price between the prevailing market price when the excess securities are actually disposed (whether or not as per the direction of the Board) and the prevailing market price when the securities were required to be diluted as per applicable norms,  
*Explanation.* – any loss caused due to disposal of excess holding shall not be used to set-off any other gains made.
  - i. the gains made in nature of excess dividends, bonus shares, and other corporate rights in proportion to the excess holding during the delay period, unless such corporate rights were part of a dilution scheme permitted by the Board,
  - ii. the gains during the period of excess holding on account of any salary, esops, fees, etc. on account of any position held in the company which would have otherwise not been held without the excess holding.
2. **Failure to give exit Opportunity:** In case of failure to give an exit opportunity (open offer/delisting, etc.), the disproportionate gains may include the following, -

### **In case of illiquid securities:**

- i. The costs avoided based on an approximation using similar issue sizes, wherever possible,
- ii. The difference between the price at which the exit offer is required to be given and prevailing market price, multiplied by the exit size.

*Explanation 1.* – In case of an open offer, the entire open offer size may not be taken, if it is proven to the satisfaction of the Board that the investors would not have taken the exit opportunity in the illiquid securities and the failure did not prejudice the investors.

*Explanation 2.* – In case of an open offer, (ii.) may not apply where the prevailing market price, at the time when the open offer is due (without delay), is higher than the price at which the offer is to be given.

*Explanation 3.* – In case of any act or omission caused or allowed by the defaulter for making the giving of the exit opportunity infructuous, such as compulsory delisting, strike-off, triggering insolvency, etc., the entire exit size may be taken instead of the difference based on price. The defaulter shall not be allowed to take the benefit of his default, including cases where the defaulter's delay has made the exit infructuous due to the prevailing price being higher than the price (inclusive of interest) at which the exit may be given.

**In case of liquid securities:** Similarly, as in case of illiquid securities, the costs avoided and the difference in price shall amount to the gain, save that, -

- i. in case the open offer is required to be given solely by persons existing in control and their related group entities, the open offer size shall be taken as at least 50% thereof or such other lower percentage, as the facts permit, if it is proven to the satisfaction of the Board that at the relevant time, the investors would not take the exit opportunity in the liquid securities and that the failure did not prejudice the investors;
- ii. in case the open offer is required to be given by any other person(s), the entire open offer size shall be taken as the relevant open offer size or such other lower percentage, as the facts permit, if it is proven to the satisfaction of the Board that at the relevant time, the investors would not take the exit opportunity in the liquid securities and that the failure did not prejudice the investors;

*Explanation.* – In liquid securities, the Board may assume that the investors would seek exit in the open offer, where the prevailing market price, at the time when the open offer is due (without delay), is higher than the price at which the offer is to be given.

- iii. in case of any act or omission caused or allowed by the defaulter for making the giving of the exit opportunity infructuous, such as compulsory delisting, strike-off, triggering insolvency, etc., the entire exit size may be taken instead of the difference based on price. The defaulter shall not be allowed to take the benefit of his default, including cases where the defaulter's delay has made the exit infructuous due to the prevailing price being higher than the price (inclusive of interest) at which the exit may be given.

## **CHAPTER IX**

### **GENERAL GUIDELINES RELATING TO DEFAULT INVOLVING SALE OR PURCHASE OF SECURITIES OR BOTH**

1. **Difference in purchase and sale price to indicate profit:** Unless otherwise provided in these guidelines or otherwise considered fit by the relevant authority, in a default involving sale or purchase or both, the disproportionate profit may include the difference between the sale and purchase of securities, subject to one or more of the following guiding principles, -
  - i. The onus to prove the relevant sale or purchase price (including cases of notional profit) of the transactions done within the relevant period, for the purpose of quantifying the disproportionate gains, shall be on the defaulter(s), failing which the Board may adopt any reasonable method of quantifying the same:

Explanation. – Wherever required, the defaulter may rely on or be required to furnish his certified income tax records, bank records, telecommunication records, transaction details and any other document or statement, which is admissible as evidence, in accordance with any law relating to stamp duty, registration or any other applicable law, unless otherwise permitted.

- ii. For the sale/purchase carried out within the default period, the disproportionate gain may be the difference between the acquisition price and sale price. Where, the relevant acquisition or sale purchase price is not available or the available value is not relevant to the default period, an approximate value in accordance with these guidelines may be used to arrive at the relevant gains or losses resulting from the default;

## 2. **Computation of Acquisition Price:**

- i. **When historical acquisition price not relevant or price not available, etc.:** Where the acquisition price of a security is not available and/or the acquisition was made one year or more prior to the default period, then a relevant acquisition price as may be deemed reasonable from the following may be selected, -
  - a. an averaging period not exceeding 90 days immediately prior to the default period may be selected to determine the acquisition price for determining the disproportionate gain and removing any legitimate gains;
  - b. in case of listing related defaults, where the shares were held prior to allotment of the public issue, any of the following deemed reasonable may be used, -
    - (i) allotment price or a suitable fraction thereof; or
    - (ii) a fraction of the price average for one month post listing

or other suitable data set.

c. Any other method considered reasonable.

ii. **Where securities are acquired within a year before the start of the default period:**

Where securities are acquired within a year before the start of the default period, the price at which it is acquired shall be relevant acquisition price and if such price is not available, then a price deemed reasonable from the following may be selected, -

a. Where securities have been acquired after listing and the acquisition price is not available, the last available closing price for the day(s) on during which the securities were acquired/credited to the account of the defaulter (or person holding on his behalf)/debited from the account of the seller, whichever is earlier;

b. in case of listing related defaults, the allotment price may be used;

c. in case of listing related defaults, where the shares were held prior to the allotment process of public issue, any of the following deemed reasonable may be used, -

(i) allotment price or a suitable fraction thereof; or

(ii) a fraction of the price average for one month post listing or other suitable data set.

d. Any other method considered reasonable.

**3. Computation of Sale Price:**

i. **Sale price in general:** Where securities are sold within the default period, the sale price shall be the relevant price, and where such price is not available or the securities have not been sold during the default

period, the sale price may be selected from any of the following as deemed reasonable, -

a. to treat the relevant profit as that profit gained when the information was made public and the market had a reasonable opportunity to digest the information. The gain is to be measured by reference to the market value of the securities at that date;

or

b. the price based on the averaging period not exceeding 90 days may be selected from the end of the relevant period.

ii. **Where securities were purchased illegally:** Where securities were purchased illegally by using funds provided directly or indirectly, by the issuer or through diversion of issue proceeds, -

a. the entire sale price of the securities sold, which were acquired through such means, shall be deemed to be the disproportionate gains;

or

b. in case the securities are not sold during the default period, the acquisition price or the price based on the averaging period not exceeding 90 days may be selected as a sale price from the end of the default period, whichever is higher.

4. **Sale of securities subject to lock-in:** Where securities subject to a lock-in of any kind are sold, the disproportionate gain (including loss avoided) shall mean the entire sale with deduction for the price immediately after the expiry of the lock-in requirement, if available;

5. **Scalping:** Disproportionate gains equals the sum of the gross fees charged for making the recommendation, the gross fees for facilitating investors to purchase through an intermediary and the profits made from personal sales of

securities;

6. **In case of acquisition of securities by issue of fraudulent or counterfeit securities, or issue of securities without proper approvals mandated by law:** The disproportionate gains shall equal the difference between:

(i) the market value of such securities as on the date of purchase, allotment, issue, etc. (or the next trading day, if no price is available) by/to the defaulter(s) or the present market value of such securities as on the date of order in case the securities continue to be held, whichever is higher; and (ii) the actual consideration paid for acquiring the securities, if any:

Provided that where such securities have been sold at a higher price, such price may be relevant for calculating the disproportionate gain.

*Explanation 1. – Uttering of securities:* Where the misconduct relates to the issue of fraudulent or forged securities, or the issue of securities without proper approvals (which voids such issue of securities), the continued holding of such securities, exercise of corporate rights and acquisition of further securities on account of such securities shall amount to a continuing violation and the disproportionate profit shall include the accrued benefits.

*Explanation 2. -* Where bonus securities or dividends have been received on such securities, the market value of such bonus securities or dividends received shall be included as part of the disproportionate gain.

## CHAPTER X

### GUIDELINES RELATING TO DEFAULT INVOLVING RELATED PARTY TRANSACTIONS

1. In addition to any other guideline applicable, the Director's profit in relation to

undisclosed related party transaction shall include profit (or part thereof) made on any trades/ESOPS/sweat equity, etc. prior to the disclosure made while in possession of such material unpublished price sensitive information relating to the transaction;

2. Directors' profit in relation to undisclosed related party transaction shall include any undue benefit given directly or indirectly, to the related party if the related party is a closely held company i.e. a private company or a public company which is not in compliance with minimum public share-holding norms and substantially controlled by the relatives of the director concerned or the director himself, singly or in concert with such relatives at the time of the transaction:

*Explanation 1.* – 'undue benefit' includes, transactions shown as 'loans' which the person receiving has no intention of paying back or fraudulently obtained, and includes any difference in interest when the loan is given at lower than commercial rate or penal rate, etc. as would have been otherwise applicable. Due regard may be given to the value of monies returned prior to the detection of the default or the security/collateral provided.

*Explanation 2.* - A person shall be deemed to have fraudulently obtained a 'loan' if,- (1) such loan was not in accordance with the applicable norms and practices and such person has ceased to pay his debts in the ordinary course of business, or cannot pay his debts as they become due, or (2) the monies were fraudulently siphoned off.

*Explanation 3.* - Unless contrary to the context, 'Director' means every director who was aware that the transaction was a related party transaction and expressly or impliedly approved the transaction with the knowledge that such approval was in contravention of law.

*Explanation 4.* – 'relative' means a relative as defined under section 2(77) of



the Companies Act, 2013 and includes a member of the promoter group.

3. Loss caused to the company and indirectly to the share-holders may include, loss on account of the undisclosed related party transaction, any penalty levied on the company by any financial sector regulator for non-compliance, cost of financial restatements and entering into new arrangements on account of the default;

*Explanation.* – ‘loss’ includes, monies received by the entity who fails to pay back.

## CHAPTER XI

### GUIDELINES RELATING TO FRAUDULENT AND UNFAIR TRADE PRACTICES, ETC.

1. **Overvaluation of Securities due to non-disclosure or manipulation:**

In case of the issue of securities that are overvalued because of disclosure failings or by reason of manipulation (to which the issuer is a party) and such securities are allotted to the public, the disproportionate gain made, shall include:

[Allotment price – Closing Price of such security as on the date immediately following the day when the misconduct ends or after the public dissemination of true information, whichever is appropriate] \* total number of shares allotted to public investors:

*Explanation 1.* – It is possible that the manipulation may be done in already existing securities to make a further issue of securities attractive to investors.

*Explanation 2.* - In these guidelines, dissemination of true information is dissemination of any information which is contrary to the false information and such information is absorbed by the market, though it is not the complete

truth.

2. **Bucketing by an intermediary:** In case of bucketing by an intermediary, the disproportionate gain shall equal the difference in prices retained by the intermediary and the gross brokerage, commission, fees, etc. charged.
3. **Churning and burning by intermediaries:** In case of churning and burning by intermediaries to generate more commission-based income, the disproportionate gains shall include the gross remuneration earned on the client account, for the period of default.
4. **Capping and Pegging:** In case of 'Capping and Pegging', the disproportionate gains shall include:
  - i. **In case of capping:** the premium collected, if any and the loss avoided based on the difference between the strike price and the closing price on the day after the manipulation has ended/expiration date, whichever is later;
  - ii. **In case of pegging:** the value gained is based on the difference between the strike price and the closing price on the day after the manipulation has ended/expiration date, whichever is later;  
*[in case forecasting using statistical methods is possible for options, the same may be used to calculate the difference between the expected and the actual deviated prices.]*
5. **Misconduct to inflate, deflate or maintain the price of securities:**
  - i. In case of misconduct to inflate or maintain the price of securities to avoid losing pledged or loaned shares or to avoid a margin call, the disproportionate gains shall include the amount of money that the defaulter would have been required to pay to avoid the sale of the pledged shares or the value of the margin to be called, whichever is applicable:  
*Explanation.* - It is sufficient that the pledgor has knowledge that the

misconduct inflates or maintains the price or it is done at his behest or instruction.

- ii. Similarly, in case of misconduct to inflate or maintain price of securities to force a conversion of a convertible debt instrument into equity, the disproportionate gains shall include the difference between the value of the debt converted (inclusive of interest) and the value of the equity instruments allotted on conversion, based on an averaging period not exceeding 90 days after the misconduct has ended or after the public dissemination of true information, whichever is appropriate.
  - iii. In case of misconduct to deflate the price of securities in order to purchase the securities at a lower price, the gains shall include the notional gains based on the difference between the price before the manipulation (or the price after the manipulation, whichever is higher) and the price at which the securities are acquired;
6. **Fraudulent dealing to avoid tax burden:** In case of fraud in connection with the dealing of securities for intentional 'buying of losses' by fraudulent dealing, the disproportionate gains shall include the tax avoided through the fraudulent dealing, if any;
7. **Default done to ensure success of public issue:** In case the default is done to ensure the success of an issue of securities, the disproportionate gains shall include, the loss aversion of the sunk cost of the issue process and the cost of refund avoided;
8. **Touting and Mis-selling:**
- i. In case of touting, the disproportionate gains shall include the commissions received from the investors and the value of the benefit received.

- ii. In case of mis-selling, the disproportionate gains shall include the commissions, fees earned in relation to the mis-selling or the period during which the mis-selling was done, as deemed fit.
  - iii. In case of touting and mis-selling, the loss caused to investors as a result of the failure or subsequent sale of the related security shall be considered as loss caused due to such default, if the default is the proximate cause of the loss.
9. In case of **inter-positioning** by an intermediary to generate risk-less profit on proprietary account by inter-posing between client orders, the disproportionate gains shall include the gains made on such trading and the commissions made;
10. In case of **portfolio-pumping** of fund's holding, the gains made shall include any commissions, fees, etc. made during the period from the manipulation to the closing of the day after the manipulation has ended (or the announcement of the relevant results, whichever is later); and loss to the investors shall include the trading costs incurred by the fund (MF/AIF/REIT/InvIT/PMS, etc.) to undertake the portfolio pumping including the losses incurred by the fund for making the default;
11. **Unlawful conversion, misappropriation or destruction of securities including physical securities resulting in permanent loss:** The value of the funds and the fair market value of the securities and other corporate assets (e.g. non-demat securities) are unlawfully taken and disposed of or destroyed, or if it is impracticable to determine the fair market value or such value inadequately measures the harm caused, the cost of replacing that property may represent the disproportionate gain made or loss caused to investors. If for some reason, the market value of the security cannot be determined, the

following methods may be used -

- i. The manageable profit-basis method (the Earning Per Share Method);
- ii. The net worth method or the break value method, or
- iii. Any other suitable method.

Provided that if third party assets have been misused in contravention of segregation norms and if such assets have been restored then instead of full value of the assets, the profit shall be determined at the rate of 1% per month simple interest on the value of such assets, to remove any financial benefit derived from the interest-free use of such assets.

12. In case of **marking the close**, the gains made can be based on the difference in value of the future/option or quarterly/annual portfolio or index reference/valuation points during the period of the manipulation and on the closing of the day after the manipulation has ended (or the announcement of the relevant results, etc., whichever is later).

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- ii. Determination of profits made and losses caused are an essential complement for proving the violation of securities laws and in fact supplement the fact-finding inquiry and does not require a separate inquiry. Hence, investigation, inspection, inquiry and audit processes of the Board should require the relevant authority to examine the aspects necessary to quantify, during the investigation, inspection, inquiry and audit process itself, as doing so will also serve as an *aperçu* to form the line of inquiry, since '*following the money*' is a salutary principle of any investigation.
- iii. A positive mandate be given to the Department of Economic and Policy Analysis, Legal Affairs Department and IVD (dealing *with* Forensic Accounting) of the Board to undertake an ongoing analysis of the various methods employed by various regulators globally to enable their adoption by the Board and updation of the

quantification approaches recommended in this report and explore the possibility of utilizing available software for carrying out complex calculations<sup>191</sup> or their in-house development;

- iv. A permanent technical standing committee be formed consisting of officers of the Board, economists, lawyers, statisticians, auditors and fund managers to help the Board on an ongoing basis to review of the manner of quantification to be carried out by the Board;
- v. Wherever the investigative/inspection/audit authority require assistance, including matters requiring statistical methods, they may seek the assistance of the Department of Economic and Policy Analysis for quantification. Wherever required SEBI may refer the matter to the permanent technical standing committee for guidance.
- vi. The Board may also consider corresponding with the USA-SEC and Italian Companies and Exchange Commission to gain from their experiences and incorporate their methods of quantification. While we have recommended many of the well-established methods adopted by global regulators, closer contacts with such regulators will help the Board and its staff in making appropriate decisions for determining the parameters to be employed in using these methods.
- vii. As a mid-term goal, the Board may consider developing an in-house software or such software through suitable service providers<sup>192</sup>, for the purpose of quantification of disproportionate gains and loss to investors based on the experience gained after implementing the suggested guidelines.

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<sup>191</sup> See <<https://wrds-www.wharton.upenn.edu/pages/analytics/>>; <<https://www.r-project.org/>>; <[https://www.sas.com/en\\_in/home.html](https://www.sas.com/en_in/home.html)>; <<https://www.stata.com/>> and <<https://www.eventstudytools.com/>>.

<sup>192</sup> See <<https://wrds-www.wharton.upenn.edu/pages/analytics/>>; <<https://www.r-project.org/>>; <[https://www.sas.com/en\\_in/home.html](https://www.sas.com/en_in/home.html)>; <<https://www.stata.com/>> and <<https://www.eventstudytools.com/>>.

viii. Unlike settlements in other kinds of disputes which are privately negotiated, settlement amounts in securities laws are arrived at using publicly available formula. This has been done to further transparency in matters of public interest. However, it is seen that transparency in settlement mechanism is open to arbitrage and defaulters try to game the enforcement mechanism by not going for settlement because there is no similar guidance for adjudication of penalties. Further, there is no uniformity even with respect to penalties levied by different adjudicating officers in respect of the same defaults. The Finance Act, 2018 has also empowered the Board to levy penalties, thus there is a possibility that different WTM's may impose differing penalties for the same kind of violation. Though there are existing internal circulars on levy on penalty they do not appear to have been applied consistently. The Hon'ble Supreme Court in *Adjudicating Officer, SEBI v Bhavesh Pabari*<sup>193</sup> has *inter alia* held that various relevant factors can be taken into account while adjudicating the levy of penalty and clauses (a) to (c) [factors relating to profit made, loss caused and repetitive nature of default] in Section 15-J of the SEBI Act are merely illustrative and are not the only grounds/factors which can be taken into consideration while determining the quantum of penalty. Accordingly, Regulation 32 of the recently issued SEBI (Settlement Proceedings) Regulations, 2018 *inter alia* provides that the *Schedule –II (dealing with quantification of settlement amount) of those regulations shall be relevant to proceedings before the Board or the Adjudicating officers and they may apply the same to the extent possible*. Hence to raise the standard of administration of justice and to ensure that defaulters do not game the enforcement mechanism of the Board, it may be essential to issue non-mandatory public guidelines for the purpose of levy of penalty to ensure the application of Schedule-II with appropriate modification and various judicial pronouncements while preserving the discretion of quasi-judicial authorities. Hence the Board may consider issuing the following guidance to the officers, -

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<sup>193</sup> 2019 (3) SCALE 447, available at [https://www.supremecourtfindia.nic.in/supremecourt/2013/36291/36291\\_2013\\_Judgement\\_28-Feb-2019.pdf](https://www.supremecourtfindia.nic.in/supremecourt/2013/36291/36291_2013_Judgement_28-Feb-2019.pdf) >.

## **GUIDELINES FOR LEVY OF PENALTY**

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### **GENERAL PRINCIPLES FOR DETERMINATION OF APPROPRIATE PENALTY**

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For the purpose of arriving at an appropriate penalty to be levied on the persons who violate securities laws, the consideration of relevant factors, including the following factors is also required, -

- (i) the amount of disproportionate gain or unfair advantage, wherever quantifiable, as a result of the default;
- (ii) the amount of loss caused to an investor or group of investors as a result of the default; and
- (iii) the repetitive nature of default.

In view of the same the following non-mandatory guidance is being issued by the Board for levy of penalty under securities laws in rescission of existing internal circulars,-

- A. This guidance may be applied to all proceedings for the levy of penalty initiated on or after the date of issuance of these guidelines;
- B. Deviation from this guidance may be for reasons to be recorded in the order imposing penalty;
- C. Second Schedule to the Securities and Exchange Board of India (Settlement Proceedings) Regulations, 2018 read with Regulation 32 of those Regulations, is relevant for determining the Indicative Penalty (IP) which may be levied.

In doing so, -

- a. Chapter VII of the Second Schedule provides guidance for consideration of the 'repetitive nature of the default' and hence repetitive defaults may be considered accordingly.

Explanation 1. - A 'repetitive' default shall not include a 'continuing' default.

Explanation 2. - A default may be a 'continuing' default if depending upon the language of securities laws which create that default, the nature of the default, and above all, the purpose which is intended to be achieved by securities laws constituting the particular act as a continuing default, and such contravention is not of a procedural or formal nature or it goes against the very grain of the statutory provision under consideration or is expressly recognized to be a continuing default or provides a penal liability or an injury which continues until the requirement is complied with.



- b. The IP may be calculated *mutatis mutandis* on the lines of calculating the IA under the Second Schedule. For determining the IP, -
  - i. PCF shall be 0.85;
  - ii. Reputation risk factor shall not be applicable;
  - iii. The IP shall not be less than the minimum penalty to be levied under securities laws and not exceed the maximum penalty permitted under securities laws; and
  - iv. Quantification of profit made and loss caused may be based on the guidelines issued by the Board, if any.
  
- D. For defaults where the maximum penalty under securities laws is not a multiple of the disproportionate profit made, -
  - a. If the profit made is less than the maximum penalty under law, then if considered appropriate, the penalty shall not be less than the profit made or the minimum penalty under law, whichever is higher;
  - b. If the profit made is more than the maximum penalty under law, then if considered appropriate, the penalty shall be the maximum penalty under law.
  
- E. For defaults where the maximum penalty under securities laws extends to three times the profit made, but disgorgement or refund of the disproportionate profit made is contemplated or direction to disgorge has been issued but not been complied with, if considered appropriate, the penalty imposed may not be less than the profit made or the minimum penalty under law, whichever is higher.
  
- F. In cases where the penalty under securities laws extends to three times the profit made and if the loss caused to investors exceeds the profit made by a multiple of 500 or more, then if considered appropriate, the penalty may not be less than the profit made but be not more than twice such profit or twice the minimum penalty under law, whichever is higher.
  
- G. In cases the where the penalty under securities laws extends to three times the profit made and if the loss caused to investors exceeds the profit made by a multiple of less than 500, then if considered appropriate, the penalty may not be less than twice the profit made or thrice the minimum penalty under law, whichever is higher.
  
- H. For the purpose of levying penalty, the profit made may be calculated jointly, severally or jointly and severally.
  
- I. The IP may be adopted and levied as penalty if deemed appropriate to the nature of the default.

Explanation. -It is clarified that any approximations, errors or irregularities while calculating in accordance with these guidelines shall not invalidate the penalty levied, if the quasi-judicial authority imposing penalty is satisfied that the penalty levied is appropriate.

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- ix. Economic litigation is becoming more and more complex every day; a defaulter guided by greed may trigger regulatory responses that he may not fully fathom. Such instances are not unique to securities laws, but are found in various economic litigation such as taxation, anti-dumping/injury margin calculation. This does not mean that advanced regulatory responses should be confined to a highly educated defaulter, well versed in law, economics, statistics, etc. The law requires that the defaulter be given an opportunity to reply to the charge either by himself or by competent professionals that he may appoint. The proposed guidelines permit such response. It must be made clear at the outset that the Committee is not recommending the creation of any 'new' statistical approaches. It is only suggesting the adoption *mutatis mutandis* of existing approaches for which literature and competent professionals exists. Though defaulters may cite difficulty in understanding these approaches, they are primarily responsible for the adoption of these methods and like the Board, they too may seek relevant competent professional assistance. However, mindful of the difficulties in these methods, the Committee recommends that the Board may also consider including course material in relation to quantification in the securities courses conducted by the NISM, Government law College, Mumbai and any other legal institution or establishment imparting a course in securities laws. Similarly, in line with the international practices, presentations may be made to the Tribunal on a regular basis by its specialist officers, to enable incorporation of views of the Bench to be considered while developing the Board's quantification methodology and enable market participants, the Bar and the Bench to become conversant with the manner of quantification to be adopted by the Board and enable exchange of ideas.

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