

# PROCEDURAL FAIRNESS IN SECURITIES ENFORCEMENT

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*Whilst there are a number of metrics, both objective and subjective, to assess the progress of a legal system, how it all stacks up against first principles of jurisprudence is, more often than not, a very dependable indicator of its maturity. The formulation of a reliable and consistent justice delivery system depends not only on nuanced legal interpretation and consistent judicial precedent, but equally on the even-handed application of procedural methodologies.*

*Such appraisals are particularly relevant for quasi-judicial proceedings today, especially since they are conducted under the aegis of regulatory bodies that don multiple hats and concurrently perform administrative, law-making and quasi-judicial roles. With a focus on the Securities and Exchange Board of India (“SEBI”) and its appellate body, the Securities Appellate Tribunal, this paper analyses how securities enforcement has performed over the years against the touchstone of principles of natural justice and the importance accorded to procedural fairness.*

*In doing so, we adopt a three-pronged approach - first, examining decisions that expound upon the role of bias and the acceptable degrees of separation of powers; second, evaluating audi alterem partem, how it has been interpreted and the various facets of a fair hearing; and lastly, concluding with an analysis on some home improvements that may be worthwhile to embark on.*

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## I. INTRODUCTION

The reason this analysis is particularly relevant for a regulatory body such as SEBI, is because of the significant powers it wields across corporate India and the securities market. From listed companies, to market intermediaries and investors, SEBI is mandated to supervise the entire ecosystem of corporate India. In order to do so effectively, as is the case with several regulators, SEBI too is legislatively conferred with executive, rule-making and “hear and determine” powers.

Even within the microcosm of its quasi-judicial functions, the securities market regulator has multiple enforcement tools at its disposal and retains the discretion to deploy whatever is necessary to tackle the issues at hand. For instance, it can initiate proceedings under Section 11B of the SEBI Act, and issue directions that can have commercial and monetary consequences for the parties. SEBI may initiate adjudication proceedings where imposition of only a monetary penalty is justified. For specific intermediaries who have demonstrated deficiencies in compliance, SEBI may initiate inquiry proceedings, which may result in substantive restrictions on the intermediary’s ability to do business.

The common thread running through all of the above though is the natural justice prerequisite. Since quasi-judicial functions occupy a different footing from administrative processes *simpliciter*, and are bound by certain processes and rules of conduct, principles of natural justice emerge as the primary litmus test. This is known as the “*duty to act judicially*”. Courts have consistently held that<sup>983</sup> a judicial decision is made according to law, whereas an administrative decision is made according to administrative policy. A quasi-judicial decision is, therefore, a decision which is subject to a certain measure of judicial procedure and hence, the decision-making authority has a concomitant responsibility to act judicially.

## II. ABSENCE OF BIAS

The absence of bias is a concern inherent in the dual/multiple functions that regulators perform, which necessitate an analysis of how conflict of interest is ascertained, managed and avoided. Over the years, within SEBI itself, the lines of demarcation have been driven by specific codes of conduct and rigorous internal segregation through different departments, divided across intermediaries and subject matters, thereby ensuring that each department operates as a distinct silo. Each such division is led by department heads also known as whole time members. Such members, in their capacity as senior officers, also preside over quasi-judicial proceedings but only on matters pertaining to departments over which they exercise operational supervision. This enables objectivity and ensures that persons engaged in investigative roles or prosecutorial roles are kept separate from those discharging a judicial responsibility. However, SEBI’s journey up until this point has not been without its learnings.

There have been interesting situations alleging institutional bias against SEBI. For instance, in a case before the High Court of Bombay, pertaining to certain accreditation courses offered by a sister institute of SEBI, the petitioners challenged SEBI’s mandate on

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<sup>983</sup>See *National Securities Depository Ltd. v. SEBI*, 2017 SCC OnLine SC 256; *Province of Bombay v. Kshaldas S. Advani* (1950) SCR 621; *N. Misra v. Dr. H.K. Paintal* (1990) 2 SCR 84.

the grounds that making courses by a sister institute mandatory in order to obtain securities market licenses showed bias and such a mandate should therefore be struck down. The Court held that only where actions of regulatory bodies are vitiated by *mala fides* is judicial review permissible and in matters of certifications and accreditations there are experts who have advanced certain criteria. Therefore, it is not for courts to substitute their views as they are not experts in the field.<sup>984</sup> On another occasion, relying on a notification by the Ministry of Corporate Affairs on 'shell companies', SEBI pre-emptively restricted the trading activities of such companies. In this case, institutional bias was alleged by a company since an inquiry was being undertaken in parallel to these restrictions being put in place. It was observed here that there is no rigid enquiry procedure prescribed under the SEBI Act and the scheme is predominantly inquisitorial. Hence, it cannot be said that the power to seek information ceases when a quasi-judicial proceeding commences and that efforts to do so must be thwarted by the principle of bias. The order found no bias exhibited by the whole-time SEBI member and correctly held that there is no bar on SEBI to seek and rely on information gathered from the notice after the quasi-judicial proceeding has begun.<sup>985</sup>

However, the spotlight was firmly cast on such concerns when an investigation against NSDL in relation to the IPO scam and its potential conflict of interest with the tenure of the then Hon'ble Chairman C.B. Bhave (who was the NSDL head during the investigation period), garnered a fair amount of media attention and debate.

In 2008 though, SEBI introduced a commendable fix vide the Code on Conflicts of Interest for Members of the Board. This Code expressly articulates safeguards and disclosures that must be maintained by members of the SEBI board to ensure objectivity in decision making and also safeguard public confidence in regulatory processes. For instance, not only does it require the chairman and whole-time members to disclose any potential interest in matters on the agenda or an enforcement action, it ensures that conflicts are avoided with past employment/fiduciary positions, personal and familial relationships as well as honorary positions in organizations.

The show-cause notice process itself has also come under judicial scrutiny and has been challenged on the grounds of bias, stating that the allegations, as framed in these notices, are reflective of SEBI's bias in its own quasi-judicial proceedings. For instance, in an enforcement action against misstatements made in OneLife Capital Advisors' prospectus, the noticees contended that SEBI made pre-determined findings in its SCN and reached a definite conclusion on the noticees liability. Placing reliance on the decision of the Hon'ble Supreme Court in *Haryana Financial Corporation*,<sup>986</sup> the order held that a show-cause notice is a self-contained document that contains all the allegations and charges against the noticees and does

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<sup>984</sup> *Financial Planning Standards Board India v. National Institute of Securities Markets & SEBI*, Writ Petition No. 1753 of 2014 (Bombay High Court).

<sup>985</sup> SEBI Order in the Matter of Nu Tek India Ltd. dated October 26, 2018.

<sup>986</sup> The theory of reasonable opportunity and principle of natural justice have been evolved to uphold the rule of law and to assist the individual to indicate his just rights. Whether, in fact, prejudice has been caused to an employee or not on account of denial to him of the report has to be considered on the facts and circumstances of each case. Even in cases where procedural requirements have been complied with, action cannot be ipso facto illegal or void, unless it is shown that non-observance has prejudicially affected the delinquent; *Haryana Financial Corporation v. Kailashchand Ahuja* 2009 (9) SCC 31, ¶ 19.

not violate any principles of natural justice and rejected the contention that the SEBI reached any pre-determined findings in its show-cause notice.<sup>987</sup>

### III. THE FAIR HEARING POSTULATE AND ITS VARIOUS COMPONENTS

As a non-derogable principle of any judicial process, the principle of the right to a fair hearing traverses much beyond the ability to avail of a hearing before the decision-making authority. It encompasses a just and even-handed approach towards the whole adversarial process itself, including clarity in the charges levied, transparency in the evidence obtained, ability to cross-examine, etc. Whilst it will be difficult to examine every such aspect comprehensively, for the purposes of this analysis we shall focus on a few recurrent themes.

An intrinsic feature of any enforcement proceeding is the ability to decipher the scope and source of the allegations. The show-cause notice of course, acts as the primary receptacle of any regulatory charge, but it is the documents and information referred to therein that help unravel and understand the crux of the matter at hand. Whilst a lot of such information is often annexed to the notice itself, some of the background data, including compelling information collected from co-noticees and other third parties is often not shared. The evidentiary basis for investigations is often far more complex, especially when the factual background involves prolonged time periods, multiple parties and non-linear chains of cause and effect. In such cases, appreciation of evidence, both exculpatory and inculpatory is critical, as is examining the position of other parties interconnected with the case itself.

#### *Accessing underlying documents*

The rationale behind granting parties an opportunity to access underlying documents is to ensure a fair opportunity to defend oneself. The main question which has arisen with predictable frequency in quasi-judicial proceedings is on the degree of access that must be provided and the boundaries cast on such rights. The landmark decision of the Hon'ble Supreme Court in *M.L. Sethi v. R.P. Kapur*,<sup>988</sup> observed that usually a party is entitled to inspect all documents which are in the possession of the other party.

In *Price Waterhouse v. SEBI*,<sup>989</sup> one of the questions was whether the appellants are entitled to copies of documents relied upon in the show-cause notice issued by SEBI. The appellants filed the petition because their request for inspection of documents was only accepted for some documents and rejected for others. The minority view in this judgement was noteworthy, in that it observed that the appellants are entitled to all the material and documents that might have been gathered by the Board during the course of the inquiry, irrespective of whether the same was relied on in the show cause notice or not. The rationale was that in this process, the Board is not acting in the capacity of a prosecutor but that of an adjudicator.

The majority view in this case, however, did not agree with the minority. It was held that the "...the application of principles of natural justice depends to a considerable extent on the

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<sup>987</sup>SEBI Order in the Matter of OneLife Capital Advisors Ltd. dated August 30, 2013.

<sup>988</sup>*M.L. Sethi v. R.P. Kapur* 1972 (2) SCC 427.

<sup>989</sup>*Price Waterhouse & Co. v. SEBI*, Appeal No. 8 of 2012 (Securities Appellate Tribunal) dated June 1, 2012.

*facts and circumstances of the case, the framework of the law under which the inquiry is held and the constitution of the Tribunal or body of persons appointed for the purpose.*” The fact that the Act itself is silent on access to information also played an important role in the decision of court.

This interpretation allows for considerable discretion in the hands of SEBI, in deciding the extent of a party’s right to access and inspect all documents.

Another factor which is also considered while deciding cases in respect of opportunity to access documents is whether the party seeking access to such documents is disadvantaged in any manner due to denial of access. The issue of discrimination is not taken into consideration if the party is not at a disadvantage due to denial of access.<sup>990</sup>

In this context, it is relevant to examine the decision in *Phillip Commodities*,<sup>991</sup> which held that where parties were not disadvantaged due to denial of access to additional documents and had all information necessary to make their representations on a notice, no case for discrimination can be made out. SEBI further stated that it would not accede to the request for grant of inspection of all the documents collected during examination, and interpreted the principles of natural justice as being adequately met once documents that were “relied upon” by the regulator were shared.

These decisions are in tandem with the order of the Hon’ble Supreme Court in *Kanwar Natwar Singh v. Directorate of Enforcement*,<sup>992</sup> where it held that “...even the principles of natural justice do not require supply of documents upon which no reliance has been placed by the Authority to set the law into motion. Supply of relied on documents based on which the law has been set into motion would meet the requirements of principles of natural justice.” The principle behind this decision was that nothing which has not been brought to the notice of the person should be used against him.

Principles regarding access to documents were most recently analysed in the matter of *Shruti Vora v. SEBI*,<sup>993</sup> where an appeal was filed in relation to the ambit of documents that can be demanded in an inspection. Dismissing the appeal, the tribunal, in line with precedents, limited the scope of information only to documents relied upon in the show-cause notice itself. What makes these observations in this case particularly noteworthy is that it involved a market conduct allegation regarding transmission of price sensitive information on the WhatsApp platform. In such cases, where SEBI investigates multiple unrelated parties, gleans a pattern and then issues a notice to show cause, all the information collected through its investigation assumes critical significance in the defence. Where the facts and issues involved are not linear and are predicated on the acts and/or omissions of unrelated third parties, SEBI should consider allowing wider access to investigation documents, to substantively meet the natural justice thresholds.

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<sup>990</sup> SEBI Order in the Matter of India Infoline Commodities Ltd. dated August 30, 2018.

<sup>991</sup> SEBI Order in the Matter of Phillip Commodities Ltd. dated June 6, 2018.

<sup>992</sup> *Kanwar Natwar Singh v. Directorate of Enforcement*, 2010 (2) SCC 497.

<sup>993</sup> *Shruti Vora v. SEBI*, Appeal (L) No. 28 of 2020 (Securities Appellate Tribunal) dated February 12, 2020.

### *Post decisional hearings*

In addition to bias and access to information, a key limb to assessing compliance with natural justice is to understand the circumstances in which the quasi-judicial authority can issue *ex-parte orders* and the limitations therein. A post decisional hearing is, as the name suggests, a hearing which takes place after a provisional decision has been given. This principle was recognized in the landmark decision of *Maneka Gandhi v. Union of India*,<sup>994</sup> where the Hon'ble Supreme Court recognized that in situations where quick action was needed and it would be impractical to have a hearing before reaching a decision, a remedial hearing, also called a post decisional hearing, should be given. In *Liberty Oil Mills*,<sup>995</sup> The Hon'ble Supreme Court held that when ad-interim orders are passed *ex-parte*, such orders themselves provide an opportunity to the aggrieved party to be heard at a later stage at their request.

SEBI's powers to issue *ex-parte* orders and then initiate post decisional hearings are legislatively recognised in Section 11(4) of the SEBI Act, which empower it to take a multitude of measures pending investigation or inquiry, including restraining persons from trading in securities and impounding proceeds of transactions under investigation

This power was interpreted by the Hon'ble Bombay High Court in the landmark decision of *Anand Rathi*,<sup>996</sup> which correctly observed that the principles of natural justice would be satisfied if the affected party is given a post decisional hearing, as a pre-decisional hearing is not always mandatory in situations where ad-interim orders are passed.

The Hon'ble Rajasthan High Court in *Avon Realcon*<sup>997</sup> delved into the interpretation of Section 11 of the SEBI Act, 1992. The second proviso to this section provides that noticees would be given the opportunity of hearing either before or after passing of orders. After passing the impugned order, the petitioners were called upon to submit their objections within a period of 21 days. The objective was to provide the petitioners an opportunity of hearing before the final decision is taken thereby satisfying requirements of post decisional hearing. A recent SEBI order confirmed the position adopted in the above decisions. The order passed before a pre-decisional hearing noted that an opportunity for post decisional hearing was provided and was therefore in compliance with the principles of natural justice.<sup>998</sup>

Whilst this position on post decisional hearings in itself is legally sound and relevant for regulators who work in dynamic environments that require prompt actions and quick fixes, they cannot be interpreted in isolation. Limited access to investigation material has a far more aggravating impact on post decisional hearings, where parties must complete the adjudicatory process while already constrained by legal sanctions.

## IV. AN ASSESSMENT

Natural justice is more than just a sum of its parts and while quasi-judicial proceedings before SEBI are not accompanied by procedural guarantees akin to what civil actions bestow,

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<sup>994</sup>*Maneka Gandhi v. Union of India*, 1978 (1) SCC 248.

<sup>995</sup> *Liberty Oil Mills v. Union of India* 1984 (3) SCC 465.

<sup>996</sup> *Anand Rathi v. SEBI* 2001 SCC OnLineBom 381.

<sup>997</sup> *Avon Realcon v. Union of India* 2010 SCC OnLine Raj 3814.

<sup>998</sup> SEBI Order in the Matter of Pine Animation Ltd. dated August 22, 2016.

jurisprudence has evolved to take intricate facts and sophisticated markets into consideration. The procedure followed by quasi-judicial bodies assumes significance because of the impact that processes are bound to have on the success of the resultant delivery of justice and the faith reposed in it.

However, in addition to the judicial keenness in bringing clarity to such procedural elements, the time has come to consider clearer rules on the process that must be followed by the regulator while discharging its quasi-judicial and adjudicatory functions, which is, as on date, undertaken entirely based on SEBI's discretion as well as past practice. A case in point here is the rules of process and procedure issued by the Securities Exchange Commission (SEC) in USA, articulating the procedural minutiae involved in the entire length of the matter, i.e., from ascertainment of a cause of action up until issuance of an order and imposition of a penalty. Applicable to administrative proceedings held by the SEC, these rules expound upon discovery and production of documents, depositions and cross examinations, appreciation of evidence pre-show cause notice submissions as well as time periods associated with each of these steps. SEBI will also do well to consider such a procedure code, that will delineate applicable practical steps, create more certainty, predictability and overall, entrench the procedural fairness of quasi-judicial action.