

Legislative Brief

The Securities Laws (Amendment) Bill, 2013

The Securities Laws (Amendment) Bill, 2013 was introduced in the Lok Sabha on August 12, 2013, replacing the Securities Laws (Amendment) Ordinance 2013. The Bill was referred to the Standing Committee on Finance (Chairperson: Mr. Yashwant Sinha) for examination and report within two months.

The Ordinance lapsed on September 16, 2013 and was re-promulgated on September 20, 2013.

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Highlights of the Bill

- ◆ The Bill seeks to amend the Securities and Exchange Board of India Act, 1992, with consequential changes in the Securities Contracts Regulation Act, 1956 and the Depositories Act, 1996.
- ◆ Collective Investment Schemes (CIS) are a class of investment products regulated by SEBI. The Bill widens the definition to include all pooling of funds of Rs 100 crore or above, that are not regulated by any law.
- ◆ The Bill empowers the Chairman of SEBI to authorise search and seizure of documents relevant to an investigation.
- ◆ The Bill provides SEBI with explicit powers to order disgorgement of unfair gains. It also permits SEBI to attach bank accounts and property, and arrest and detain a person for his failure to comply with disgorgement orders or pay any monetary penalty.
- ◆ The Bill establishes special courts to try offences under the Act.
- ◆ Two provisions are being enacted with retrospective effect – (i) SEBI is being given the powers to settle non-criminal proceedings by issuing consent orders, and (ii) it may sign agreements for exchange of information with foreign financial regulators.

Key Issues and Analysis

- ◆ The expanded definition of CIS relaxes some conditions such as the need for not having operational or managerial control of funds. As a result, some schemes not conventionally understood as CISs could fall under the new definition.
- ◆ SEBI has been given the power to define what constitutes a CIS through regulations. This raises the question of excessive delegation of legislative powers.
- ◆ The power to order disgorgement of unfair gains, without approaching a court, is in contrast with the equivalent provisions of the Companies Act, 2013.
- ◆ The Bill does not explicitly provide the first right to the disgorged funds to those who suffered wrongful losses due to unfair actions.
- ◆ The Bill provides SEBI with the power to investigate, search and seize, adjudicate, attach bank accounts/property and arrest and detain a person in prison without the need to approach a court. These provisions remove earlier safeguards in the SEBI Act, which were at par with the Code of Criminal Procedure, 1973.

PART A: HIGHLIGHTS OF THE BILL¹

Context

In India, different financial products are regulated by different entities such as the Reserve Bank of India (RBI), the Insurance Regulatory and Development Authority, the Pension Fund Regulatory and Development Authority and the central and state governments. The Securities and Exchange Board of India (SEBI) regulates mutual funds, security exchanges including stock markets and Collective Investment Schemes (CISs).

It has been felt that some gaps in the regulatory structure and enforcement mechanisms need to be plugged. First, there have been some recent instances where it has been alleged that investment schemes have managed investors' money without supervision by SEBI or any other regulator.² Second, there has been a need to strengthen the investigative and prosecutorial powers of SEBI. Third, in 2007, SEBI issued guidelines for consent settlements, i.e. out of court settlements with market participants.³ SEBI's power to settle cases through consent orders was challenged in a Public Interest Litigation filed in the Delhi High Court in 2012.^{4,5} Fourth, since 1998, SEBI has signed a number of agreements for exchange of information with foreign regulators but the SEBI Act, 1992 does not explicitly give it the power to do so.

The Securities Laws (Amendment) Ordinance, 2013 was promulgated on July 18, 2013 to address these issues by amending the SEBI Act, 1992, and making consequential amendments to the Securities Contracts Regulation Act, 1956 (SCRA, 1956) and the Depositories Act, 1996.⁶ The Ordinance was replaced by the Securities Laws (Amendment) Bill, 2013 on August 12, 2013, which is currently pending in Parliament. The Ordinance lapsed on September 16, 2013 and was re-promulgated on September 20, 2013.

Key Features

Definition of Collective Investment Scheme (CIS)

- The Act defines a CIS as a scheme which meets all of the following four conditions: (i) funds of investors are pooled, (ii) yields profits, income, property or produce, (iii) is managed on behalf of investors, and (iv) investors do not have operational or managerial control. Additionally, the Act exempts certain types of schemes which are regulated by other authorities. These include mutual funds, deposits by non-banking financial companies and public limited companies, insurance and pension schemes, chit funds etc.
- The Bill, through a proviso, adds a new definition where any scheme or arrangement is deemed to be a CIS if it meets all the three following conditions: (i) funds are pooled, (ii) it is neither registered with SEBI, nor exempted by the SEBI Act, and (iii) it has a corpus of Rs 100 crore or more. A scheme would qualify as CIS if it falls under either of these two definitions.
- In addition, SEBI is delegated the power to frame regulations specifying the conditions under which any scheme or arrangement can be defined as a CIS. The central government can add any scheme or arrangement to the list of excluded schemes, in consultation with SEBI.

Disgorgement (repayment) of unfair gains/averted losses

- SEBI has, in the past, used the power to issue directions (as provided by the Act) to order market participants to disgorge the profits made or losses averted through their unfair actions.⁷ The Bill deems SEBI to have always had such a power. Similarly, the SCRA, 1956 and the Depositories Act, 1996 are also being amended.
- The Bill specifies that the disgorged amount shall be credited to the Investor Education and Protection Fund (IEPF), and shall be used in accordance with SEBI regulations.

Investigation and prosecution

- The Act allowed SEBI to conduct search and seizure operations on a suspected violator's premises after obtaining permission from a First Class Judicial Magistrate. The Bill removes the need for a Magistrate's permission, and instead empowers the SEBI Chairman to authorise such operations. It gives SEBI the power to formulate regulations regarding search and seizure, in the absence of which, the provisions of the Code of Criminal Procedure, 1973 (CrPC) shall apply.
- The Bill provides for the establishment of special courts to undertake speedy trials of offences under the Act.

- The Act allowed SEBI to attach the bank account of a person for up to one month, if he fails to pay the penalty imposed, after obtaining permission from a First Class Judicial Magistrate. The Bill instead empowers an authorised SEBI officer to attach the bank account and property of, and arrest and detain a person who defaults on paying penalty or disobeys a disgorgement order. A similar provision has been added to the SCRA, 1956 and the Depositories Act, 1996.

Provisions with retrospective effect

- The Bill allows SEBI to enter into a consent settlement with a person against whom proceedings have been initiated. This provision validates the consent settlement guidelines issued by SEBI in 2007.⁴
- The Bill allows SEBI to exchange information with foreign regulators and enter into agreements to that effect. This clause will be effective retrospectively from March 6, 1998, when SEBI signed an agreement with the United States Securities and Exchange Commission.⁸

PART B: KEY ISSUES AND ANALYSIS

Broad definition of CIS

Clause 3(i) (b) The Act specifies conditions for a scheme or arrangement to qualify as a CIS. It requires that funds be pooled, that there be a commercial motive, that the money be managed on behalf of the investors, and that the investors not have operational or managerial control over the funds. The Bill expands the definition of CIS, through a proviso, to include any scheme where funds are pooled, where the corpus is Rs 100 crore or more and which is neither registered with SEBI nor exempted by the Act. This implies that a scheme which satisfies the conditions specified in the proviso would be considered to be a CIS even if it does not satisfy the four conditions of the main clause.

This could result in some schemes that are not conventionally understood as CISs falling under the new definition. To illustrate, schemes which are private arrangements (e.g. partnership firms) or which are not investment oriented (e.g. housing schemes) could be deemed to be CISs.

Delegation of legislative powers

Clause 3(iii) (2A) The Bill gives SEBI the power to frame regulations specifying conditions under which any scheme may be termed a CIS. This implies that the regulations issued by SEBI could determine the schemes that will fall within its jurisdiction. This provision raises the question of excessive delegation of legislative powers. Usually, the parent Act defines whom to regulate while the details of how to regulate may be delegated to the regulator.

Power to order disgorgement without court authorisation

Clauses 4, 13, 19 The Act allowed SEBI to issue directions to protect investors' interests, without explicitly providing it with the power to order disgorgement of unfair gains. The Bill explicitly provides SEBI with such powers without specifying the need for prior court authorisation. This is at variance with equivalent provisions of the Companies Act, 2013 which require an order from a court for disgorgement of unfair gains.⁹

Clause 4 The Bill provides that the disgorged funds will be credited to the IEPF and that investors will be compensated as per regulations governing the IEPF. Currently IEPF regulations do not provide the first right to disgorged funds to those who suffered wrongful losses due to the unfair actions of other market participants.¹⁰ However, such a right is provided in the Companies Act, 2013 and the draft Indian Financial Code* (draft IFC).¹¹

Limited safeguards to powers of search, seizure and attachment

Clauses 5, 10, 15, 21 The Act permits SEBI to conduct search and seizure operations on a suspected violator's premises after obtaining permission from a Judicial Magistrate. The Bill removes the requirement of prior permission from a Magistrate. Instead, it empowers the SEBI Chairman to authorise such operations. Further, the Bill grants SEBI the power to attach a person's property or arrest and detain him in certain cases, without the need to approach a court.

*The draft IFC was proposed by the Financial Sector Legislative Reforms Commission to replace several financial sector laws including the SEBI Act, the Forwards Contract (Regulation) Act, 1952 and the Insurance Regulatory and Development Authority Act, 1999.

Most financial regulators do not have the power to conduct search and seizure operations or to attach property without obtaining court approval. For example, the RBI, the Company Law Board and the Forwards Market Commission are required to seek prior court approval for the aforementioned steps.¹² Further, even the CrPC places certain checks on such actions. It requires that a police officer investigating a case obtain a warrant from a court before conducting search and seizure operations. In certain exceptional circumstances, the police officer may conduct a search operation without a warrant but is required to inform the nearest Magistrate, in writing and at the earliest.¹³

On the other hand, some authorities have been given powers to undertake such action without prior court approval. For example, the Directorate General of Economic Enforcement, the Income Tax Department and police authorities under the Unlawful Activities Prevention Act, 1967, have such powers.¹⁴

Notes

1. This Brief has been written on the basis of the Securities Laws (Amendment) Bill, 2013 that was introduced in the Lok Sabha on August 12, 2013.
2. “Order in the Matter of M/S. Saradha Realty India Ltd.”, Securities and Exchange Board of India, April 23, 2013. http://www.sebi.gov.in/cms/sebi_data/attachdocs/1366731012533.pdf; “Order in the matter of Rose Valley Hotels and Entertainments Limited”, Securities and Exchange Board of India, July 10, 2013. http://www.sebi.gov.in/cms/sebi_data/attachdocs/1373456813231.pdf.
3. “Guidelines for (i) Consent Orders and (ii) For considering requests for composition of offences under SEBI Act, SC(R) Act and Depositories Act, Securities and Exchange Board of India”, April 20, 2007. <http://www.sebi.gov.in/circulars/2007/CirEFD2007001.pdf>.
4. Deepak Khosla vs Securities and Exchange Board of India, W.P.(C) 6949/2011, High Court of Delhi, October 17, 2011.
5. In a consent settlement, the market participant agrees to pay a settlement amount while the regulator discontinues investigation or prosecution against him. Such out-of-court settlements are used by many financial regulators across the world to settle cases and avoid a lengthy litigation process, or where the case for prosecution may not be strong enough to result in a conviction. For example, The United States Securities and Exchange Commission settles over 90% of non-criminal cases through consent orders. (See paragraph 4 of SEBI guidelines regarding consent orders: <http://www.sebi.gov.in/circulars/2007/CirEFD2007001.pdf>).
6. Statement of Objects and Reasons, Securities Laws (Amendment) Bill, 2013.
7. “Order under sections 11 and 11B of the Securities and Exchange Board of India Act, 1992 in the matter of investigation into Initial Public Offerings”, Securities and Exchange Board of India, November 21, 2006. <http://www.sebi.gov.in/cmorder/IPO.pdf>.
8. “Memorandum of Understanding Regarding Cooperation, Consultation and the Provision of Technical Assistance”, The United States Securities and Exchange Commission, The Securities and Exchange Board of India March 6, 1998. http://www.sec.gov/about/offices/oia/oia_bilateral/india.pdf.
9. Section 38, Companies Act, 2013.
10. Section 5, Securities and Exchange Board of India (Investor Education and Protection Fund) Regulations, 2009.
11. Section 125, Companies Act, 2013; Clause 410, draft Indian Financial Code, 2013.
12. Section 45T, Reserve Bank of India Act, 1934; Section 209, Companies Act, 2013; Section 22 A, Forwards Contract (Regulation) Act, 1952.
13. Section 93 and 165, Code of Criminal Procedure, 1973.
14. Section 37, Foreign Exchange Management Act, 1999; Section 5, 17, 18 and 19, Prevention of Money Laundering Act, 2002; Section 22, Income Tax Act, 1961; Section 33 and 43A, Unlawful Activities Prevention Act, 1967.

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