IN THE SECURITIES APPELLATE TRIBUNAL
MUMBAI

Appeal No.92/2006

Date of decision: 08.01.2007

Karvy Stock Broking Ltd. Appellant

Versus

Securities & Exchange Board of India. Respondent

Shri C.A. Sundaram, Senior Advocate with Shri Shyam Mehta, Advocate Shri Vinay Chauhan, Advocate and Ms. Rohini Musa, Advocate for the Appellant

Shri J.J. Bhatt, Senior Advocate alongwith Shri Chirag Balsara, Advocate and Shri Ravi Hedge, Advocate for the Respondent

CORAM

Justice N. K. Sodhi, Presiding Officer
C. Bhattacharya, Member
R. N. Bhardwaj, Member

Per: Justice N. K. Sodhi, Presiding Officer

This appeal filed under section 15T of the Securities and Exchange Board of India Act, 1992 (hereinafter referred to as the Act) is directed against the order dated May 26, 2006 passed by the whole time member of the of the Securities and Exchange Board of India (hereinafter referred to as the Board) directing amongst others, the appellant not to act as a depository participant pending inquiry and passing of final orders except for acting on the instructions of existing beneficial owners. The appellant as a stock broker has also been directed not to undertake any proprietary trades in securities till the passing of the final order in the inquiry. Facts giving rise to this appeal may first be noticed.

The issue regarding alleged manipulations in Initial Public Offerings (IPOs) of various companies had been engaging the attention of the Board for some time. It received some information regarding the alleged abuse and misuse of the IPO allotment process. As a part of its ongoing surveillance activity, the Board initiated a probe and also advised the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE) to examine the dealings in the shares issued through IPOs before the shares are listed on the stock exchanges. The aforesaid two exchanges submitted their preliminary observations on the IPO of Yes Bank Limited (YBL) in which it was hinted that there could be a possibility of large scale off market transactions immediately following the date of allotment and prior to the listing of shares on the stock exchanges. The Board then carried out a preliminary scrutiny by calling for data from the depositories and the Registrar to the Issue. It found that certain entities had cornered IPO shares reserved for retail applicants by making applications in the retail category through the medium of thousands of fictitious/ benami IPO applicants with each application being for small value so as to be eligible for allotment under the retail category. It was also discovered that subsequent to the receipt of IPO allotment, fictitious/benami allottees transferred the shares to those who controlled those accounts who in turn transferred the shares to the persons financing the transactions i.e. those who made available the funds for executing the game plan. The financiers in turn sold the shares on the first day of listing thereby making a windfall gain since the price of allotment was less than the listing price in view of the booming market. In nutshell, a handful of persons virtually monopolized the retail allotment by elbowing out the genuine

investors. The Board found that large number of multiple dematerialized accounts with common addresses had been opened by a few entities. By order dated 15th December, 2005 passed in the case of YBL, Ms.Roopalben Nareshbhai Panchal and Devangi Dipakbhai Panchal, amongst others, had been directed not to buy, sell or deal in the shares of YBL and in other ensuing IPOs directly or indirectly. National Securities Depository Ltd., (NSDL) which is one of the two depositories in the country was also directed to undertake a comprehensive inspection of the appellant herein which is one of its depository participants particularly focusing on the systems and procedures, if any, put in place by the appellant for implementing the "know your client" (KYC) norms which the participants are required to follow. A reference had also been made to the Reserve Bank of India to examine the role of Bharat Overseas Bank and Vijaya Bank in opening bank accounts of benami entities which were funding their IPO applications.

Soon after the passing of the order in the case of YBL, the Board examined the dealings in another major IPO of Infrastructure Development Finance Co. Ltd. (IDFC) and found that the very same players were suspected to have played a major role in cornering the shares meant for the small retail investors. In pursuance to the directions issued during the course of the investigations in the case of YBL, NSDL and the other depository - Central Depository Services (India)Ltd. (CDSL) had submitted their inspection reports to the Board observing therein that the appellant as a participant had opened accounts of investors by obtaining the supporting documents mechanically and had not taken proper precautions to ascertain the identity and genuineness of the persons. The depositories also

observed in their reports that the appellant had entirely relied upon the documents issued by the scheduled commercial banks submitted by the investors as documents in support of "proof of identity" and "proof of address" even though the same persons opened their beneficial owner accounts in different names. The reports also mentioned that the appellant had not exercised proper care and precautions while processing the debit instruction slips for transfer of securities and that such slackness and deficiencies in procedures and manner of conducting the depository participant operations were not in conformity with the procedures prescribed by the Board and the two depositories. On a consideration of the reports received from the two depositories and also the material that it could gather during the course of the investigations, the Board found that IDFC had come out with an IPO in July, 2005 and the retail portion of the issue was oversubscribed by 5.27 times. The shares were credited to the allottees on August 5 and 6,2005. The shares of IDFC were listed on stock exchanges on August 12,2005. On August 8, 2005 i.e. prior to the listing on stock exchanges, Roopalben Panchal received in her demat account with CDSL 266 shares each from 14,790 demat accounts aggregating to a total of 39,43,184 shares in off market transactions from 14,807 demat account holders. The Board found that out of these 14,807 demat account holders as many as 4946 had a common address of Ahmedabad and another 4990 account holders had another address in Ahmedabad which was the same. Another 4871 account holders had a different common address in Ahmedabad. All the 14,807 demat account holders had their bank accounts with Bharat Overseas Bank Ltd. Ahmedabad and demat account with the appellant herein. The record further indicated that

all these demat accounts had been opened by the appellant on July 15 and 16, 2005 when the issue opened on July 15, 2005. A similar pattern was observed in respect of Roopalben Panchal's demat account with NSDL wherein also she had received a total of 32,61,426 shares from 12,257 demat accounts in off market transactions. All these demat accounts were with the appellant. It also transpired that subsequent to the receipt of shares in her demat account from thousands of entities, Roopalben Panchal in turn transferred the shares to various entities prior to August 12, 2005 i.e. the date of listing of shares on the stock exchanges. Apart from Roopalben Panchal, a similar pattern was observed in the case of Sugandh, Purshottam Budhwani and Manojdev Seksaria who according to the appellant, were its unregistered IPO sub brokers (IPO application collecting agents). It may be mentioned that all the common addresses on the IPO applications and in the demat accounts were those of the so called sub brokers. From the material available with the Board it prima facie concluded that the appellant as a participant had knowledge about the fictitious nature of such multiple accounts. The Board also took note of the fact that both NSDL and CDSL had directed the appellant not to open new demat accounts till the matter was thoroughly investigated. In the light of the material available with the Board it passed an order on 12.1.2006 in the case of IDFC IPO the relevant portion of which reads as under:

> " 11.20. The above facts cast grave doubts as to the genuineness of the thousands of IPO applicants who have apparently furnished the address of Roopalben Panchal or Sugandh or Purshottam Budhwani as their address. **The findings of the**

investigation/inspection of the concerned banks by RBI has fortified the initial findings of SEBI that Karvy-DP has actively colluded with the above entities in opening multiple/benami bank accounts and dematerialized accounts in the names of fictitious persons.

11.21. Even presuming for the sake of argument that these dematerialized account-holders do exist, the chain of events as adumbrated above, involving a huge population of putative investors who prima facie appear to be mere name-lenders, mostly sharing a common address, having bank accounts with the same Bank and dematerialized accounts with the same Depository Participant and acting in unison demonstrates unity of control by Roopalben Panchal, Sugandh, Purshottam Budhwani and Manojdev Seksaria. Since Roopalben Panchal and Sugandh have in turn transferred the shares to various other entities, it is suspected that Roopalben Panchal and Sugandh were themselves merely a front for financiers."

In view of the above findings the Board in its order dated 12.1.2006 issued ex parte ad interim directions as under:

"12.1. In the interim, in view of the grave emergency arising out of the conduct of parties with the added risk that such devious practices, if unchecked, would be continued with impunity in future and, with a view to protect the interest of investors and

securities market from further such acts, in exercise of the powers delegated to me by the SEBI Board in terms of Section 19 of the Securities and Exchange Board of India Act 1992 read with Section 11B and 11 (4)(b), pending investigation and passing of final order, I hereby issue the following directions, by way of ad interim, ex parte order:

12.2 The following entities are directed not to buy, sell or deal in the securities market, directly or indirectly, till further directions:

i. Ms. Roopalben Nareshbhai Panchal.

ii. Sugandh Estates & Investments P Ltd.

iii. Shri Purshottam Ghanshyam Budhwani

iv. Shri Manojdev Seksaria

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12.4. NSDL and CDSL are directed to ensure that the dematerialized accounts which served as conduit for Roopalben Panchal, Sugandh, Purshottam Budhwani and Manojdev Seksaria are not utilized for manipulation of IPO allotment in future.

12.5. Thousands of dematerialized accounts being opened on the same day with the same branch and being introduced by the same bank should have alerted the DPs at the time of opening of the dematerialized accounts. **However the fact that DPs failed to exercise even this basic due diligence gives rise to a suspicion that they have actively colluded with the perpetrators. It is a**

matter of serious concern that Karvy-DP has opened such apparently benami/fictitious accounts working out to over 95% (42,056 nos) of the multiple dematerialized accounts in relation to IDFC IPO. I note that Karvy-DP has already been directed by the depositories to verify the genuineness of the dematerialized account-holders and to close those dematerialized accounts where it is unable to verify the genuineness of identity and address of the dematerialized account holders. The depositories have prohibited Karvy-DP from opening new dematerialized accounts till the above process has been completed. I hereby direct Karvy-DP and Pratik-DP to complete the process of verifying the identity and address of dematerialized account-holders and to close/freeze the dematerialized accounts where they are unable to do the verification not later than January 31, 2006. Further Karvy-DP and Pratik-DP shall put in place systems and procedures to ensure that in future no non-genuine dematerialized accounts are opened by them. Karvy-DP and Pratik-DP shall submit a detailed report to SEBI narrating the actions taken by them in this regard and also give an undertaking that the SEBI's above directions have been fully complied with. I further direct

that Karvy-DP and Pratik-DP shall not open new dematerialized accounts till the submission of above report and undertaking to SEBI and obtaining a no-objection from SEBI for accepting fresh business as DP.

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12.12. Further the entities/persons against whom this direction is issued may file their objections, if any, to this order within 15 days from the date of this order and, if they so desire, avail themselves of an opportunity of personal hearing at the Securities and Exchange Board of India, Head Office, First Floor, Mittal Court, B Wing, Nariman Point, Mumbai – 400 021 on a date and at a time to be fixed on a specific request, to be received in this behalf from the entities/persons within 15 days from the date of this order.

This order shall come into force with immediate effect."

Even before the aforesaid order could be issued, the appellant herein addressed a detailed communication dated 12.1.2006 to the Board by way of a voluntary action taken report and brought to the notice of the Board the various steps which, according to it, it had taken in the light of the queries made by the Board during the course of the

investigations in the YBL case and also in the light of the observations made by the two depositories in their reports submitted to the Board.

It appears that after passing the aforesaid order on January 12, 2006 in the case of IDFC IPO, the Board carried out inspection of the books of accounts, records and various documents maintained by the appellant. During the course of the inspection the Board, according to it, collected sufficient incriminating documents and the inspection raised a doubt in its mind as to whether the appellant had really failed to get alerted to the abuse of its systems by the so called sub brokers or whether there was active collusion of the appellant with its clients for abusing the IPO process and sharing the gains arising from the same. The Board prima facie concluded as under:

> **"As may be seen from the discussions in the following paragraphs, it appears that Karvy DP having strategised the business plan for wrenching the IPO market, aided abetted and actively colluded with Roopalben Panchal and other clients by not only opening thousands of dematerialized accounts in fictitious /benami names in gross disregard of KYC norms and providing/arranging IPO finance to these benami/fictitious entities but also by indulging in fabrication of documents to cover the tracks."**

The Board also found that in order to seemingly comply with the KYC norms, the bank letterheads were forged and photographs were affixed on

both the bank letters and the demat application forms and it further concluded that the appellant had done post event documentation as an after thought to cover up its lapses and to set the records straight for a possible inquiry by the Board. In view of these prima facie findings another order was passed on April 27, 2006 issuing amongst others, the following direction to the appellant:

> SEBI vide ex-parte ad interim order dated January 12, 2006 in the case of IDFC has already directed Karvy DP and Pratik DP not to open new dematerialized accounts till the submission of verification report and obtaining a no-objection from SEBI for accepting fresh business as a DP. In view of the detailed findings against Karvy DP and Pratik DP in the order, Karvy DP and Pratik DP, in my view prima facie do not appear to be fit to deal in securities market as SEBI registered intermediaries. Appropriate quasi-judicial proceedings are being initiated against the two DPs. In view of the substantial findings of a serious nature brought out in this order against Karvy DP and Pratik DP, in addition to what has been noticed in the earlier two interim orders in the cases of Yes Bank and IDFC, I direct that Karvy DP and Pratik DP shall not carry on the activities as DP till the completion of inquiry and passing of final order, excepting (sic) for effecting transfer of BO account to another SEBI registered DP on request. Notwithstanding this direction, Karvy DP and Pratik DP shall continue to be

governed by the SEBI (Depositories and Participants) Regulations, 1996 and other applicable legal provisions in other aspects."

This order was to be treated as show cause notice and the persons against whom the order was issued were required to file their objections within 15 days from the date of the order so that they could be given post decisional hearing in terms of the second proviso to section 11(4) of the Act. The appellant filed a detailed reply dated May 9, 2006 rebutting all the allegations levelled against it. It was also contended by the appellant that since the interim order dated 12.1.2006 was still continuing to operate, there was no urgency to issue ex parte directions under section 11(4) and 11B of the Act. The appellant also submitted that the Board could not take punitive action under sections 11 and 11B and for these reasons the ex parte directions issued by the Board stood vitiated. It was also pleaded that it was not a fit case to pass interim directions thereby stopping further business of the appellant. After considering the reply filed by the appellant and the oral submissions made on its behalf the Board concluded "that the present proceeding cannot assume the role of a full fledged inquiry. Its purpose merely is to consider the submissions made at the post decisional hearing with a view to decide whether the ad interim order should be continued, varied or revoked". The Board also observed that an inquiry under the Securities and Exchange Board of India (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002 (hereinafter called the inquiry regulations) has been initiated and "point by point examination of the factual submissions of the noticees

will be done by the Enquiry Officer in light of the available evidence." The Board did not find the explanation given by the appellant to be convincing in view of the fact that thousands of demat accounts had been opened with common addresses by fictitious persons and also in view of the fact that more than 10,000 accounts were opened in one day. The Board also found that the appellant as a depository participant had not exercised due diligence while establishing the identity of the persons to ensure the safety and integrity of the depository system. The explanation furnished by the appellant that it had placed blind faith in its IPO sub brokers was not accepted, as according to the Board it was an after thought because the primary responsibility in this regard was that of the appellant as a depository participant. The Board also noticed that the appellant had expanded its business by exploiting its relationship with its sub brokers which was a tangible gain. Having considered the explanation of the appellant and from the data relating to the demat accounts closed by the appellant, the Board concluded that numerous demat accounts with common addresses had been opened and the common addresses were those of the appellant's sub brokers referred to hereinabove and, therefore, it observed that the prima facie findings in this regard had not been rebutted by the appellant. The Board had also recorded a prima facie finding in its order dated 27.4.2006 that the appellant had forged bank letters to make it appear that it had complied with the KYC norms and that finding too has not been displaced. The Board observed that "in view of the substantial prima facie findings of misconduct as a DP, the entity KSBL has conducted themselves in a manner unbecoming of a registered securities market intermediary."

In view of the aforesaid conclusions arrived at by the Board in its order dated May 26, 2006 it issued the following directions:

> "(a) KSBL is directed not to act as a depository participant, pending enquiry and passing of final orders, except for acting on the instructions of existing beneficial owners, so that the interests of existing BOs remain unaffected. It shall transfer the demat account of an existing BO to another SEBI registered DP, on request. It is clarified that KSBL shall continue to be governed by the SEBI (Depositories and Participants) Regulations, 1996 and other applicable legal provisions.
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> (b) KSBL, as a stock broker is directed not to undertake any proprietary trades in securities, either off-market or on market, pending enquiry and passing of final orders.
>
> (c)..... ....."

An inquiry officer has been appointed to conduct an inquiry under the inquiry regulations which has just begun. Feeling aggrieved by these directions, the appellant has filed the present appeal.

The learned Senior Counsel for the appellant strenuously contended that the impugned order is punitive in nature and without jurisdiction in as much as the appellant has been restrained from opening new accounts pending the outcome of the inquiry under the inquiry regulations and this, according to him, amounts to an interim punishment which power the Board does not possess. According to the learned senior counsel an intermediary could be

kept out of the market only by passing a regulatory order under sections 11 or 11B which is not the case here. He urged that sections 11 and 11B are a code by themselves and the inquiry contemplated therein is only for the purpose of passing a regulatory order and that such an order could not be linked with the outcome of the inquiry.

On merits it is contended on behalf of the appellant that even though very large number of demat accounts had been opened with the appellant in the name of fictitious persons, they were all closed/frozen as per the directions of the depositories and the Board after verifying the genuineness of the account holders. These demat accounts were opened, according to the appellant, in the last two years with most of them being opened during the periods coinciding with various IPOs. It is the categoric stand of the appellant that the account opening application forms were brought by the so called different IPO sub brokers with an introductory letter from the client's banker in support of the proof of identity and proof of address. Even though the letters from the bank later turned out to be forged, those appeared on the face of it to be genuine and there was no occasion for the appellant to suspect the bonafides of the applicants whose identification had been certified by their banker. Moreover, the said bank certificates were computer generated and did not give rise to any suspicion. He also contended that the Board has drawn a wrong inference from the downloading of data by the appellant from CDSL during July, 2005. The Board had inferred that by frequently accessing the data base of CDSL in July 2005 the appellant had culled out the particulars of bank branches and addresses which it later used in fabricating the bank certificates. According to the

learned senior counsel, the appellant downloaded the data for its various business needs in the normal course of business. He contended that it was not possible for it to foresee in July itself about the events which were discovered in November-December, 2005. The learned senior counsel, therefore, forcefully submitted that the Board's inference in this regard is totally wrong and unwarranted. The bank letters were accepted by the appellant as according to it those were according to the KYC norms prescribed by the depositories and the Board. As regards the different demat accounts of the same account holders having different photographs, the appellant submitted that there was no occasion for it to suspect the genuineness of those photographs as there was no mechanism to identify or cull out the same photographs as they appeared in the subsequent or different lots of applications. What is contended on behalf of the appellant is that close to an IPO, applications for opening new demat accounts were received in thousands and those were dealt with by different persons in different lots and that when the appellant learnt about the fictitious accounts the same were closed. The learned senior counsel very strongly contended that the appellant itself had been defrauded by the sub brokers in the matter of opening of new demat accounts close to different IPOs and that when all this was discovered, it (appellant) besides closing the fictitious accounts filed a criminal complaint against the sub brokers which is pending in the Court of IIIrd Addl. Chief Metropolitan Magistrate at Hyderabad. The learned senior counsel urged that the Board was not justified in recording a prima facie finding that the appellant had colluded in the opening of fictitious accounts when it itself had been defrauded by the so called sub brokers or business

associates who had committed breach of trust with the intention to cheat the genuine investors. In the alternative the learned senior counsel contended that even if it be assumed that the bank letters were forged, even then according to the Board, this was done in order to make it appear as if the appellant had complied with KYC norms when in fact they had been totally disregarded. The gravamen of the charge, according to the appellant, is that it had done post event documentation as an after thought to set the record straight with a view to cover up its lapses in not complying with the KYC norms and that the charge is not that the appellant colluded in the opening of demat accounts. This charge, according to the learned senior counsel, only amounts to non compliance of the KYC norms and is not that serious so as to warrant a direction to the appellant not to open new demat accounts till the completion of the inquiry. It was also contended on behalf of the appellant that fictitious demat accounts with common addresses were opened not only with the appellant but also with other depository participants like HDFC, IDBI, ICICI etc. and that the practice of using IPO sub brokers was then prevailing in the market and was well established and recognized. It was also submitted that the requirement at the relevant time was to provide only the correspondence address in NSDL and either correspondence address or permanent address in CDSL and the sub brokers gave their own address as correspondence address and this according to the appellants, was not an unusual practice. The appellant submits that the issue of common address was a systemic issue and is not peculiar to the appellant alone. The appellant also seriously disputed the finding of the Board that it had introduced 50 additional names which were added by enclosing a list

with the account opening form of its sub broker (Roopalben Panchal) whose transactions were to be included in the sub broker's bank account. It was also contended that the Board was in error in concluding that delivery instruction slips (DIS) had been generated by the appellant to make up the record by conveniently using the credit identification number (CIN) along with the debit identification number (DIN). Reference was made to the instruction slips for delivery in support of this plea. The learned senior counsel for the appellant further submitted that Karvy Consultants Limited, a company of the Karvy group which is a non banking finance company had provided IPO funding to the investors in the normal course of its business and that there was nothing wrong in its receiving back the amount from the account of Roopalben Panchal which was towards the return of loan in the case of another IPO (Amar Remedies). In view of the aforesaid submissions, the appellant contends that even though fictitious demat accounts were opened by a large number of depositors, the appellant had not connived in the opening of those accounts and that the sub brokers had cheated the appellant itself in the opening of those accounts.

Shri J. J. Bhatt, learned senior counsel appearing for the Board, on the other hand, was emphatic in contending that section 11, in so far as an intermediary of the market is concerned, gives power to the Board to adopt interim measures in the interests of the investors or the securities market pending completion of an investigation or inquiry. According to the learned senior counsel, section 11 also gives power to pass final orders against registered intermediaries if there was no suspension or cancellation of the certificate of registration under section 12(3) of the Act. He also

submitted that the very nature of the measures prescribed in section 11(4)(a) to (f) would show that these are interim in nature and that no final order could be passed thereunder. Final order qua intermediaries could be passed, according to Shri Bhatt under section 11B after ordering an inquiry under that provision or under the inquiry regulations. Any interim and/or final directions against non intermediaries could, however, be passed under section 11(4) read with section 11B after ordering an inquiry under that provision. According to Shri Bhatt the word inquiry in section 11(4) would mean an inquiry either under section 11B or under Chapter VIA or under the inquiry regulations framed under section 12(3) of the Act and that while such an inquiry is pending the Board could, according to him, pass interim orders pending final decision in that inquiry. Shri Bhatt nevertheless argued that orders under sections 11 and 11B could be passed only for the development of the securities market or to protect the interests of the investors or to prevent the affairs of any intermediary from being conducted in a manner detrimental to the interests of investors or to the securities market.

On merits the learned senior counsel for the Board pointed out that it is not in dispute that thousands of benami/fictitious demat accounts were opened with various depository participants and that 85% of such accounts were opened with the appellant. He also referred to the "Idea Paper" to contend that the appellant was aware of its responsibilities as a participant and that it was required to carry out due diligence itself and that when we look at the averments made by Karvy in the complaint filed by it against its sub brokers it is clear that in order to gloss over its active or passive complicity in the fraud it has sought to transfer the responsibility of due diligence to

its so called IPO sub brokers who were not the regulated entities. Shri Bhatt also contended that there was a tie up between the appellant and Bharat Overseas Bank for funding various IPOs and that the two of them are trying to shift the blame on each other. His argument is that it was for the appellant to ensure that the demat accounts were duly opened after complying with the KYC norms which admittedly, the appellant failed to comply with in respect of thousands of accounts opened through its IPO sub brokers. He also referred to the large number of accounts with common addresses of the sub brokers. According to Shri J. J. Bhatt several accounts were opened on the basis of forged bank letters which forgery could be detected by a mere cursory look at those letters. He pointed out that the particulars of bank letters matched those in the depository accounts but in many cases they did not match with the records of the banks which purportedly issued those letters. The case of the Board is that in addition to the total failure on the part of the appellant to observe KYC norms, the latter introduced the bank accounts in suspicious circumstances. The learned senior counsel referred to some instances including the case of Jayshree Doshi and pointed out that her signatures on different forms did not tally with the signatures on her PAN (Permanent Account Number) card issued by the Income Tax Department. He argued that genuine demat accounts were used to open fictitious accounts with banks on the introduction of the appellant and on the strength of these bank accounts other fictitious demat accounts were opened with the appellant. It was also argued that the manner in which the appellant filled up, issued and maintained delivery instruction slips clearly points out to the appellant's prima facie complicity and in any case to

its culpable negligence in performing its duties as a participant. Reference was made to the loose delivery slips issued by the appellant which, according to the respondent, did not comply with the guidelines issued by the Board. In view of these submissions it was contented on behalf of the Board that the impugned orders dated 27th April, 2006 and May 26, 2006 are based on relevant considerations and being reasonable were liable to be upheld. The learned senior counsel for the respondent relied upon the Division Bench Judgement of the Bombay High Court in Anand Rathi vs. Securities and Exchange Board of India (2001) 32 SCL 227 to contend that the Board as a regulator of the capital market has powers to take necessary measures to protect the interests of the investors of the securities market and, therefore, it is fully competent to pass interim order in aid of the final orders. He also referred to the unreported decision of the Gujarat High Court in Rajan Vasudevbhai Dhapki & Ors. vs. Securities and Exchange Board of India Special Civil Application No.10523 of 2006 decided on 17.7.2006 and urged that the ex parte order dated 27th April, 2006 passed by the Board had been upheld.

We have heard the learned senior counsel for the parties. Their arguments have been lengthy and the record is voluminous. However, the issue that arises for our consideration is – Has the Board erred in restraining the appellant from opening fresh demat accounts and from carrying on proprietary trades as a stock broker pending inquiry. To answer this question, it is necessary to notice the historical sequence of events and the relevant provisions of the Act.

To promote orderly and healthy growth of the securities market and for investors' protection, the Board was established in the year 1988 through a Government resolution. It had been monitoring the activities of stock exchanges, mutual funds, merchant bankers etc. Since then the capital market witnessed tremendous growth by the increasing participation of the public. Investors' confidence in the capital market had to be sustained by ensuring their protection. To achieve this object, the Act was enacted to vest the Board with statutory powers to deal effectively with all matters relating to capital market. Section 3 of the Act provides for the establishment of the Board which is a body corporate and its composition and management are provided for in section 4. The procedure which it follows and the manner of holding its meetings is provided in Chapter II. Chapter III deals with transfer of assets, liabilities etc. of the then existing Securities and Exchange Board to the newly constituted statutory Board. Chapter IV is significant and deals with its powers and functions. Section 11 of the Act which finds mention in this chapter provides that the duty of the Board is to protect the interests of investors in securities and to promote the development of and to regulate the securities market *by such measures as it thinks fit.* The words in italics indicate the width of power conferred on the Board by the Parliament. It has been empowered to adopt any 'measure' that a situation may demand. Sub section (2) illustratively enumerates the regulatory and promotional measures which the Board may take. Since the Board has to regulate the market, section 12 appearing in Chapter V provides for the registration of intermediaries such as stock brokers, sub brokers, share transfer agents and others. Under sub section (3) of section 12, the Board has power to suspend or

cancel a certificate of registration in such manner as may be determined by the regulations. In this regard the Board has framed the inquiry regulations for imposing minor and major penalties including the penalty of suspension or cancellation of the certificate of registration. Chapter VI deals with the grants by the Central Government to the Board and its finance, accounts and audit. Chapter VIA which was introduced with effect from 25.1.1995 by Act 9 of 1995 makes a provision for adjudication and imposition of monetary penalties on the erring intermediaries and other market participants. Sections 15K to 15Z contained in Chapter VI-B were also introduced in the year 1995 and they provide for appeal to the Securities Appellate Tribunal against the orders passed by the Board and for a further appeal to the Supreme Court under section 15Z. Chapter VII which is the last chapter in the statute deals with miscellaneous matters including power of the Central Government to issue directions to the Board on questions of policy. The Central Government has also power to supercede the Board. Power has been given to the Central Government to frame rules to carry out the purposes of the Act and power has also been given to the Board to make regulations in this regard. The rules and regulations so framed are required to be laid before the Parliament.

Since the answer to the question posed hereinabove depends on the interpretation of sections 11 and 11B, it is necessary to reproduce them at this stage:

POWERS AND FUNCTIONS OF THE BOARD

Functions of Board.

11. (1) Subject to the provisions of this Act, it shall be the duty of the Board to protect the interests of investors in securities and to promote the development of, and to regulate the securities market, by such measures as it thinks fit.

(2) Without prejudice to the generality of the foregoing provisions, the measures referred to therein may provide for—

(*a*) regulating the business in stock exchanges and any other securities markets;

(*b*) registering and regulating the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and such other intermediaries who may be associated with securities markets in any manner;

(*ba*)registering and regulating the working of the depositories, participants, custodians of securities, foreign institutional investors, credit rating agencies and such other intermediaries as the Board may, by notification, specify in this behalf;

(*c*) registering and regulating the working of venture capital funds and collective investment schemes, including mutual funds;

(*d*) promoting and regulating self-regulatory organisations;

(*e*) prohibiting fraudulent and unfair trade practices relating to securities markets;

(*f*) promoting investors' education and training of intermediaries of securities markets;

(*g*) prohibiting insider trading in securities;

(*h*) regulating substantial acquisition of shares and take over of companies;

(*i*) calling for information from, undertaking inspection, conducting inquiries and audits of the stock exchanges, mutual funds, other persons associated with the securities market, intermediaries and self-regulatory organisations in the securities market;

(*ia*) calling for information and record from any bank or any other authority or board or corporation established or constituted by or under any Central, State or Provincial Act in respect of any transaction in securities which is under investigation or inquiry by the Board;

(*j*) performing such functions and exercising such powers under the provisions of the Securities Contracts (Regulation) Act, 1956 (42 of 1956), as may be delegated to it by the Central Government;

(*k*) levying fees or other charges for carrying out the purposes of this section;

(*l*) conducting research for the above purposes;

(*la*) calling from or furnishing to any such agencies, as may be specified by the Board, such information as may be considered necessary by it for the efficient discharge of its functions;

(*m*) performing such other functions as may be prescribed.

(2A) Without prejudice to the provisions contained in sub-section (2), the Board may take measures to undertake inspection of any book, or register, or other document or record of any listed public company or a public company (not being intermediaries referred to in section 12) which intends to get its securities listed on any recognised stock exchange where the Board has reasonable grounds to believe that such company has been indulging in insider trading or fraudulent and unfair trade practices relating to securities market.

(3) Notwithstanding anything contained in any other law for the time being in force while exercising the powers under clause (*i*) or clause (*ia*) of sub-section (2) or sub-section (*2A*), the Board shall have the same powers as are vested in a civil court under the Code of Civil Procedure, 1908 (5 of 1908), while trying a suit, in respect of the following matters, namely :—

(*i*) the discovery and production of books of account and other documents, at such place and such time as may be specified by the Board;

(*ii*) summoning and enforcing the attendance of persons and examining them on oath;

(*iii*) inspection of any books, registers and other documents of any person referred to in section 12, at any place;

(*iv*) inspection of any book, or register, or other document or record of the company referred to in sub-section (2A);

(*v*) issuing commissions for the examination of witnesses or documents.

(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:—

(*a*) suspend the trading of any security in a recognised stock exchange;

(*b*) restrain persons from accessing the securities market and prohibit any person associated with securities market to buy, sell or deal in securities;

(*c*)suspend any office-bearer of any stock exchange or self-regulatory organisation from holding such position;

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

(*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;

(*f*) direct any intermediary or any person associated with the securities market in any manner not to dispose of or alienate an asset forming part of any transaction which is under investigation :

Provided that the Board may, without prejudice to the provisions contained in sub-section (2) or sub-section (2A), take any of the measures specified in clause (*d*) or clause (*e*) or clause (f), in respect of any listed public company or a public company (not being intermediaries referred to in section 12) which intends to get its securities listed on any recognised stock exchange where the Board has reasonable grounds to believe that such company has been indulging in insider trading or fraudulent and unfair trade practices relating to securities market :

Provided further that the Board shall, either before or after passing such orders, give an opportunity of hearing to such intermediaries or persons concerned.

11B.**Power to issue directions --**

Save as otherwise provided in section 11, if after making or causing to be made an inquiry, the Board is satisfied that it is necessary,—

(*i*) in the interest of investors, or orderly development of securities market; or

(*ii*) to prevent the affairs of any intermediary or other persons referred to in section 12 being conducted in a manner detrimental to the interest of investors or securities market; or

(*iii*) to secure the proper management of any such intermediary or person, it may issue such directions,—

(*a*) to any person or class of persons referred to in section 12, or associated with the securities market; or

(*b*) to any company in respect of matters specified in section 11A, as may be appropriate in the interests of investors in securities and the securities market.

The primary function and duty of the Board is to protect the interests of the investors in securities and to regulate the

securities market. The preamble to the Act which declares the dominant purpose also makes it clear that the Board has been established for this purpose. This duty is performed under sections 11 and 11B of the Act which are the very soul and heart of it. These two sections are the very reason for the existence of the Board. The Act as originally enacted in the year 1992 had only sub sections (1) and (2) in section 11. The Act and the Securities Contracts (Regulation) Act, 1956 then governed the operation of the capital market. Under section 11, as it then stood, the Board could regulate the securities market by taking such measures as it thought fit but it felt handicapped when it came to issuing directions to any market intermediary or persons associated with the securities market. On the basis of the past experience of the Board, a need was felt to amend the Act to enable it to issue directions, whenever necessary, for the purpose of protecting the interests of investors and the securities market. Parliament by Act 9 of 1995 introduced section 11B with effect from 25.1.1995. This section enables the Board to issue directions to any intermediary of the securities market or any other person associated therewith if it thinks it is necessary in the interests of investors or orderly development of securities market or to prevent the affairs of any intermediary or any other person referred to in section 12 from being conducted in a manner detrimental to the interests of investors or securities market or to secure the proper management of any such intermediary. For regulating the securities market and with a view to protect the same, the Board started issuing interim orders/directions under this newly added provision to keep the erring intermediaries or other delinquents associated therewith out of the market. The exercise of this power was

challenged in different courts and even though the same was upheld, Parliament thought that the provisions of the Act were inadequate and in its wisdom amended section 11 by introducing sub section (4) therein with effect from 29.10.2002 and gave specific power to the Board to pass interim as well as final orders in the interests of investors or the securities market. This sub section provides that the Board may, by order, for reasons to be recorded in writing, in the interests of investors or securities market take any of the measures referred to therein. The measures that the Board may take or the nature of the order that could be passed under this newly added sub section is to suspend the trading of any security in a recognized stock exchange or restrain persons from accessing the securities market and prohibit any person associated therewith to buy, sell or deal in securities. The Board may also suspend any office bearer of any stock exchange or any self regulatory organization from holding such position, impound and retain the proceeds or securities in respect of any transaction which is under investigation, attach the bank accounts of any intermediary or restrain any intermediary or any person associated with the market from disposing of or alienating any asset forming part of a transaction which is under investigation. As is clear from the language of sub section (4) the measures that the Board may take or the orders that it may pass would be "either pending investigation or enquiry or on completion of such investigation or enquiry". The word 'investigation' as used in section 11(4) has not been defined. It obviously refers to the investigation as ordered under section 11-C of the Act because sections 11-C and 11(4) were introduced simultaneously in the year 2002 when Parliament found that the Board prior to their introduction did not

have statutory power to investigate. The word 'inquiry' too has not been defined in the Act though it finds mention in Sections 11, 11B, 11D and 15I. Under section 12(3) of the Act also, the Board holds an inquiry under the inquiry regulations for imposing major or minor penalties including the penalty of suspension or cancellation of a certificate of registration. It is, thus, clear that an inquiry is held under sections 11, 11B and 11D, it is also held under section 12(3) and also under section15I. Having regard to the scheme of the Act, the rules and regulations made thereunder we are clearly of the view that even though the inquiries contemplated by the Act may be held under different set of provisions, their object is one and the same viz. to help the Board to promote the development of and to regulate the securities market and protect the interests of investors. The inquiry under section 11 of the Act is held by the Board to find out what measures it needs to take to protect the interests of the investors and what steps it needs to take to promote the development of and to regulate the securities market. Similarly, the inquiry which the Board is required to make or causes to be made under section 11B is to find out what directions should be issued to an intermediary or any person associated with the securities market or to a company in respect of matters referred to in section 11A. As already observed, the Board also causes an inquiry to be made by an inquiry officer under the inquiry regulations and/or by an adjudicating officer under Chapter VIA. It is during the pendency of any of these inquiries or on their completion that the Board may pass appropriate order – interim or final. This is clear from the language of section 11(4). Even under section 11(1) and thereafter with the introduction of section 11B in the year 1995, the power of the Board was very wide and it could

take every measure that a situation would demand and issue such directions that it considered necessary including the suspension of an intermediary. Yet, to put everything beyond the shadow of doubt, even the implicit has been made explicit by adding sub section (4) in Section 11 which now expressly authorizes the Board to issue various kinds of orders, "either pending investigation or enquiry or on completion of such investigation or enquiry". To illustrate: The Board on receipt of a complaint or as a result of any investigation or otherwise has reason to believe that some registered intermediary or any person associated with the securities market has committed or is about to commit any market malpractice or is indulging in any unfair trade practice, it would first of all hold a preliminary inquiry, howsoever brief it may be, to find out whether a case is made out for a further inquiry into the matter. After ascertaining the prima facie facts, it may find that the complaint was baseless. In that event the complaint would be dropped. If the prima facie facts disclose a case for proceeding further in the matter and depending upon the nature and gravity of the wrong doing, it would decide what measures it needs to take under section 11 to protect the securities market and also the interests of the investors. If it feels that immediate preventive action is essential, it can "restrain persons from accessing the securities market and prohibit any person associated with securities market to buy, sell or deal in securities" with immediate effect. Even the proceeds of a transaction which may still be under investigation could be impounded. It may also decide to issue directions under section 11-B of the Act to a registered intermediary or any other person associated with the market with a view to secure the interests of investors in securities and the securities market. If

the facts found in the preliminary inquiry disclose a grave misconduct on the part of an intermediary, it may simultaneously initiate inquiry against the delinquent under the inquiry regulations for imposing any of the penalties referred to therein including the penalty of suspension or cancellation of his certificate of registration so that he may get an opportunity to defend himself and establish his innocence. This is also the requirement of the proviso to sub section (3) of section 12 of the Act. If an order is passed imposing a penalty, the same may be punitive so far as the delinquent is concerned, it nevertheless helps the Board in the regulation of the market in as much as it sends the right signals to others. This by itself is a regulatory measure. The Board could impose monetary penalties also in addition to or other than penalties of suspension or cancellation of certificate of registration which may not be appropriate in all cases of defaults.

As already observed, section 11 is the very heart and soul of the Act. This provision has been periodically amended and today it is substantially different from what it was at its inception in the year 1992. The scope of the power has been considerably widened. The introduction of sub section (4) in section 11 and various other provisions like section 11B is indicative of the legislative intent. These provisions are meant to arm the Board with authority so as to be able to effectively exercise power and achieve the declared objectives of the Act. It is clear that a common thread runs through the various provisions of the Act and that is to empower the Board to take preventive as well as punitive measures so as to protect the investor and to promote the securities market. We cannot lose sight of the fact that the Board has to regulate a speculative market and in

such a market varied situations may arise all of which cannot be envisaged and there may be an urgent need to pass an order even when an inquiry or investigation is pending. We cannot even entertain a thought that the Board has no power to restrain an intermediary from accessing the market who is alleged to have committed grave irregularities which may adversely affect the interests of investors or the market.

On an examination of the provisions as noticed above, we find that the legislative scheme is clear. The provisions of the Act are basically intended to protect the interests of the investors and to promote the market. However, the Act as initially enacted provided primarily for taking promotional or protective measures. The power to take preventive or punitive measures was implicit. Now it has been expressly extended to taking even the preventive or punitive measures. Without doubt, these, too, are ultimately aimed at achieving the basic objectives of investor protection and promotion of the development and regulation of the securities market as contained in the preamble.

The question whether the term inquiry referred to in section 11 also includes the inquiry under the inquiry regulations came up before us in Bhoruka Financial Services Ltd. vs. Securities & Exchange Board of India – Appeal No.18 of 2006 decided on 10.5.2006 wherein we observed as under:

> " The term 'enquiry' has also not been given a statutory meaning. However, in the year 1995 the Parliament amended the Act and introduced Chapter VIA containing Sections 15A to 15J by Act 9 of 1995 with effect from 25/01/1995.

This Chapter provides for penalties and adjudication. Penalties can be levied for various violations referred to in this Chapter and Section 15I requires that before any penalty could be levied, the Board shall appoint an adjudicating officer for holding an enquiry in the prescribed manner and give the person concerned a reasonable opportunity of being heard. Apart from the provisions of Chapter VIA, the Board as a regulator with a view to protect the interest of the investors and the integrity of the securities market has framed a host of Regulations for the violation of which it can take action and before it can proceed against those who violate the Regulations it has to hold an enquiry in accordance with the provisions of the Securities and Exchange Board of India (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty)Regulations, 2002 (for short 'the Regulations'). An enquiry under these Regulations can be held for the purpose of passing an order for the contravention of any of the provisions of the Regulations referred to in Regulation 4 of these Regulations. It is, thus, clear that the Board can order an enquiry either for the purpose of imposing a penalty under Chapter VIA of the Act for which an adjudicating

> officer shall be appointed or it may order an enquiry under the Regulations. The word enquiry referred to in Section 11(4) of the Act refers to either of these two enquiries and it is during the pendency of such an enquiry that Section 11(4) empowers the Board to pass an interim order/directions."

In view of the above, we hold that the word 'inquiry' used in section 11(4) refers to the inquiries held under sections 11, 11B, also to the enquiry under the inquiry regulations framed under section 12(3) and also to the inquiry held under Chapter VIA and it is during the pendency of any of these inquiries that an interim order could be passed with a view to protect the interests of investors or in the interest of the market. It is in this background of the legal position that we have to examine the validity of the impugned order.

When we examine the impugned order this is what we find: the Board has prima facie found that the so called IPO sub brokers of the appellant had cornered lacs of IPO shares reserved for retail applicants by making applications in the retail category by opening thousands of fictitious/benami demat accounts with the appellant which shares were subsequently transferred to those who made the funds available for executing the game plan. As already observed, the Board found that Roopalben Panchal, one of the sub brokers of the appellant had received more than 39 lac shares in off market transactions in her demat account with CDSL and more than 32 lac shares in her demat account with NSDL. This was only in regard to one IPO in the case of IDFC. Similarly, other sub brokers had also

acquired shares in the same manner. The appellant says that it could at the most be said to have failed in exercising due diligence and to comply with KYC norms at the time of opening of demat accounts but it did not connive with the sub brokers. It also claims to have been cheated by its sub brokers. The Board, on the other hand has found prima facie after inspecting the records of the appellant that the latter appears to have aided, abetted and actively colluded with the sub brokers and other clients by not only opening thousands of fictitious/benami demat accounts by disregarding the KYC norms but also indulged in fabricating bank documents to cover up its lapses. What needs to be examined is whether the appellant had really failed to get alerted to the abuse of its systems by the so called sub-brokers or whether there was active collusion of the appellant with its clients for abusing the IPO process and sharing the gains arising from the same. We cannot decide these issues at this stage nor can it be said as to which of these two versions is correct. It is an undisputed fact that thousands of fictitious/benami demat accounts were opened with the appellant with common addresses and more than 10000 accounts were opened on one single day. The appellant was under a duty to check and comply with the various norms. The obvious appears to have been overlooked. Is the action of the appellant innocent is the question. The appellant is clearly under a cloud and the truth can be known only after a detailed inquiry. The findings of the inquiry will either remove the appellant or the cloud. Till then the impugned order passed by the Board will operate which is in conformity with the provisions of the Act, rules and the regulations framed thereunder. Since the enquiry is pending, the Board had power to pass the impugned order

restraining the appellant from opening fresh demat accounts and from carrying on proprietary trades as a stock broker. No fault can thus be found with the said order. In view of the fact that the matter is pending with the enquiry officer, we have refrained from making comments on the merits of any of the contentions advance by either party.

It was also argued on behalf of the appellant that the Board was not justified in issuing ex-parte directions on April 27, 2006 when a restraint order dated 12.1.2006 passed in the case of IDFC was already operating against the appellant. We cannot agree with the learned senior counsel for the appellant. It is true that a restraint order dated 12.1.2006 was operating but till that time the Board had with it the investigation report in the case of IDFC IPO on the basis of which it had some suspicion about the role played by the appellant in the opening of thousands of fictitious/benami demat accounts. After passing of the order on 12.1.2006 the Board undertook an inspection of the records of the appellant and collected material which according to it establishes the connivance of the appellant in the opening of large scale fictitious/benami demat accounts. It was then that the Board issued the impugned directions on April 27, 2006 by the ex parte order which has been confirmed after affording a post decisional hearing to the appellant in terms of the second proviso to section 11(4) of the Act. In the circumstances, we find that the Board was justified in issuing the directions as aforesaid though the correctness of the allegations made would be gone into by the enquiry officer.

Before concluding, we may also notice another contention raised on behalf of the appellant. The learned senior counsel urged

that the findings recorded in the impugned order are strongly worded and they do not leave any scope for the enquiry officer to decide any issue all of which have already been decided by the impugned order. We are unable to accept this contention. Much as we wish that the impugned order had been brief and short, the findings recorded therein, though strongly worded, are only prima facie. It would be open to the appellant to rebut the allegations by leading evidence before the enquiry officer. Since the findings recorded in the impugned order are only prima facie we have no doubt in our mind that the enquiry officer will record his findings based on the material that is placed before him. However, in order to allay the fears in the mind of the appellant we direct the enquiry officer to record his findings without being influenced by any observation made in the impugned order. He is further directed to complete the enquiry expeditiously but not later than 3tst March, 2007. The Board will then take a final decision thereon in accordance with law within two months thereafter.

In the result, the appeal fails and the same is dismissed with no order as to costs.

Sd/-

Justice N. K. Sodhi
Presiding Officer

Sd/-

C. Bhattacharya
Member

Sd/-

R. N. Bhardwaj,
Member

Smn/