

# Dispute Resolution Hotline

June 15, 2022

## CAN A REGULATOR HIDE ITS INVESTIGATION REPORT WHICH HAS BEEN RELIED UPON AS PART OF ITS ADJUDICATION?

Supreme Court held that:

- A quasi-judicial authority has a duty to disclose the material relied upon at the stage of adjudication, and the test is whether such material is relevant for the purpose of the adjudication.
- An authority's *ipse dixit* (unproven assertion) that it has not relied on certain material would not exempt it from its liability to disclose such material "if it is relevant to and has a nexus to the action that is taken by the authority".
- Disclosure of information serves the purposes of reliability, fair trial, and transparency and accountability.
- Right to disclosure is not absolute and may affect other third-party interests and the stability and orderly functioning of the securities market. In such a scenario, SEBI should *prima facie* establish the impact of the disclosure.
- Where some portions of the enquiry report involve information on third parties or confidential information on the securities market, SEBI cannot for that reason assert privilege against disclosing any part of the report. While SEBI can withhold the disclosure of those sections of the report, however, it is duty bound to provide copies of such part of the report which concern the specific allegations made in the show cause notice.

### INTRODUCTION

Recently, the Supreme Court of India ("Supreme Court") pronounced a landmark decision in *T. Takano v. Securities & Exchange Board of India*<sup>1</sup> illuminating the position on disclosure of documents in judicial and quasi-judicial proceedings against a person charged with a violation.

Forums adjudicating upon an individual's allegedly violative actions are innumerable. They wield considerable power and discretion conferred upon them either by way of ambiguous language in statutes or delegated legislations or the absence of any provision to that effect. However, principles of natural justice have been incorporated as a mandate to be followed by judicial and quasi-judicial bodies alike to preclude authorities from possessing such unreasonable power. In this analysis, we attempt to examine and analyze the Supreme Court's decision and offer our views with respect to the implications of this decision.

### FINANCIAL IRREGULARITIES IN ACCOUNTS

BSR & Co. were appointed as Ricoh India Limited ("Company")'s statutory auditors in 2016 ("Auditors"). The Auditors suspected certain discrepancies in the Company's financial statements for the quarters ended 30 June 2015 and 30 September 2015. Consequently, the Company's audit committee appointed PWC to carry out a forensic audit of the financial statements. Upon receiving Price Water House Coopers ("PWC")'s preliminary report on 20 April 2016, the Company reached out to Securities & Exchange Board of India ("SEBI") stating that the financial statements for the two quarters did not reflect the true affairs of the Company and requested SEBI to carry out an independent investigation for possible violations of the SEBI (Prohibition of Fraudulent and Unfair Trade Practices) Regulations 2003 ("Regulations"). PWC's final report was shared with SEBI on 29 November 2016.

### SEBI PROCEEDINGS AND INVESTIGATION

Summons were issued to the managing director, chief financial officer and chief operating officer of the Company for the financial year 2015-16. While the Company suspected these individuals to have misstated the Company's financial affairs, SEBI in an *ex parte* order-cum-show cause notice *prima facie* found the Appellant (and two others) responsible for facilitating such misstatement as well. The Appellant was implicated on the basis that he was the managing director of the Company when the fraud started. Upon further investigation by SEBI, it was noted that the misstatements began from 2012-13 and the Company suffered a loss due to transfer to third parties, write-offs and a sale made to Fourth Dimension Solutions Limited ("FDSL"), and that the share prices of the Company had gone up due to such misstatements.

The violations levied against the Appellant along with five others ("Noticees") were of Section 12A(a), 12A(b) and 12A(c)<sup>2</sup> of the SEBI Act, and Regulations 3(b), 3(c), 3(d), 4(1), 4(2)(e), 4(2)(k), and 4(2)(n)<sup>3</sup> of the Regulations. SEBI in an *ex parte* order dated 12 February 2018 *inter alia* (a) directed a detailed forensic audit of the books of accounts of the Company from 2012-13 and called for its report within 3 months; (b) issued a show cause notice ("1<sup>st</sup> SCN") for directions under Sections 11, 11(4), 11B of the SEBI Act<sup>4</sup> (including directions for restraining/ prohibiting him from accessing the securities market and ; (c) The Appellant and five other managerial persons were restrained from

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The Appellant submitted that – *firstly*, the Appellant had no knowledge of the misstatements and transactions; *second*, the inclusion of his name in the 1<sup>st</sup> SCN was speculative and only made assuming that he also had a role to play since the succeeding managing director did; *third*, only the financial team was privy to the intricacies of the financial statements.

SEBI *vide* an order dated 16 August 2018 confirmed the *ex-parte* order of 12 February 2018, and stated that the chronology of the irregularities and the exact roles of the Noticees had not been ascertained, and hence, giving credence to the submissions of individual Noticees would be “*premature*”. Accordingly, Pipara & Co. were appointed on 20 February 2019 to conduct a forensic audit of the books of accounts of the Company, and they submitted their report on 25 October 2019.

The Appellant challenged the order dated 16 August 2018 before SAT, Mumbai. The SAT allowed the appeal and quashed the order on 29 January 2020 on account of *inter alia* the following – (a) the order was only based on a suspicion about the Appellant’s role; (b) Appellant’s submissions were not addressed adequately; and (c) Appellant was not in a position to influence decisions since the Company was in insolvency. However, SAT gave SEBI the permission to issue a fresh SCN in case evidence against the Appellant surfaces through the forensic audit report or SEBI’s investigation.

Accordingly, a fresh show cause notice was issued on 19 March 2020 by SEBI under Sections 11(1), 11(4), 11((4A), 11B(1), 11B(2), 15HA of the SEBI Act and Section 12A(2) r/w 23H of the Securities Contracts (Regulation) Act 1956 (“**SCRA**”) (“**2<sup>nd</sup> SCN**”), on the basis of the forensic report and SEBI’s investigation. The Appellant responded to the 2<sup>nd</sup> SCN stating that although he had received the forensic audit report submitted by Pipara & Co, he had not received SEBI’s investigation report (“**Report**”) and in turn, requested inspection of all material “*on which reliance has been placed...and on which reliance is intended to be placed.*”. SEBI, in response, claimed that the Report is an “*internal document*” which cannot be shared. Upon the Appellant’s reiteration of his request for inspection, SEBI claimed that the Report was not relied upon to issue the SCN, and hence, would not be provided.

## APPEAL BEFORE THE BOMBAY HIGH COURT

The Appellant filed a writ petition before the Bombay High Court (“**HC**”) challenging the 2<sup>nd</sup> SCN. The alternate prayer was to allow the inspection of the material sought, and it was contended that:

- a. The 2<sup>nd</sup> SCN is bad in law as it violates the procedure laid down under the Regulations; and
- b. SEBI’s action to proceed further with the enquiry without furnishing necessary documents is in breach of principles of natural justice.

While the Appellant contended that non-disclosure of all the relevant documents relied on to issue the show cause notice violated the principles of natural justice, the HC by judgment dated 29 September 2020 held that the investigation report prepared under Regulation 9 of the Regulations<sup>5</sup> is solely for internal purposes. In coming to the conclusion, the HC relied on the judgment of the Supreme Court in *Natwar Singh v. Directorate of Enforcement*<sup>6</sup>. In substance, the HC concluded that the report does not form the basis of the show cause notice and therefore, need not be disclosed. The review petition challenging the judgment was also rejected.

## SUBMISSIONS MADE BEFORE THE SUPREME COURT

The Appellant contended that:

- It was contended that Regulation 10<sup>7</sup> has two requirements, (i) consideration of the investigation report and satisfaction on such consideration that there is a violation of the Regulations and (ii) hearing. There is no intermediate stage between the consideration of the report and the adjudication of liability, making the investigation report primary material which the adjudicator relies upon under the Regulations.;
- HC erred in holding that the Report is a preliminary report and to be used for “*internal administrative discipline*”, as suggested by SEBI before the HC;
- HC erred in observing that the Report was not used against the Appellant;
- Duty to disclose is invoked when a request made for a document is found to be reasonable and relevant for the defense to be taken by the noticee;
- Risk of conferring unfettered discretion to SEBI;
- Redactions can be made with written reasons supporting the same, such as business secrets and personal data.
- Relied on the judgment of the Supreme Court in *Natwar Singh and Khudiram Das v. State of West Bengal*<sup>8</sup> to contend that material relied upon in a quasi-judicial proceeding must be disclosed to the person to whose prejudice such material may be used for taking adverse action, and where a statute prescribes reliance on certain material, such material should be disclosed to opposite party.

SEBI’s submitted that:

- SEBI Act and the SCRA are wider in scope than the Regulations;
- No document other than the ones annexed to the 2<sup>nd</sup> SCN was relied upon for adjudication;
- Regulation 9 does not require furnishing of the Report to the Noticees;
- Report is not a piece of evidence but rather a culmination of documents;
- Disclosure of such information may adversely affect the market; and
- Provisions of the Right to Information Act prohibit disclosure of certain information.

## Scope of judicial interference and inquiry in an application for appointment of arbitrator under the (Indian) Arbitration and Conciliation Act, 1996

## DECISION OF THE SUPREME COURT:

The Supreme Court in its ruling majorly relied on the ruling in *Natwar Singh* and allowed the appeal, setting aside the HC's decision. The Supreme Court made the following key observations<sup>9</sup>:

- a. In *Natwar Singh*, a Show-cause notice had been issued under the Foreign Exchange Management (Adjudication Proceedings and Appeal) Rules 2000, as to why an enquiry should not be initiated against the noticee. While the Supreme Court in *Natwar Singh* had established that "*natural justice requires the disclosure of the reports and evidence in the possession of the deciding authority... unless the scheme of the Act specifically prohibits such disclosure*", it went on to distinguish the stages of proceedings and thereby distinguishing the significance of disclosures therein. Since in *Natwar Singh*, the Show Cause Notice was issued before the stage of investigation, it was sufficient that only documents that have been "*relied upon*" are disclosed.
- b. Relying on *Krishna Chandra Tandon v. Union of India* and *Khudiram Das v. State of West Bengal*, the Supreme Court held that a quasi-judicial authority has a duty to disclose the material relied upon at the stage of adjudication,<sup>10</sup> and the test is whether such material is relevant for the purpose of the adjudication.<sup>11</sup> It further held that an authority's *ipse dixit* (unproven assertion) that it has not relied on certain material would not exempt it from its liability to disclose such material "*if it is relevant to and has a nexus to the action that is taken by the authority*"<sup>12</sup>.
- c. Compliance with the principles of natural justice cannot be interpreted to encompass the right to disclosures pertaining to unconnected matters or matters relating to the dealings of third parties. SEBI must first *prima facie* establish that the disclosure of the Report would affect third party rights. The onus would then shift to the Appellant to prove that the information is necessary to defend his case appropriately.
- d. As a result of the mandate of Regulation 10, SEBI has to consider the Report as an intrinsic element in arriving at its satisfaction whether there has been a violation of the Regulations, and therefore, the Report is not merely an internal document.
- e. The jurisprudence surrounding the principles of access to justice and transparency range from identifying the purpose and extent of disclosure required, to balancing the conflicting claims of access to justice and grounds of public interest such as privacy, confidentiality and market interest. Disclosure of information serves the purposes of reliability<sup>13</sup>, fair trial<sup>14</sup>, and transparency and accountability<sup>15</sup>.
- f. Right to disclosure is not absolute and may affect other third-party interests and the stability and orderly functioning of the securities market. In such a scenario, SEBI should *prima facie* establish that the disclosure of the Report would affect third-party rights and the stability and orderly functioning of the securities market. The onus would then shift to the Appellant to prove that the information is necessary to defend his case appropriately.
- g. Where some portions of the Report involve information on third parties or confidential information on the securities market, SEBI cannot assert privilege against disclosing any part of the Report. While SEBI can withhold the disclosure of those sections of the Report which deal with third party personal information and strategic information bearing upon the stable and orderly functioning of the securities market, however, it is duty bound to provide copies of such part of the report which concern the specific allegations made in the show cause notice.

## ANALYSIS

The Supreme Court has set the record straight with respect to the law on disclosure of material relevant to an investigation. It is pertinent to note that the principles of natural justice have been read into the intent of the Regulations to allow inspection even though such a requirement is not expressly mandated. The amount of discretion in the hands of such quasi-judicial authorities is immense – several cases exist to contend that disclosure is not a prerequisite to a fair hearing and can be dispensed with. The Supreme Court's decision, although does not propound new law, greatly clarifies the scenario wherein disclosures have to be made. Relevance, or '*deemed*' relevance is the deciding factor and not whether reliance has actually been placed on the material or not. Further, the distinction drawn by the Supreme Court between *Natwar Singh* and the present facts was also a welcome move, considering that neither SEBI, nor the HC managed to carefully examine the differences between the two.

Further, it makes a much-required observation with respect to taking a quasi-judicial body's unproven statements with a pinch of salt. The mere word of such an authority that it has not relied upon certain material should indeed not influence the Court to condone such non-disclosure.

That said, the floodgates of what is permissible to be inspected by a noticee and what is not might open soon, in light of this ruling of the Supreme Court. Further, the discretion to redact certain information still remains with the quasi-judicial authority. Although it might not be completely unfettered, such discretion requires some scrutiny to ensure that the noticee is not being unfairly and unjustly deprived of information relevant to his/her case.

— Arth Nagpal, Alipak Banerjee & Vyapak Desai

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<sup>1</sup> 2022 SCC OnLine SC 210

<sup>2</sup> "12A. No person shall directly or indirectly—

(a) use or employ, in connection with the issue, purchase or sale of any securities listed or proposed to be listed on a recognized stock exchange, any manipulative or deceptive device or contrivance in contravention of the provisions of this Act or the rules or the regulations made thereunder;

(b) employ any device, scheme or artifice to defraud in connection with issue or dealing in securities which are listed or proposed to be listed on a recognised stock exchange;

(c) engage in any act, practice, course of business which operates or would operate as fraud or deceit upon any person, in connection with the issue, dealing in securities which are listed or proposed to be listed on a recognised stock exchange, in contravention of the provisions of this Act or the rules or the regulations made thereunder."

<sup>3</sup> 3. "No person shall directly or indirectly—

(b) use or employ, in connection with issue, purchase or sale of any security listed or proposed to be listed in a recognized stock exchange, any manipulative or deceptive device or contrivance in contravention of the provisions of the Act or the rules or the regulations made there under;

(c) employ any device, scheme or artifice to defraud in connection with dealing in or issue of securities which are listed or proposed to be listed on a recognized stock exchange;

(d) engage in any act, practice, course of business which operates or would operate as fraud or deceit upon any person in connection with any dealing in or issue of securities which are listed or proposed to be listed on a recognized stock exchange in contravention of the provisions of the Act or the rules and the regulations made there under.

...

4(1) Without prejudice to the provisions of regulation 3, no person shall indulge in a manipulative, fraudulent or an unfair trade practice in securities markets.

Explanation.—For the removal of doubts, it is clarified that any act of diversion, misutilization or siphoning off of assets or earnings of a company whose securities are listed or any concealment of such act or any device, scheme or artifice to manipulate the books of accounts or financial statement of such a company that would directly or indirectly manipulate the price of securities of that company shall be and shall always be deemed to have been considered as manipulative, fraudulent and an unfair trade practice in the securities market.

4(2) Dealing in securities shall be deemed to be a manipulative fraudulent or an unfair trade practice if it involves any of the following:—

(e) any act or omission amounting to manipulation of the price of a security including, influencing or manipulating the reference price or benchmark price of any securities;

...

(k) disseminating information or advice through any media, whether physical or digital, which the disseminator knows to be false or misleading in a reckless or careless manner and which is designed to, or likely to influence the decision of investors dealing in securities;

...

(r) knowingly planting false or misleading news which may induce sale or purchase of securities."

<sup>4</sup> "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.

11(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, for a period not exceeding ninety days, bank accounts or other property of any intermediary or any person associated with the securities market in any manner involved in violation of any of the provisions of this Act, or the rules or the regulations made thereunder:

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

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

(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.(1) Save as otherwise provided in section 11, if after making or causing to be made an enquiry, 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.

Explanation.— For the removal of doubts, it is hereby declared that the power to issue directions under this section shall include and always be deemed to have been included the power to direct any person, who made profit or averted loss by indulging in any transaction or activity in contravention of the provisions of this Act or regulations made thereunder, to disgorge an amount equivalent to the wrongful gain made or loss averted by such contravention.

11B(2) Without prejudice to the provisions contained in sub-section (1), sub-section (4A) of section 11 and section 15-I, the Board may, by an order, for reasons to be recorded in writing, levy penalty under sections 15A, 15B, 15C, 15D, 15E, 15EA, 15EB, 15F, 15G, 15H, 15HA and 15HB after holding an inquiry in the prescribed manner."

<sup>5</sup> "9. The Investigating Authority shall, on completion of investigation, after taking into account all relevant facts, submit a report to the appointing authority:

Provided that the Investigating Authority may submit an interim report pending completion of investigations if he considers necessary in the interest of investors and the securities market or as directed by the appointing authority."

<sup>6</sup> (2010) 13 SCC 255

<sup>7</sup> "10. The Board may, after consideration of the report referred to in regulation 9, if satisfied that there is a violation of these regulations and after giving a reasonable opportunity of hearing to the persons concerned, issue such directions or take such action as mentioned in regulation 11 and regulation 12:

Provided that the Board may, in the interest of investors and the securities market, pending the receipt of the report of the investigating authority referred to in regulation 9, issue directions under regulation 11:

Provided further that the Board may, in the interest of investors and securities market, dispense with the opportunity of pre-decisional hearing by recording reasons in writing and shall give an opportunity of post-decisional hearing to the persons concerned as expeditiously as possible."

<sup>8</sup> (1975) 2 SCC 81

<sup>9</sup> The summary of the conclusions is set out at paragraph 51 of the judgment.

<sup>10</sup> See paragraph 39 (i) of the judgment.

<sup>11</sup> See paragraph 39 of the judgment.

<sup>12</sup> See paragraph 39 (ii) of the judgment.

<sup>13</sup> See paragraph 22 (i) of the judgment.

<sup>14</sup> See paragraph 22 (ii) of the judgment.

<sup>15</sup> See paragraph 22 (iii) of the judgment.

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