BEFORE THE SECURITIES APPELLATE TRIBUNAL MUMBAI

Appeal No. 6 of 2007

Date of decision : 2.5.2008

Karvy Stock Broking Ltd. …… Appellant

Versus

Securities and Exchange Board of India …… Respondent

Mr. Navroz Seervai Senior Advocate with Mr. Shyam Mehta and Mr. Vinay Chauhan Advocates for the Appellant.
Mr. Rafique Dada Senior Advocate with Dr. Poornima Advani Advocate and Ms. Sejal Shah Advocate for the Respondent.

Coram : Justice N.K. Sodhi, Presiding Officer
Arun Bhargava, Member
Utpal Bhattacharya, Member

Per : Justice N.K. Sodhi, Presiding Officer

The Securities and Exchange Board of India (hereinafter called the Board) received some information regarding the alleged abuse and misuse of the initial public offering (IPO) allotment process. As a part of its ongoing surveillance activity, the Board initiated a probe. The preliminary investigations revealed that certain entities had cornered IPO shares reserved for retail investors by making applications in the retail category through the medium of thousands of fictitious/benami applicants with each application being for small value so as to be eligible for allotment under the retail category. Since some of the demat accounts that had been used for cornering IPO shares had been opened during the year 2003, the Board broadened its investigations to all IPOs between 2003 and 2005. On the basis of the preliminary investigations the Board prima facie found that the appellant as a depository participant (DP) had opened large number of fictitious demat accounts in collusion with its so called sub brokers (application collecting agents) including Roopalben Panchal by disregarding the ‘know

your client' norms and that it also provided finance to the fictitious entities and indulged in fabrication of documents. After examining the role played by the appellant in the IPO scam, 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 investigations also revealed that subsequent to the receipt of IPO allotment, fictitious/benami allottees transferred the shares to the key operators who controlled those accounts and who in turn transferred the shares to the persons financing the transactions, that is, those who made available the funds for executing the game plan. The Board also found that the financiers in turn sold the shares on the first day of the listing and made a windfall gain since the price of allotment was far less than the listing price in view of the booming market. In view of the aforesaid conclusions, the Board by an ex-parte ad-interim order dated April 27, 2006, inter alia, directed the appellant not to carry on the activities as DP till the completion of the enquiry and passing of final order except for effecting transfer of beneficial owner account to another DP on request. Apart from the appellant, 24 key operators including Roopalben Panchal and 82 financiers (as identified by the Board in its order dated April 27, 2006) had also been directed not to buy, sell or deal in the securities market including IPOs till further directions.

(2) As a result of the investigations, the Board further found that the financiers who had received the shares from the key operators were the ultimate beneficiaries of the IPO abuse committed by the key operators and the DPs. It is pertinent to mention that the terms 'Financier' and 'Master Account Holders / Key Operators' were defined in the order. Financier, according to the Board, was one who provided finance for IPO subscription and was the ultimate beneficiary in the scheme of cornering retail allotment

and forking out a big gain on sale immediately after listing. Key operators are the 24 entities including Roopalben Panchal as identified in the said order whose demat accounts were used for temporarily parking credits received from a multitude of afferent accounts before transfer to the financiers. The ex-parte order dated April 27, 2006 was later confirmed in the case of most of the entities by passing separate orders after affording an opportunity of hearing to them. In the case of the appellant, the ex-parte order was confirmed on May 26, 2006. After the completion of investigations, the Board initiated appropriate proceedings against all the concerned entities including the key operators and the financiers and those are in progress. In the case of the appellant two separate proceedings were initiated - (i) enquiry under the Securities and Exchange Board of India (Procedure for Holding Enquiry by Enquiry officer and Imposing Penalty) Regulations, 2002 (enquiry regulations) and (ii) adjudication proceedings under chapter VI A of the Securities and Exchange Board of India Act, 1992 (for short the Act). The Appellant had been found to have played a dubious role as a DP by allegedly opening large number of fictitious demat accounts in collusion with Roopalben Panchal and others. For these illegalities/violations the Board ordered an enquiry under the enquiry regulations. The appellant is also alleged to have financed some transactions as a stock broker and is said to have made an illegal gain of Rs.7,79,125/- for which adjudication proceedings had been ordered by the Board. While appropriate proceedings were pending against the entities concerned including the enquiry and adjudication proceedings against the appellant and when their guilt was yet to be established and whether any of those entities had made any ill-gotten gains was yet to be found out, the Board felt the need to require those entities which, according to it, were perpetrators of the fraud leading to the IPO scam, to disgorge in larger public interest the ill-gotten gains made by them to ensure that those were not hidden or transferred. By an ex-parte order dated November 21, 2006, the Board directed 10 entities including the appellant herein to disgorge a sum of Rs.115.82 crores. Entities which have been asked to disgorge are the two depositories and their participants. Since appropriate proceedings in the form of enquiries and adjudication

proceedings were pending when this ex-parte order came to be passed, the Board observed in para 47 of the order that "**There will be no separate hearing granted to the parties, as the findings of this order will be co-terminus with the findings of the enquiry. A final order on the substantive area of wrong-doing will render a person liable under this order and conversely, any final order exonerating the person will free the person from any liability from this order**." The liability of all the 10 entities to disgorge the aforesaid amount was made joint and several as, according to the Board, they were a party to one large fraud where they either deliberately closed their eyes when the wrong doers perpetrated their illegality or were actively involved in the transactions. Quite interestingly, the Board observed that the exact apportionment of the liability between various parties could be decided by them inter se either by settlement or by suits of indemnity/contribution between each other and from all persons including financiers, key operators and other violators. It was further observed that "**It is not in the interest of the public that the regulator should spend its time in deciding private disputes between various perpetrators of the IPO fraud/cornering of shares**". It is against this order that the present appeal has been filed.

(3) The appellant is one of the 10 entities against whom the impugned order has been passed. It filed the present appeal to challenge that order. The other 9 entities also challenged the order by filing Appeals no. 147 and 149 of 2006, 5 and 7 to 12 of 2007. All these appeals including the present one came up for hearing before us on 22.11.2007. We allowed the appeals of the other nine entities on the short ground that the appellants therein had not been afforded an opportunity of hearing before the impugned order of disgorgement was passed against them. Same is the position with the present appellant. While allowing the other appeals we left it open to the Board to initiate, in accordance with law, disgorgement proceedings against such entities as may become liable to disgorge. The learned senior counsel for the appellant herein did not want us to pass the same order in this appeal. This appeal was accordingly separated from the bunch of other appeals and is being disposed of by this order.

(4) Shri N. H. Seervai learned senior counsel for the appellant took us through the record and strenuously urged that in the case of the appellant, the enquiry proceedings under the enquiry regulations initiated against it had already come to an end and that the appellant had been found guilty of some wrong doings for which a notice was issued to it to show cause why the appellant be not prohibited from acting as a DP for a period of 18 months and that by order dated 22.6.2007 the Board while accepting the enquiry report has prohibited the appellant from opening fresh demat accounts till the end of December 2007. Appeals no. 75 and 111 of 2007 have been filed by the appellant against this order which are pending. He further pointed out that the enquiry officer after holding an enquiry relied upon the findings of the investigating officer and concluded that the appellant had not made any illegal gains and, therefore, the Board having accepted that report could not initiate fresh proceedings for disgorgement against the appellant. Shri Rafique Dada, learned senior counsel, appearing for the Board was equally emphatic in contending that the question of ill-gotten gains made by the appellant has not been examined by the Board in view of the stay order granted by us on 11.1.2007 while admitting this appeal and other appeals. He also argued that in view of the said order, the Board could not have gone into that question and that the appellant whether it be a DP or a registered stock broker, is a composite entity and the Board would like to examine the question of ill-gotten gains, if any, made by it as a result of its wrongful acts. The learned senior counsel took us through the detailed order dated 22.6.2007 and urged that in view of the serious charges established against the appellant and the strong findings recorded against it, it would be in public interest to allow the Board to examine the question of ill-gotten gains made by the appellant.

(5) Before we deal with the contentions of the parties, it is necessary to understand what disgorgement is. It is a common term in developed markets across the world though it is new to the securities market in India. Black's Law Dictionary defines disgorgement as "The act of giving up something (such as profits illegally obtained) on demand or by legal compulsion." In commercial terms, disgorgement is the forced

giving up of profits obtained by illegal or unethical acts. It is a repayment of ill-gotten gains that is imposed on wrongdoers by the courts. Disgorgement is a monetary equitable remedy that is designed to prevent a wrongdoer from unjustly enriching himself as a result of his illegal conduct. It is not a punishment nor is it concerned with the damages sustained by the victims of the unlawful conduct. Disgorgement of ill-gotten gains may be ordered against one who has violated the securities laws/regulations but it is not every violator who could be asked to disgorge. Only such wrongdoers who have made gains as a result of their illegal act(s) could be asked to do so. Since the chief purpose of ordering disgorgement is to make sure that the wrongdoers do not profit from their wrongdoing, it would follow that the disgorgement amount should not exceed the total profits realized as the result of the unlawful activity. In a disgorgement action, the burden of showing that the amount sought to be disgorged reasonably approximates the amount of unjust enrichment is on the Board.

(6) We will now deal with the rival contentions of the parties. In the light of what we have said above, the only question that needs to be answered is whether any finding has been recorded at any stage of the proceedings that the appellant has made no illegal gains. If there is such a finding, as contended by the learned senior counsel for the appellant, then he is right and the Board cannot be permitted to initiate fresh proceedings for that purpose and if not, it would be open to the Board to go ahead. We have given our thoughtful consideration to the contention of the appellant and express our inability to agree with Shri Seervai, learned senior counsel, appearing on its behalf. The enquiry officer has not recorded any finding to the effect that the appellant made no illegal gains. As a matter of fact, the issue whether the appellant had made any ill-gotten gains as a result of its unlawful activities was not the subject matter of the enquiry. The enquiry officer was enquiring into the alleged misdeeds of the appellant and the question of disgorgement did not arise before him. The learned senior counsel for the appellant referred to the following observations made by the enquiry officer in

para 46.1 of his enquiry report to contend that there was a positive allegation against the appellant that it had made undue gains:

> "…It is alleged that above practice adopted by a market intermediary like Karvy group acting in concert with Key Operators is a deceptive, fraudulent and manipulative device aimed at cornering the shares and making undue gains in the process to the detriment of the retail investors.…"

Again, reference is made to paragraphs 46.2.6 and 46.3.1 of the enquiry report and it is urged that the enquiry officer after noticing the denial of the appellant that it had made no undue gains, has recorded a finding in its favour that it had in fact not made any such gains. Reliance is placed on the following observations made by the enquiry officer:

> "46.2.6 It is denied that Karvy group has acted in concert with any of the Key operators or had indulged in any deceptive, fraudulent or manipulative practice aimed at cornering the shares and making undue gains in the process to the detriment of retail investors as alleged. It is submitted that Karvy group has neither made any undue gains nor has cornered any shares to the detriment of retail investors."

> "46.3.1 In this regard it is pertinent to note the submission of Karvy DP that it had given funding only in respect of 5 Public issues and the said entities were acting as IPO sub brokers in many other public issues and also in respect of many other institutions. Further, it is noted that the investigation report had not mentioned that the gain from the above illegal activities accrued to Karvy DP. It is pertinent to note from the submissions of Karvy DP that it has gained only DP charges and interest earned in the financing activity. Considering the above submission and also considering the submission of Karvy that margin money was collected in respect of the said entities though belatedly, it cannot be concluded on the basis of the existing evidence that the said key operators were the front entities of Karvy."

We have carefully gone through the aforesaid observations of the enquiry officer and have not been able to persuade ourselves to agree with the appellant that a finding has been recorded that it made no illegal gains as a result of its wrongful activities. This issue has not at all been examined during the course of the enquiry. We have also gone through the show cause notice dated September 22, 2006 that was issued to the

appellant by the enquiry officer and are of the view that the question of ill-gotten gains, if any, made by the appellant was not the subject matter of that notice and only the details of its wrong doings have been referred to therein. We are also of the considered opinion that the enquiry officer has not undertaken any exercise to find out the ill-gotten gains, if any, made by the appellant and the enquiry was only to find out the wrongful acts allegedly committed by the appellant. The observations to which reference has been made by the learned senior counsel for the appellant are to be read in the context of the illegalities allegedly committed by the appellant. Those cannot be read out of context to mean that a firm finding had been recorded that no illegal gains had been made. The observations have no reference to any specific charge in the show cause notice pertaining to illegal gains and those could not be used to urge that the Board should not be allowed to initiate disgorgement proceedings separately if it otherwise chooses to do so. It is true that the enquiry report has been accepted by the Board as contended on behalf of the appellant and that is why a penalty has been levied debarring it from opening fresh demat accounts till the end of December 2007. Mere acceptance of the enquiry report by the Board does not, in our view, advance the case of the appellant. Further, on receipt of the enquiry report another show cause notice was issued to the appellant on May 4, 2007 enclosing the enquiry report. We have perused that show cause notice as well and find that there is nothing therein to suggest that the appellant had made ill-gotten gains or anything about disgorgement. In this view of the matter, we have no hesitation in holding that the question regarding illegal gains, if any, made by the appellant has not been examined at all at any stage of the proceedings.

(7) This, however, does not mean that the appellant has to fail. It is the admitted case of the parties that the impugned order was passed without affording an opportunity of hearing to the appellant and other entities which have been ordered to disgorge a sum of Rs.115.82 crores. The least that was required of the Board was to have called upon

the appellant to show cause why it should not be ordered to disgorge the amount determined in the impugned order. Not having done so, the principles of natural justice have been flagrantly violated. The impugned order, therefore, deserves to be set aside on this ground alone. We also cannot approve the observations made by the Board in para 47 of the impugned order which have been reproduced in the earlier part of our order and are of the view that action for disgorgement should have been initiated only after the appropriate proceedings against the entities had concluded and their guilt established. We are satisfied that the case of the appellant is no different from the case of the other entities against whom appropriate proceedings are still pending and whose appeals came up for hearing before us on 22.11.2007.

(8) Before concluding, we cannot resist expressing our anguish over the irrational manner in which the Board proceeded to pass the impugned order only against the two depositories and their participants. Why we say so is that by its ex-parte order dated April 27, 2006 which is to be read as a part of the impugned order, the Board itself had found that the financiers of the key operators were the ultimate beneficiaries of the IPO scam and it went on to identify 82 financiers and even computed the illegal gains made by some of them in that order and yet issued no directions to them to disgorge the illegal gains made by them. Instead, the two depositories and their participants against whom enquiries are pending have been ordered to disgorge the entire amount of illegal gains without even recording a finding that they made any such gains. If the illegal gains were made by financiers it was they who ought to have been directed to disgorge the amount. One is left guessing why the Board did not issue such directions to them. It did not even initiate disgorgement proceedings against them for reasons better known to the Board. It appears that after identifying the financiers who were the ultimate beneficiaries of the scam, the Board turned a nelson’s eye towards them and chose to proceed against the depositories and their participants and that too, exparte which, to say the least, was most unfair. What is really amazing is that the Board has noticed the correct position in law in para 30 of the impugned order but did not follow the same and

ordered disgorgement against those entities against whom no findings of ill-gotten gains have been made, leaving out those against whom such findings had been recorded in the ex-parte order of April 27, 2006. We need not say anything more and leave the matter at that.

In view of what has been said above and for the reasons stated in our order dated 22.11.2007 passed in Appeal no. 147 of 2006, we allow the appeal and set aside the impugned order leaving it open to the Board to initiate further proceedings in accordance with law. There is no order as to costs.

Sd/-
Justice N.K. Sodhi
Presiding Officer

Sd/-
Arun Bhargava
Member

Sd/-
Utpal Bhattacharya
Member

2.5.2008
ddg/-