BEFORE THE SECURITIES APPELLATE TRIBUNAL MUMBAI

Appeal No. 52 of 2007

Date of decision: 15.4.2008

HSBC Investment Securities (Netherlands) NV …… Appellant

Versus

The Adjudicating Officer
Securities and Exchange Board of India. …… Respondent

Present: Mr. V. Tulzapurkar, Senior Advocate for the Appellant
Mr. J. J. Bhatt, Senior Advocate with Dr. Poornima Advani and
Mr. Haihangrang E.H. Newme Advocates for the Respondent

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

Per : Utpal Bhattacharya, Member

The limited question for decision in this appeal is whether in terms of regulation 20 of the Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, 1995 (FII Regulations, for short), read with the Securities and Exchange Board of India (the Board, for short) circular No. FITTC/CUST/14/2001 of 31.10.2001, an FII is required to report to the Board the issuance of participatory notes against the purchase or sale of Indian securities. The facts leading to this appeal are briefly outlined below.

The appellant was a banking corporation registered in the Netherlands and was granted a certificate of registration as an FII by the Board on 9.5.2000. In response to its application dated 14.7.2003, the Board cancelled its registration as FII on 17.11.2003. With effect from 7.3.2006, the appellant stands liquidated under the laws of the Netherlands. In August-September 2000, the appellant issued participatory notes (a derivative instrument) against the purchase/sale of shares of Bharat Petroleum Corporation Ltd (BPCL for short), an Indian company, to Union Global Management and Union Investment in the U. K. Admittedly, this was not reported to the Board. However, the Board, having been informed of the issuance of these participatory notes

by HSBC Securities, the appellant's broker in India, wrote to the appellant on 1.9.2003 seeking detailed information on the subject. In response, the appellant furnished the details of the participatory notes on 12.9.2003. Thereafter, on 16.7.2004, the Board issued a show cause notice to the appellant under the Securities and Exchange Board of India (Procedure for Holding enquiry and imposing penalties by Adjudicating Officer) Rules, 1995 alleging breach of regulation 20 of the FII Regulations, 1995 read with the Board's circular of 31.10.2001. The adjudication proceedings that followed the reply given by the appellant culminated in the Board's order dated 22.12.2006 imposing on the former a penalty of Rs. 10 lacs under section 15A of the Securities and Exchange Board of India Act, 1992 (the Act, for short). It is this order that is under challenge in this appeal.

The learned senior counsel for the appellant strongly denies that there was any violation on the part of the latter to comply with regulation 20 of the FII Regulations, which is reproduced below:

> " Every Foreign Institutional Investor shall, as and when required by the Board or the Reserve Bank of India, submit to the Board or the Reserve Bank of India, as the case may be, any information, record or documents in relation to his activities as a Foreign Institutional Investor as the Board or as the Reserve Bank of India may require."

An FII is defined under regulation 2(f) of the FII Regulations as "an institution established or incorporated outside India which proposes to make investment in India in securities……..." Hence, according to the learned senior counsel, the information desired by the Board in its circular of 31.10.2001 has necessarily to be restricted to the activities of an FII in India and not outside. He points out that a foreign institution that issues derivatives, outside India, on underlying Indian securities is not required to be registered with the Board as an FII. The appellant's action of issuing participatory notes abroad was not an action as an FII registered with the Board but as a banker in a jurisdiction outside India. The learned senior counsel clarifies that the appellant issued such participatory notes as standard products to clients involving underlying securities of many countries; the fact that the underlying security in the present case was Indian was only incidental.

Another argument of the learned senior counsel for the appellant relates to regulation 20A of the FII Regulations which was introduced by the Board only subsequently on 28.8.2003 requiring full disclosure of information concerning the terms of and the parties to all derivative instruments including participatory notes. The argument is that in the absence of this regulation at the relevant time, there was no obligation on the appellant to furnish the information required by the circular of 31.10.2001. The learned senior counsel also contends that when the Board cancelled the certificate of registration of the appellant, it was aware that the latter had issued participatory notes on BPCL shares abroad and that this had not been reported. But the Board did not consider this to be a breach of the regulations since the letter cancelling the registration was made effective subject only to any action that the Board might take regarding the very minor violation of short sale of 102 shares of National Aluminium Company Ltd; non-reporting of the issuance of participatory notes abroad was not mentioned as an outstanding violation. Under the circumstances, the issue of the show cause notice of 16.7.2004 was not warranted.

The last (but certainly not the least) contention of the learned senior counsel for the appellant is that at the time of issuance of the participatory notes in question, the penalty prescribed under section 15A of the Securities and Exchange Board of India Act was a maximum of “one lakh and fifty thousand rupees for each such failure” which was enhanced only with effect from 29.10.2002 and so the penalty is clearly beyond the maximum prescribed under the then provisions of the Act.

The learned senior counsel for the respondent Board considers the stand taken by the opposing counsel that regulation 20 of the FII Regulations can relate only to an FII’s activity in India to be a totally incorrect proposition. He argues that any issuance of derivative instruments abroad by an FII against an Indian security has to count as an activity “in relation to” his activity as an FII within the meaning of regulation 20 ibid. He further argues that regulation 20A is only clarificatory in nature and all activities of an FII in relation to Indian securities, whether in India or abroad, are covered within the ambit of regulation 20.

We agree with the argument of the learned counsel for the respondent Board. This is so because a registered FII can issue derivative instruments abroad against an Indian security and is at liberty to trade and invest in the same security in the Indian market at the same time. In fact, this is what happened in the present case. The appellant was trading in BPCL shares in the Indian market during the same time when it was issuing participatory notes against these shares abroad. A foreign operator who is not a registered FII can not do this. Clearly, in order to get a complete picture of the operations of an FII in Indian securities, it is essential to have full information regarding his activities involving derivative instruments against Indian securities abroad. Thus, the obligation cast upon FII's by the Board in its circular of 31.10.2001 under regulation 20 of the FII Regulations has to be considered a legitimate one. The question framed by us in the opening paragraph of this order has, therefore, to be answered in the affirmative.

The appellant's plea regarding the Board's omission to mention non-reporting of the issuance of participatory notes abroad as an outstanding matter in its letter cancelling the appellant's FII registration is also untenable because such omission can not preempt the Board from issuing a show cause notice for any regulatory violation. The argument regarding the quantum of penalty, however, commends itself to us. It is quite clear that the quantum of penalty imposed in this case is way beyond the maximum prescribed under the Act at the relevant time. Section 15J of the Act specifies the factors for adjudging the quantum of penalty in the following terms:

> "While adjudging the quantum of penalty under section 15I, the adjudicating officer shall have due regard to the following factors, namely:-
> (a) the amount of disproportionate gain or unfair advantage, wherever quantifiable, made as a result of the default;
> (b) the amount of loss caused to an investor or group of investors as a result of the default;
> (c) the repetitive nature of the default."

As found by the Adjudicating Officer, there is no identifiable disproportionate gain in this case for the appellant nor any evidence of loss caused to any investor. The default, which has been admitted, is also not repetitive. There is, thus, no case for pitching the

quantum of penalty to the high level of Rs. 10 lacs, particularly when the appellant has ceased being an FII and can no longer affect the investors or the market as such.

In the light of the foregoing discussions, we dismiss the appeal and reduce the quantum of penalty to be paid by the appellant to a sum Rs.10000 only, which would adequately meet the ends of justice in this case. No costs.

Sd/-
Justice N. K. Sodhi
Presiding Officer

Sd/-
Arun Bhargava
Member

Sd/-
Utpal Bhattacharya
Member

15.4.2008
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