

SECURITIES AND EXCHANGE BOARD OF INDIA

ORDER

In the matter of Order under Regulation 13 (4) of the SEBI (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002, read with clause(a) of Sub Regulation (3) of Regulation 15 of SEBI (FII Regulations), 1995 in the matter of short selling by Taib Bank E.C.

WTMO/4/09/03

- 1.0 M/s Taib Bank E.C. (hereinafter referred to as "FII"), a public company incorporated in Bahrain and listed on the Bahrain Stock Exchange, is registered with the Securities and Exchange Board of India (hereinafter referred to as "SEBI") as a Foreign Institutional Investor under Registration No. IN-UE-FE-119-93 under SEBI (Foreign Institutional Investors) Regulations, 1995 (hereinafter referred to as "FII Regulations"). The 'Everest Fund (Mauritius) Ltd' is one of their sub accounts registered with SEBI.
- 2.0 During an investigation by SEBI of ANZ Grindlays Bank (presently Standard Chartered Grindlays Bank), Custodian, in October, 2000, certain apparently short sales were observed in respect of trades conducted by the FII on behalf of their sub-account, The Everest Fund as under:
- 2.1 Sale of 15000 equity shares of SSI Ltd on 5.5.1999 without adequate stock balance and subsequent purchase of 5800 equity shares of SSI Ltd on 7.5.1999 (balance auctioned by the Stock Exchange).
- 2.2 Sale of 5000 shares of TELCO on 22.11.1999 for settlement on 24.11.1999. 350 shares were debited from the Depository Account of the Bank on 29.11.1999 towards partial delivery for the above trade and shortfall of 4650 shares were auctioned by the Stock Exchange.
- 2.3 Sale of 4000 shares of Hindustan Petroleum on 29.11.1999 for settlement on 1.12.1999, when the balance on 30.11.1999 was nil. The shares were auctioned by the Stock Exchange on 8.12.1999.
- 2.4 sale of 3000 equity shares of Vikas WSP Ltd on 2.5.2000 and 2000 equity shares of Vikas WSP Ltd on 3.5.2000 without adequate stock balance and subsequently squaring up the entire 5000 shares on 14.5.2000.
- 2.5 Sale of 5000 equity shares of Wipro Ltd on 31.8.2000 @ Rs.3265.81 whereas the stock available with the sub-account was only 4000 shares. Thereafter, 1000 shares were purchased @ Rs.3394.86 on spot basis and the same were credited to the demat account on 5.9.2000 in order to meet obligations to the clearing house.
- 2.6 Sale of 10000 equity shares of DSQ Ltd on 14.10.2000 while deliverable stock was only 9500 equity shares. 500 shares were purchased later to offset the short sale.
- 3.0 A show cause notice was issued to the FII on 6.8.2001 to which FII submitted its reply on 20.8.2001. In respect of specific instances, the FII's reply was to the following effect:
- 3.1.1 The sale of shares of SSI Ltd in question was part of the bonus shares issued by the company for which the ex-bonus date was 22nd March 1999 on the BSE and 24th March 1999 on NSE. The FII was informed by the company that the shares would be sent in the first week of May; however, the FII sold the shares on 5th May 1999, due to an oversight, without verifying the receipt of the 17500 bonus shares. Eventually, the bonus shares were received on 13th May, 1999, but in physical form and were then sent for demat and they got the credit for demat only on 7th June, 1999.
- 3.1.2 The fund bought a total of 45,000 shares of TELCO during 15th to 23rd July, 1999 and were gradually sold from 24th August 1999. As on 29th November 1999 there were 30,000 shares to be sold. Through oversight, they sold 35,000 shares on 22nd November in 3 lots (20000 through DSP Merrill, 10000 through Mafatlal and again 5000 through DSP Merrill). The last sale of 5000 shares was due to human error.

- 3.1.3 Based on the stock statement which showed 11,500 shares of Hindustan Petroleum as on 29th November, 1999, the 4,000 shares were erroneously sold, without taking into account pending sale. "The period was also quite confusing" as HPCL issued bonus shares during the period in question. While the ex-bonus date was 13th October, 1999, the bonus shares were received on 25th December, 1999.
- 3.1.4 The FII had given orders for sale of shares of Vikas WSP Ltd) by oversight to two brokers simultaneously. While 5000 shares were sold through one broker on 2nd and 3rd May 2000 , 6000 shares were sold on 3rd and 4th May, 2000 through another broker. This happened due to over-sight and on realization of the mistake, the FII immediately placed the order to square up the erroneous sale of 5000 shares.
- 3.1.5 The short sale of shares of Wipro also was due to oversight as the concerned person was traveling and his replacement erroneously ignored the sale of 1000 shares on 25th August 2000. This was a genuine mistake for just 1000 shares.
- 3.1.6 The 'short sale' of the shares of DSQ Software was due to genuine human error, involving just 500 shares out of 10,000.
- 3.2 The FII submitted that the fund has undertaken thousands of transactions during the period in question, instances of selling without checking stock were few and far between and that all such cases were genuine mistakes which mainly occurred due to a bonafide human error. The Bank further stated that there was never any intention to short sell in any of the cases cited.
- 3.3 The FII also contended that in all the above cases, the quantity involved was too insignificant to have any impact on the market price of the shares in question or on the market sentiment in general.
- 4.0 On considering the reply, an Enquiry Officer was appointed vide order dated 15.11.2002 in terms of SEBI (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002 (hereinafter referred to as "enquiry regulations") to hold an enquiry into the alleged contravention of Regulation 15 (3) (a) of the FII Regulations
- 4.1 The Enquiry Officer submitted his report to SEBI on 27.2.2003. In his report, the Enquiry Officer has found that the instances of short sales have not been disputed and observed that six instances of short selling showed that the fund acted negligently and failed to exercise due diligence. He also stated that the fund had sold the securities without verifying the stock availability. The Enquiry Officer also noted that fund had since strengthened the internal check and control mechanism. After taking into consideration the submissions of the fund, the Enquiry officer recommended suspension of the certificate of registration of the FII for a period of three months.
- 4.2 Pursuant to the Enquiry Report, Show cause notice dated 23.4.2003 was issued to the FII in terms of Regulation 13 (2) of the enquiry regulations. The FII submitted a reply to the same through M/s Borkar and Muzumdar, Chartered Accountants vide letter dated 9.5.2003.
- 5.0 In their said reply, the Bank has submitted, inter alia, to the following effect:
 - 5.1.1 the recommendation of the enquiry officer is extremely harsh and disproportionate to the violations.
 - 5.1.2 the Bank had not violated the provisions of law in the context in which they were formulated and that the acts were bonafide and in any case accidental.
 - 5.1.3 None of the transactions were naked short sales and are cases of slight excess sales.
 - 5.1.4 It was not as if, they sold shares that they did not have at all; on account of bonafide arithmetic, communication and similar mistakes, they sold shares slightly in excess of stock.
 - 5.1.5 In each and every transaction, the reason for the small difference between the quantity sold and the quantity in hand that was delivered was explained by bonafide explanation such as non-receipt of bonus shares etc.
 - 5.1.6 If there had been the slightest intention of deliberateness in the acts, they would have profited in some of the transactions. But, in almost every case cited, they had suffered loss.
 - 5.1.7 None of the scrips in respect of which the transactions took place were involved in any price manipulation.

5.1.8 The Enquiry Officer fully accepted and not disputed the fact that they had proper systems in place to ensure due compliance of the law...In each and every case so cited, the size of the transaction was miniscule in proportion to the size of the transactions otherwise undertaken by them or otherwise in the total market.

5.1.9 The transactions were few and far between.

5.1.10 There was never more than one such transaction in the same scrip

5.1.11 The concerned transactions did not violate Regulation 15(3)(a) of the FII Regulations.

5.1.12 There should be an element of continuity and regularity that was totally absent in the present case and that the Regulations cannot cover sporadic cases particularly if they were accidental

5.1.13 The Regulation talks of "engaging in short selling" and this denotes that the seller should consciously sell shares short. It cannot remotely cover selling shares by mistake on the impression that the shares were in stock.

5.1.14 Referring to definitions of "short position" and "short sale" in Black's Law Dictionary and "short selling/selling short" in Time International's Dictionary of Financial and Investment Terms, the FII has contended that there was an assumption that short sales should involve an intention to buy back at a lower price. In the Facts of the present case, there was no intention at all to buy back the shares at a lower price.

5.1.15 There was no negligence as alleged.

6.0 The FII has further argued that the proceedings are without jurisdiction for the following reasons:

6.1 The FII Regulations have been amended in September 2002 and a totally different form and classification of punishment has been proposed along with many other changes. Regulations 22 and 29 which governed in detail the whole procedure of taking action for violation and even prescribed the type and nature of penalties giving express limitation in certain cases, have been fully omitted from the regulations and a common set of provisions in a separate regulations have been prescribed.

6.2 The whole form and content of levying penalty has been totally recast from September 2002. However, these changes are not retrospective and cannot apply to past acts. These are substantial changes in law and without express retrospective application, in accordance with well accepted principles of law, the amended provisions will have only prospective applicability for acts committed after the date of amendment.

6.3 Despite this, the enquiry, related proceedings and even the recommendation for levy of penalty have been carried out in accordance with the amended law which has no applicability at all to transactions that took place in 1999 and 2000. This is thus totally illegal and even without jurisdiction.

6.4 That proceeding under the substantially changed law has a much more prejudicial impact on us. Thus, adopting these new provisions against us can cause grievous and greater loss and without express retroactive effect, this would not be in accordance with law.

7.0 The Bank has contended that highest punishment was proposed without justification for the following reasons:

7.1 In terms of Rule 5(2) of the Securities and Exchange Board of India (Procedure for holding inquiry and imposing penalties by adjudicating officer) Rules, 1995 the Enquiry Officer is obliged to give consideration to certain factors in arriving at a recommended penalty, 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 any default.

7.2 The Enquiry Officer awarded the maximum penalty which can be levied for a minor violation without having given consideration to the above factors.

7.3 The Enquiry Officer had without justifying how the acts were serious, provided for a penalty that was effectively for major violations. He had awarded the maximum penalty leviable for minor violation (see Regulation 13(1)). Considering that the maximum penalty leviable was proposed, at the very least, though not very strictly required under law, the considerations for levying major penalties should be at least considered, in terms of justice and fair play. Regulation 13(6) specifically provides that major penalties shall be levied only if certain circumstances exist. It is seen that the Regulation lists very serious offences such as "price or market manipulation", insider trading, disobeying orders or directions, etc. None of these existed nor were they alleged to have existed. Such a harsh punishment was not justified at all nor any attempt had at all been made in the recommendation of the Enquiry Officer to justify the same.

7.4 The Enquiry Officer had not taken into account that this was a first violation and also a purely technical one and that none of the scrips or even the transactions were involved in price manipulation, nor they were alleged to be so.

8.0 The FII has contended that no penalty can be levied for bonafide acts for the following reasons:

8.1 Section 80 of the Indian Penal Code 1860 states "nothing is an offence which is done by accident or misfortune and without any criminal intention or knowledge in the doing of a lawful act in a lawful manner by lawful means and with proper care and caution.

8.2 The Enquiry Officer had fully accepted the explanation that the transactions were fully bonafide without any intention to violate the law nor to claim any benefit nor to cause loss to any person. He had fully recorded our submissions that the transactions were bonafide and not disputed or disproved them nor provided any evidence to the contrary.

8.3 The only allegation was that these acts were against the provisions of law merely because they are against the provisions of law, punishment ought to be levied.

9.0 Without prejudice to the submission that there was no violation of law, FII submitted that it is now well settled that a mere violation of law does not automatically mean that penalty can be levied. The Securities Appellate Tribunal has repeatedly held this. Some examples of such decision, are *Chandrakant Gandhi Stock Brokers (P) Ltd. Vs SEBI* (2000) 37 CLA 238; 25 SCL 1 and *Cabot International Capital Corporation vs Adjudicating Officer, SEBI* (2001) 29 SCL 399(SAT).

10.0 The FII also referred to the Supreme Court decision in *Hindustan Steel Ltd. Vs State of Orissa* (AIR 1970 SC 253 where the following remarks were made:-

"An order imposing penalty for failure to carry out a statutory obligation is the result of a quasi criminal proceeding and penalty will not ordinarily be imposed unless the party obliged either acted deliberately in defiance of law or was guilty of conduct contumacious or dishonest or acted in conscious disregard of its obligation. Penalty will not also be imposed merely because it is lawful to do so. Whether penalty should be imposed for failure to perform a statutory obligation is a matter of discretion of the authority to be exercised judicially and on a consideration of all the relevant circumstances... Even if a minimum penalty is prescribed, the authority competent to impose the penalty will be justified in refusing to impose penalty, when there is a technical or venial breach of the provisions of the Act or where the breach flows from a bonafide belief that the offender is not liable to act in the manner prescribed by the statute."

11.0 The FII was also granted an opportunity of being heard in person on 1.9.2003. In the course of hearing, representative of the FII submitted that:

11.1 The six instances cited above were among thousands of transactions done by the FII and these were genuine transactions.

11.2 There were no second sales in the same scrips and the short sales were due to human error and were not intentional.

11.3 In all cases, there was no profit earned; on the other hand, there was loss.

11.4 The FII had not engaged in short selling; rather these were isolated incidents

11.5 the total value of the short sales done by them constitute less than 0.05% of the total value of the trades entered into by them.

11.6 The penalty proposed to be imposed was not commensurate to the facts of the case.

12.0 I have considered the report of the Enquiry Officer and the submissions of the FII and the other material on record. The following issues arise for consideration:

(i) Whether the enquiry proceedings conducted by the Enquiry Officer recommending a penalty as per amendments made to the provisions of FII Regulations in 2002, in respect of violations of the said Regulations committed in the years 1999 and 2000, are valid.

(ii) Whether the Bank engaged in "short selling" in securities in violation of Regulation 15(3)(c) of the FII Regulations.

(iii) Whether the penalty recommended by the Enquiry Officer is commensurate with the nature of violations and, if not, penalty, if any, to be imposed on the FII.

12.1 To take the jurisdictional issue raised at (i) above, the argument put forth is that the violation was committed during the years 1999 and 2000, whereas the enquiry and post enquiry proceedings were taken in accordance with the amendments made to FII Regulations in the year 2002. Hence the validity of the proceedings has been questioned by the FII. It is relevant to look at the amendments made and their intent and purpose.

12.2 Prior to introduction of SEBI (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations 2002, FII Regulations contained the provisions (Regulations 21 to 28) dealing with penalty for non-compliance with/ contravention of the provisions of the Regulations, the grounds on which penalty of suspension/ cancellation of certificate can be imposed, procedure to be followed in this regard, including manner of holding enquiry, holding of hearing, issuance of show cause notice, etc. The SEBI (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations introduced in 2002, comprehensively deal with the Enquiry procedure to be followed in respect of non-compliance/ contravention of various Regulations of SEBI and also list out various kinds of penalties, classified as minor and major, that may be imposed. Consequent upon introduction of such consolidated exclusive regulations for enquiry procedure and penalty imposition, the erstwhile relevant provisions in the individual Regulations stand deleted. However, in terms of a saving provision in Regulation 23 of the Enquiry procedure Regulation, notwithstanding the amendment of various Regulations specified (which includes the FII Regulations), anything done or any action taken including any proceeding for inspections or investigation or enquiry commenced or any notice issued under the said regulations before the commencement of the Enquiry Procedure Regulations shall be deemed to have been done or taken under the corresponding provisions of the Regulations. Having regard to the above, I do not see any merit in the argument regarding jurisdiction.

12.3 Coming to the substantive issue, Regulations mandatorily provide that FII shall not engage in "short selling" in securities. I note that the term "short selling" has not been defined in the FII Regulations. In the absence of any definition of "Short Selling" in the relevant Regulations, it may be in order to fall back upon the dictionary meaning of the term. The Black Law Dictionary 7th Edition quoted by the FII, describes 'short sale' as a sale of security that the seller does not own or has not contracted for at the time of sale and that the seller must borrow to make delivery. According to the Handbook of International Finance Terms, 'short sale' or 'short selling' is the process of selling an asset that one does not own, to another party on the expectation of being able to buy it back later at a lower price.

It is also necessary to take cognizance of the understanding of the term in the market and the legislative intention behind frowning upon such short selling. In the market parlance, short selling constitutes selling of securities by a person, without being in possession thereof, in anticipation of or for causing fall in prices, with an intent to buy the securities at a resultant lower price, thus hoping to make a profit. Such deliberate short selling by market players is viewed by Regulators as high risk activity and is also expected to have the potential of setting/ accentuating bear trend in the market. In this case, the FII has admitted that in six instances cited, it had sold shares without having possession of sufficient shares on hand. Thus there is no denying the fact that FII had committed violation of FII Regulations, however technical or unintentional the violation might be. Having said this, it should also be noted that the instances did not involve "naked short sales" i.e. sale of securities without having any stock. The six instances of short sales had occurred not in a regular pattern or within a limited period but were spread over a period of almost a year and a half and the number of shares in shortage in each time was not so large as to point to a deliberate short selling. It is also pertinent to note that FII had not made profit on account of the transactions but incurred a loss. From the facts presented and the arguments made, I am, therefore, inclined to agree that the short sales could have occurred due to oversight and/ or in absence of adequate internal check and control mechanism.

12.4 Finally, the kind of penalty to be imposed has to be considered. In terms of Regulation 21 of FII Regulations, Foreign Institutional Investor who contravenes any of the provisions of the Act, rules or Regulations shall be dealt with in the manner provided under SEBI (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations 2002. Regulation 4(j) of the Enquiry Regulations provides that an enquiry may be held for the purpose of passing an order for contravention of FII Regulations. According to Regulation 13 of the said Regulations, the Enquiry Officer shall, after

considering the written statement and oral submission, if any, of the intermediary, under provision of the relevant regulations, submit a report to the Chairman or Member designated in this behalf and recommend for the imposition of any of the penalties listed in the Regulations. The nature of the penalties which can be recommended by the Enquiry Officer has been classified into two categories, minor and major penalties. The minor penalties which range from warning or censure to debarring a Branch or Office of intermediary from carrying its activities for a period of 6 months includes suspension of registration for a period of 3 months. The major penalties range from cancellation of certificate of registration to debarring a branch or office of intermediary or from carrying out its activities for a period extending 6 months. The Chairman or the Member, as the case may be after considering the report and also the reply to the show cause notice is empowered to pass such order "as he deems fit".

Considering all relevant facts, and circumstances of the case as well as the arguments put forth by the FII, I am of the view that the penalty recommended by the Enquiry Officer, viz. suspension of Registration for a period of 3 months, though falling under the category of minor penalty, appears to be harsher than warranted.

13.0 I, therefore, in exercise of the powers conferred on me as Whole Time Member under Section 19 of SEBI Act, 1992 read with Regulation 21 of SEBI (Foreign Institutional Investors) Regulations, 1995 and Regulation 13(4) of SEBI (Procedure for Holding Enquiry by Enquiry Officer and Imposition of Penalty) Regulations 2002, hereby warn M/s. Taib Bank E.C. that any recurrence of short selling or any violation of FII Regulations in future will be viewed seriously.

Place : Mumbai

Date:20/09/2003

T.M. NAGARAJAN

WHOLE TIME MEMBER

SECURITIES AND EXCHANGE BOARD OF INDIA