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Disgorgement of Profits: A Truly Equitable Remedy?

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ABSTRACT

The Securities and Exchange Board of India (SEBI) was established with the main aim of protecting the investors and ensuring a free and fair investment market in India. The protection of investors is a crucial objective for the SEBI, and in this background, this paper analyses the mechanism of disgorgement of profits, which has been put in place as a measure of restitution for those investors against whom acts of mischief have been committed by any player in the Indian securities markets.

The main questions addressed by this paper deal with the equitability of disgorgement of profits as a remedy to wronged investors, and consequently, whether it fulfils the SEBI's primary function of investment protection. The authors aim to present a comparative analysis of the frameworks governing disgorgement of profits in India and the US, and accordingly, draw out the various flaws in the Indian framework.

On conducting an analysis of various Indian and American laws, case laws and studies, the authors have reached a conclusion that, even though Indian framework of disgorgement consists of elements of both, penalty and equity, there exists an administrative gap in the implementation of this framework that prevents the disgorged funds from being utilised for restitution of the wronged investors. Accordingly, it has been suggested that, following the example of the American framework, detailed guidelines need to be framed in order to ensure that the disgorged funds are utilised to compensate the wronged investors for their losses, thereby making it a truly equitable remedy.

I. INTRODUCTION

The main objective behind the establishment of the Securities and Exchange Board of India (*"SEBI")* is given under the preamble to the Securities and Exchange Board of India Act, 1992 (*"SEBI Act, 1992")*. The first and primary objective laid down in this preamble is to *"protect the interests of the investors in securities…".*[3]

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The protection of investors is the most crucial aspect of regulating the securities market. Without a system with a proper mechanism for protection of investors' interests, it becomes very easy for wrongdoers to misappropriate investors' funds. When this happens, the entire functioning of the securities market is compromised, especially when the investors do not have confidence in the market. Thus, every securities market requires a deterrent enforcement system in the securities market[4], that promotes public confidence and creates a fair market environment.[5]

One of the ways in which the SEBI, much like many other securities regulators of the world, protects the interests of the investors and prevents wrongful activities in the securities market is by making use of its power to direct the 'disgorgement' of profits in cases where mischief has been committed. The term disgorgement is defined as the act of surrendering something, usually profits and wrongful gains by legal compulsion or demand.[6] Therefore, disgorgement stems from the well-known concept of 'unjust enrichment', as the main objective is to deprive persons of their ill-gotten gains and deter such malpractices for the future as well.[7]

In India, the proceeds of disgorgement are transferred to an 'Investor Protection and Education Fund', which may not always be used for the restitution of the affected investors. As opposed to this, the statutory framework in the USA provides for using the proceeds of disgorgement to pay the wronged investors as damages. In the light of such differences, this paper aims to analyse the effectiveness of disgorgement as an equitable remedy India, given that the proceeds are not fully utilised to compensate the investors for their losses.

(A) Research Questions

1. Whether the nature of disgorgement of profits in India is truly equitable, given that the disgorged profits are transferred to the Investor Protection and Education Fund , which is not always utilised for the restitution of investors.
2. Whether, in light of the question hereinabove, the current regulations governing disgorgement are sufficient to fulfil SEBI's primary goal of 'investor protection'.

(B) Scope and Objective

This paper aims to analyse the flaws in the Indian framework on disgorgement, and present

[4] S.N. Ghosh, *Protection of Harmed Investors: The Missing Link in the Disgorgement Orders Of the SEBI*, 14 NALSAR Student Law Review 4 (2020), https://nslr.in/wp-content/uploads/2020/07/NSLR-Vol-14-No-4.pdf, last seen on 17/10/2020.

[5] *Objectives and Principles of Securities Regulation*, International Organization of Securities Commissions, May, 2003, available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf, last seen on 17/10/2020.

[6] Bryan A Garner, *Black's Law Dictionary*, 568 (10th edn., 2014).

[7] Karvy Stock Broking Co. Ltd. v. SEBI, Appeal No. 6 of 2007 (Securities Appellate Tribunal, 2/5/2008).

whether they make disgorgement an effective equitable remedy, as it is supposed to be. In order to do this, the author compares the Indian framework with the U.S. framework, and also states how the Indian authorities can follow some of the positive steps that have been taken by the U.S. authorities in this regard.

II. DISGORGEMENT: THE EQUITABLE VS. PUNITIVE DEBATE

Disgorgement is a tool that is used widely in the USA, as opposed to India, where it is rarely used. In fact, the Indian framework on disgorgement has taken inspiration from that in the USA, which makes the American developments on disgorgement quite significant for India.

In the landmark case of *Kokesh v. SEC*[8], the US Supreme Court held that disgorgement is a remedy against a crime against the state and not a specific individual. It was further held that disgorgement is punitive in nature, rather than being remedial. This ruling, however, is not entirely followed in India. An example of the same is the case of *Gagan Rastogi v. SEBI*[9], where it was clearly held by the Securities Appellate Tribunal (*SAT"*) that disgorgement is an 'equitable' remedy as opposed to a punitive measure. The case of *Kokesh*[10] was specifically distinguished as not being applicable in the Indian scenario, especially since that case dealt with an issue of limitation as well, which played a major role in imposing criminal liabilities, as opposed to equitable remedies.

However, one aspect of the *Kokesh*[11] case that seems to be applicable in India is that disgorgement is a measure concerns itself only with preventing the unjust enrichment of wrongdoers, while having nothing to do with the damages sustained by the victims of such malpractices and wrongful conduct. This has been expressly upheld in the case of *Karvy Stock Broking Co. Ltd. v. SEBI.*[12]

The money derived from disgorgement in India is credited to the Investor Protection and Education Fund.[13] The main purpose of this fund, as the name suggests, is to promote investor protection and education. However, the its utilization for the protection of investors has been minimal.[14] Further, non-utilization of this fund to provide damages to the victims of malpractices does not protect investors against the losses which they have faced due to the wrongful activities of certain players in the securities market which the SEBI is mandated to

[8] Kokesh v. SEC, 581 U. S. 3-8 (2017).
[9] Gagan Rastogi v. SEBI, Appeal No. 91 of 2015 (Securities Appellate Tribunal, 12/07/2019).
[10] Supra, note 7.
[11] Ibid.
[12] Supra, note 6.
[13] Section 11(5), Securities and Exchange Board of India Act, 1992.
[14] Supra, Note 3.

regulate. This results in an administrative gap that needs to be addressed.

III. UTILIZING PROCEEDS OF DISGORGEMENT AS DAMAGES TO THE INVESTORS

While the ruling in *Kokesh* emphasizes that disgorgement is an exercise to prevent malpractices in securities markets and is punitive in nature, the same is considered to be applicable only to a specific scenario. In general, the framework in the USA has now evolved to provide for damages to be paid to the victims of unjust enrichment. Thus, it is important to compare the Indian and American frameworks in order to better understand the fallacy present in the Indian system.

(A) Comparison of the Indian Framework vis-à-vis US Framework

Similar to the functions of the SEBI, the first goal of the Securities Exchange Commission in the USA (*"SEC"*), as a part of its 'three-part mission' is to protect the investors.[15] This function is performed by the SEC by enforcing securities laws and punishing the violators.[16]

In the USA, the Sarbanes-Oxley Act, 2002 (*"SOX Act"*) also contains provisions for the protection of investors, including those specifically related to disgorgement of profits. Section 308 of the SOX Act contains a provision for the establishment of a 'Fair Fund' and allows the SEC to levy civil penalties, over and above the disgorgement, for the purpose of compensating the investors for losses via this Fair Fund, *inter alia*.[17] While this comes in the nature of a penalty, it also possesses an aspect of equity, in the sense that this penalty is levied for providing individual relief, as opposed to a method for providing justice for a crime committed against the State.[18]

In India, the Investor Protection and Education Fund is governed by the SEBI (Investor Protection and Education Fund) Regulations, 2009 (*"Investor Protection Fund Regulations"*) and Section 125 of the Companies Act, 2013. Section 125(3) of the Companies Act, 2013 specifically provides that the fund shall be utilised for distribution of the disgorged amount to identifiable investors who have suffered losses.[19] However, regulation 5 of the Investor Protection Fund Regulations gives discretion to the advisory board of the SEBI to decide the scope of restitution via the Investor Protection and Education Fund, in a case where disgorgement is imposed. This leads to a fallacy between two laws, enacted by different

[15] *The Role of the SEC,* U.S. SEC, available at https://www.investor.gov/introduction-investing/investing-basics/role-sec, last seen on 17/10/2020.
[16] Supra, note 3.
[17] Sarbanes-Oxley Act, Act of July 30, 2002, S. 308.
[18] Barbara Black, *Should the SEC Be a Collection Agency for Defrauded Investors?,* Faculty Articles and Other Publications, available at http://scholarship.law.uc.edu/fac_pubs/55, last seen on 17/10/2020.
[19] Section 125(3), Companies Act, 2013.

bodies but governing the same subject.

The word *"shall"*, as also used in section 125(3) of the Companies Act, 2013 generally refers to an act that is mandated by the law, however, the courts are of the view that the facts of the case and legislative intent must be examined before interpreting a clause as mandatory or directory.[20] In a situation where the investors have been defrauded and deprived of their money, such a provision must be construed as mandatory, especially since disgorgement is an 'equitable' remedy and no extra penalty is levied on the wrongdoers. Yet, the courts still rely on the case of *Karvy Stockbroking Co. Ltd.*[21] despite the amendments and insertion of the new law, as is evident from the recent case of *In Re: Kamal Jitendra Katkoria.*[22]

(B) Disgorgement Without Restitution is Against Equity

As seen from the comparative analysis hereinabove, the laws regarding restitution and disgorgement are very similar in India and the USA. The major difference lies in the implementation of these laws and regulations in both countries.

The courts in the USA have started placing great emphasis on the concept of restitution in disgorgement cases, in order to make it truly equitable in nature. In *Liu v. SEC*[23], the US Supreme Court noted that the many recent instances of not complying with the principle of restitution were against the concept of disgorgement, which has its roots in equity. The court concluded by stating that not disbursing damages to the investors indefinitely is against the principles of equity and cannot be accepted.

In India, however, there exists a mismatch between the Investor Protection Fund Regulations and the Companies Act, 2013. In addition to this, the implementation of restitution of harmed investors does not seem to be satisfactory. According to the latest data on Annual Statement of Accounts for 2017, only 10% of the Investor Protection and Education Fund has been used.[24] This, however, does not mean that the Indian courts have totally neglected the principle of restitution in disgorgement cases.

The Supreme Court of India in *Sahara Real Estate Corp. Ltd. v. SEBI*[25] has held that the SEBI is mandated under statute to protect the interests of the investors, and this can only be done if harmed investors are compensated for their losses. The Securities Appellate Tribunal

[20] Dinesh Chandra Pandey v. High Court of Madhya Pradesh, (2010)11 SCC 500.
[21] Supra, note 6.
[22] In Re: Kamal Jitendra Katkoria, WTM/MPB/SEBI/EFD/DRA-3/05/2018.
[23] Liu v. SEC, 754 Fed Appx. 505.
[24] *Annual Statement Of Accounts 2017-18*, SEBI, available at https://www.sebi.gov.in/reports/annual-accounts/jul-2019/sebi-annual-accounts-financial-year-2017-18_43728.html, last seen on 17/10/2020.
[25] Sahara Real Estate Corp. Ltd. and Anr. v. SEBI and Anr., (2012) 174 Comp Cas 154 (SC).

has also followed suit, in *Ram Kishori Gupta & Anr. v. SEBI*[26], where the court held that there is no point in disgorgement without restitution. Even though implementation of these principles is far from good, the courts have recognised the importance of restitution in the protection of investors.

Thus, the framework, in its present state, supports restitution as a part of disgorgement. The major problem lies in its implementation, largely due to the fact that the Investor Protection Fund Regulations do not provide any clear guidelines for the same. Further, the Tribunals seem to follow the judgments of the past, aspects of which should be rendered nullified as a result of the provision under the Companies Act. These aspects call for slight changes and improvements in the existing framework in order to make a fully functional and beneficial for the investors.

IV. SUGGESTIONS AND RECOMMENDATIONS

In the USA, the SEC has recently issued a document called 'Rules of Practice', which include comprehensive rules on the Fair Fund and disgorgement of profits. Rule 1100 mandates the creation of a fund to compensate harmed investors,[27] while rule 1101 directs the SEC to submit a comprehensive plan for distribution of funds and administration of the Fair Fund and disgorgement funds.[28] Further, the SEC has also introduced an 'Information Portal for Harmed Investors' on their website[29], apart from making use of technology to collect data on harmed investors and also provide them with the requisite information.

The author submits that the SEBI can also follow in the footsteps of its American counterpart, by incorporating measures to make the framework for disgorgement more equitable. The SEBI should enact certain rules and guidelines for disgorgement of profits, with special emphasis on providing damages to harmed investors and investor protection.

It is further submitted that the use of information technology in this regard can prove extremely helpful, especially in the identification of harmed investors and providing them with the requisite information. The World Bank and International Monetary Fund, in their report on India under the 'Financial Sector Assistance Programme', has stated that the SEBI is equipped with some of the best communication and surveillance systems in the world. Further, it also makes use of modern technologies like Artificial Intelligence and machine

[26] Ram Kishori Gupta & Anr. v. SEBI , Appeal No. 44 of 2019 (Securities Appellate Tribunal).
[27] U.S. SEC Rules of Practice, R. 1100.
[28] U.S. SEC Rules of Practice, R. 1101.
[29] *Information for Harmed Investors,* U.S. SEC, available at https://www.sec.gov/divisions/enforce/claims.htm, last seen on 17/10/2020.

learning.[30] The ready-availability of these technologies will make the adoption and implementation of such investor protection systems easy and seamless.

V. CONCLUSION

It is now a widely accepted fact that the main function of a securities market regulator is investor protection. Based on this assumption, this paper presents a comparative analysis of the Indian and U.S. frameworks on disgorgement of profits.

To answer the first research question, the present framework for disgorgement in India, at least in practice, does not provide for a truly equitable remedy for frauds and malpractices, which is the essence of disgorgement. This is largely due to the fact that no proper guidelines are provided to implement the system of restitution, which, as stated in the previous sections, is an essential aspect of disgorgement as an equitable remedy.

The second research question is a follow-up to the first one. The answer to the same is that the current framework does not effectively fulfil the SEBI's primary goal of investor protection. The author submits that protection entails two aspects, namely the prevention of fraudulent activities and malpractices in the securities market, while also ensuring that the investors are not deprived of their money due to the acts of other players in the securities market. Disgorgement without restitution does not fulfil the second aspect, thus making this mechanism ineffective from the point of view of the investors, while also not meeting SEBI's primary goal of investor protection.

Thus, it is in the author's humble opinion that the SEBI should take inspiration from the U.S. SEC and adopt and implement detailed guidelines on disgorgement that promote the restitution and the interest of the investors. This will increase the people's trust in the SEBI, thereby increasing investors' confidence and satisfaction.

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[30] *Financial Sector Assessment Program*, International Monetary Fund, available at https://www.imf.org/en/About/Factsheets/Sheets/2016/08/01/16/14/Financial-Sector-Assessment-Program, last seen on 17/10/2020.