

Unfit and Improper Intermediaries? An Overview of the SEBI (Intermediaries) Regulations, 2008 For Directors and Promoters of Stock Market Intermediaries

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ABSTRACT

Stock market intermediaries serve as bridges between the public and the secondary market. It is thus essential that they are run by management whose good character is not the subject of doubt. To overcome this issue and to maintain trust in our financial institutions, the Securities and Exchange Board of India ('SEBI') has laid down certain criteria for qualification to be appointed as promoter, director or key managerial personnel in a stock market intermediary. These 'Fit and Proper' criteria, as they are commonly known, have been laid down in a variety of regulations, the most general and far-reaching of which is the SEBI (Intermediaries) Regulations, 2008. They provide for the automatic disqualification of stock market intermediaries from participating in the secondary market, if any person holding a controlling interest in the intermediary is found to be non-compliant with these criteria.

These criteria have, however, been put to scrutiny by various experts, and concerns have been raised regarding the fairness and proportionality of the 'Fit and Proper' test when compared to similar criteria laid down by other regulators, which also have a similar goal. The purpose of this project will be to determine firstly, if SEBI's 'Fit and Proper' criteria are sound and do not suffer from regulatory excesses, conflict with other laws, and are fit to address emerging concerns; secondly, how other regulators assess the fitness and character of market players; and thirdly, what modifications, if any, may be suggested to SEBI's 'Fit and Proper' criteria to bring them in line with national and international standards.

RESEARCH PROBLEM

Two primary problems exist in SEBI's '*Fit and Proper*' criteria, that led to the undertaking of this project –

1. It is unclear whether there is sufficient market knowledge regarding SEBI's '*Fit and Proper*' criteria as under the SEBI (Intermediaries Regulations), 2008, and whether SEBI has done enough to clarify the same;

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2. It is unclear if SEBI's '*Fit and Proper*' criteria are excessively punitive and over-inclusive.

RESEARCH METHODOLOGY

The project is based on the qualitative method. The project relies on the Secondary Method of Research. Secondary data is information which has already been collected, compiled and published by other researchers. Data is collected from secondary sources such as research papers on stock market intermediaries and the materials of international organizations and foreign regulators.

AN OVERVIEW OF THE SEBI (INTERMEDIARIES) REGULATIONS, 2008

The Securities and Exchanges Board of India ("SEBI" or "the Board") has regulated the primary and secondary financial markets for over three decades now. As of today, there are well over 5,000 intermediaries registered with the Board.¹⁵¹

The Fit and Proper Criteria Before 2008

Earlier, SEBI's approach to regulation involved framing specific regulations for different types of intermediaries. This can be seen in SEBI's regulations in the 1990s – the SEBI (Stock-Brokers) Regulations, 1992,¹⁵² the SEBI (Merchant Bankers) Regulations, 1992¹⁵³ and the SEBI (Mutual Funds) Regulations, 1996¹⁵⁴ were all aimed at regulating specific classes of intermediaries.

Practical difficulties arose, however, when these regulations prescribed different criteria for different intermediaries to be deemed as a financially, reputationally and managerially sound entity for registration as intermediary. To remedy this disparity, SEBI introduced the SEBI (Criteria for Fit and Proper Person) Regulations, 2004 ("2004 Regulations") as a common regulation applicable to all types of intermediaries.¹⁵⁵ As per Section 3 of the regulations, the regulator laid down the '*Fit and Proper*' Criteria for the registration of an intermediary in the

¹⁵¹ Ameya Gokhale et al., '*Fit and Proper*' Criteria under the SEBI (Intermediaries) Regulations — Is it time to Revisit? SCC ONLINE BLOG EXP 58 (Last visited Oct. 31, 2023), <https://www.scconline.com/blog/post/2023/07/06/fit-and-proper-criteria-under-the-sebi-intermediaries-regulations-is-it-time-to-revisit/>.

¹⁵² SEBI (Stock-Brokers) Regulations, 1992.

¹⁵³ SEBI (Merchant Bankers) Regulations, 1992.

¹⁵⁴ SEBI (Mutual Funds) Regulations, 1996.

¹⁵⁵ SEBI (Criteria for Fit and Proper Person) Regulations, 2004, Reg. 3.

secondary market prohibit persons of questionable repute and financial record from misusing public funds. The list of criteria under Section 3 was restricted to the following disqualifications¹⁵⁶ –

- 1) Conviction for an offence involving moral turpitude, economic offence, securities laws or fraud of the whole-time director or managing partner;
- 2) Declaration of insolvency of the whole-time director or managing partner, if not discharged at the time of applying for registration;
- 3) An Order for winding up passed against the proposed or operating intermediary;
- 4) An Order prohibiting or debarring the proposed or operating intermediary or its whole-time director or managing partner from dealing in securities in the capital market or from accessing the capital market, unless three years have elapsed from the date of expiry of the Order;
- 5) An Order canceling the certificate of registration of the intermediary for indulging in insider trading, fraudulent and unfair trade practices or market manipulation, unless three years have elapsed from the date of expiry of the Order; and
- 6) An Order withdrawing or refusing to grant any license/approval to the proposed or operating intermediary which has a bearing on the capital market, or to its whole-time director or managing partner, unless three years have elapsed from the date of expiry of the Order.

These regulations were fairly straightforward, preventing an intermediary from operating in the market only when some kind of adverse action was taken against an intermediary's officers for a matter relating to financial markets and securities. Further, these criteria were only applicable to whole-time directors, managing partners and the applicant as an entity.

The Fit and Proper Criteria After 2008

In 2008, SEBI notified the SEBI (Intermediaries) Regulations 2008, ("2008 Regulations") which provided for a common regulatory framework applicable to all intermediaries.¹⁵⁷ Among its changes and additions included the incorporation – and expansion – of the Fit and Proper criteria laid down in the 2004 Regulations. Schedule II of the 2008 Regulations contained a

¹⁵⁶ *Ibid.*

¹⁵⁷ SEBI (Intermediaries) Regulations, 2008, Sch. II.

comprehensive list of criteria and disqualifications that an intermediary needed to comply with for grant of certificate of registration by the Board. In 2021, the list was made far more comprehensive through the SEBI (Intermediaries) (Third Amendment) Regulations, 2021.¹⁵⁸

Notable additions involved, *firstly*, the inclusion of a wide variety of officers of the intermediary under the ambit of the new Regulations. While the 2004 Regulations applied only to the intermediary, its whole-time director and managing partner, Schedule II of the 2008 Regulations applied to a much broader class of persons –

- a) The applicant/intermediary;
- b) The principal officer;
- c) All the directors or managing partners;
- d) The compliance officer;
- e) The Key Management Persons (“KMPs”); and
- f) the promoters or persons holding controlling interest or persons exercising control over the applicant or intermediary, directly or indirectly.

Secondly, the 2008 Regulations laid down certain subjective criteria for the determination of fitness and propriety. The Board had to satisfy itself of the integrity, honesty, ethical behaviour, reputation, fairness and character of all of the persons mentioned hereinabove.¹⁵⁹ *Thirdly*, the 2008 Regulations automatically disqualified any person against whom a criminal complaint, recovery proceedings, winding up proceedings has been instituted.¹⁶⁰

This project will examine how each of these new requirements are punitive, disproportionate, and inconsistent with the Fit and Proper criteria of other regulators.

ANALYZING THE PROBLEMS WITH THE ‘FIT AND PROPER’ CRITERIA

Various stakeholders in securities regulation have commented, for various reasons, on the excessiveness of the 2008 Regulations’ Fit and Proper criteria.

Pre-Conviction Punishments

¹⁵⁸ SEBI (Intermediaries) (Third Amendment) Regulations, 2021.

¹⁵⁹ SEBI (Intermediaries) Regulations, 2008, Sch. II, cl. 3(a).

¹⁶⁰ SEBI (Intermediaries) Regulations, 2008, Sch. II, cl. 3(b).

Market regulation's chief aim is to promote confidence in the fair functioning of the stock market. This inherently involves the disqualification of people lacking good character, reputation, experience and honesty from participating as intermediaries, since public money is involved.¹⁶¹ Thus, it is essential to debar individuals that do not inspire public confidence in the stock market. The problem, however, with the 2008 Regulations is its over-proactiveness in disqualifying promoters and directors of an intermediary merely on the basis of a complaint instituted against them.¹⁶² Further, the intermediary is required to promptly replace the individual so disqualified within 30 days.¹⁶³

All of this places an undue burden on the promoter, director and KMP as well as the intermediary as a whole. The approach applied by SEBI in the formulation of these rules goes against the basic common law principle of the presumption of innocence.¹⁶⁴ The Supreme Court of India has held the presumption of innocence, in the context of a company, to be a "normative parameter" of general jurisprudence¹⁶⁵ as well as a fundamental human right.¹⁶⁶

To illustrate how peculiar a pre-conviction disqualification approach is, even other regulators do not follow such excessively harsh criteria. Take, for example, the Reserve Bank of India's ("RBI") RBI (Fit and Proper Criteria for Elected Directors of PSBs) Directions, 2019.¹⁶⁷ The criteria laid down here only prohibit those individuals who have been removed or dismissed from government service on a charge of bribery or corruption, or have been convicted of an offence involving moral turpitude. The Companies Act, 2013 also does not follow such an approach, taking a very liberal approach to the appointment of directors. The Companies (Appointment and Qualifications of Directors) Rules, 2014¹⁶⁸ read with Section 164 only disqualifies individuals with a conviction or a declaration of insolvency or of unsound mind.¹⁶⁹ The Insurance Regulatory Development Authority of India also follows a post-conviction

¹⁶¹ Dhaval Bothra & Akshat Jain, *Evaluating SEBI's Fit & Proper Test: Striking the Right Balance*, INDIA CORPLAW (Last updated Aug. 2, 2023), <https://indiacorplaw.in/2023/08/evaluating-sebis-fit-proper-test-striking-the-right-balance.html>.

¹⁶² SEBI (Intermediaries) Regulations, 2008, Sch. II, cl. 3(b).

¹⁶³ SEBI (Intermediaries) Regulations, 2008, Sch. II, cl. 6.

¹⁶⁴ *Coffin v. United States* (1895) 156 U.S. 432; *Gurbaksh Singh Sibbia v. State of Punjab*, 1980 AIR 1632; *In Re Oliver*, 1948 SCC OnLine US SC 31.

¹⁶⁵ *Sahara India Real Estate Corpn. Ltd. v. SEBI*, (2012) 10 SCC 603, ¶¶21.

¹⁶⁶ *Ranjitsing Brahmajetsing Sharma v. State of Maharashtra*, (2005) 5 SCC 294.

¹⁶⁷ RBI (Fit and Proper Criteria for Elected Directors of PSBs) Directions, 2019, Reg. 4.3.

¹⁶⁸ Companies (Appointment and Qualifications of Directors) Rules, 2014, Rule 14(5).

¹⁶⁹ Companies Act, 2013, §164 (1).

approach to disqualification of directors and promoters.¹⁷⁰ SEBI's approach to appointment and qualifications is more the exception than the norm, it appears. The Advocates Act, 1960¹⁷¹, the Chartered Accountants Act, 1949¹⁷² and interestingly, even the Representation of the People Act, 1951¹⁷³ all provide for disqualification only upon conviction for specific offences.

Over-Inclusion of Personnel for Assessment

Another issue with the 2008 Regulations that has not been brought up in literature, but one that the author has found, is its over-inclusionary approach in identifying relevant persons to whom the Fit and Proper test applies. The long list of personnel mentioned in Chapter I are also longer than that of any other regulator. This puts more people that required under the scrutiny of a regulatory framework that is already disproportionate in its disqualification. Furthermore, while the Companies Act provides for a fairly simplistic definition of KMPs¹⁷⁴, SEBI's classification of individuals that are deemed to be KMPs are much broader. Under the Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2018, a KMP is defined to be¹⁷⁵ –

- a) The managing director or executive director;
- b) The head of a department or vertical and directly reporting to the managing director or to the directors on the governing board of a stock exchange or clearing corporation;
- c) a person serving as the head of a core function;
- d) a person who stands higher in hierarchy to the head of any department(s), handling core function(s) in a stock exchange or clearing corporation;
- e) reporting officials of key management personnel; and
- f) any person defined as a “key managerial personnel” under the Companies Act, 2013; and

¹⁷⁰ Guidelines for Corporate Governance for Insurers in India, INSURANCE AND REGULATORY DEVELOPMENT AUTHORITY OF INDIA, IRDA/F&A/GDL/CG/100/05/2016, May 18, 2016.

¹⁷¹ The Advocates Act, 1960.

¹⁷² The Chartered Accountants Act, 1949, Sch. I & 2.

¹⁷³ Representation of the People Act, 1951.

¹⁷⁴ Section 2(51) of the Companies Act, 2013 states –

“key managerial personnel”, in relation to a company, means—

- (i) the Chief Executive Officer or the managing director or the manager;
- (ii) the company secretary;
- (iii) the whole-time director;
- (iv) the Chief Financial Officer;
- (v) such other officer, not more than one level below the directors who is in whole-time employment, designated as key managerial personnel by the Board; and
- (vi) such other officer as may be prescribed;’

¹⁷⁵ Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2018, Reg. 2(j).

- g) any other person who is a key decision making authority at the level of a stock exchange or clearing corporation or its direct or indirect material subsidiaries.

Thus, with this overly broad definition (in relation to an intermediary with limited employees), the criteria laid down in the Regulations serve to become even more arbitrary and discretionary.

Lack of Market Knowledge Regarding Applicability

As mentioned earlier, SEBI's intermediary-specific regulations, such as the SEBI (Stock Broker) Regulations, 1992 and the SEBI (Merchant Bankers) Regulations, 1996 provide already for Fit and Proper Criteria for specific types of intermediaries. This becomes important considering that the 1992 Stock-Broker Regulations are updated only till 2004, when the 2004 Regulations were incorporated into these Regulations. Thus, compliance with one set of Regulations does not necessarily mean compliance with the other. This can cause immense problems for a prospective intermediary, that fulfills the Fit and Proper criteria under the intermediary-specific regulations, but not under the 2008 Regulations, causing an application to be rejected. This leads to unnecessary delays, an outcome which intermediaries have tried to avoid through the use of the Informal Guidance Scheme.

An analysis of various SEBI Informal Guidance Scheme Documents reveals that even today, there exists confusion as to whether, for example, a stock broker must comply with the Fit and Proper criteria under the 1992 Regulations or under the 2008 Regulations.¹⁷⁶ A lack of clarity regarding which regulations apply for intermediaries – the older, specific ones, or the newer, general regulations – was observed by the author in an Informal Guidance Scheme document as recently as in March 2023.¹⁷⁷

This confusion is exacerbated by three reasons in particular –

1. SEBI replies to Informal Guidance Scheme queries resolve any possibility of conflict, and clarify that the Intermediaries Regulations, 2008 apply over all earlier regulations regarding

¹⁷⁶ *Informal Guidance sought by Muthoot Health Care Private Limited regarding eligibility criteria for Issue and listing of structured debt securities/ market linked debt securities*, SEBI (Last updated Mar. 14, 2023), <https://www.sebi.gov.in/enforcement/informal-guidance/mar-2023/>; Request for Interpretive letter under the Securities and Exchange Board of India Informal Guidance) Scheme, 2003 in relation to the SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992 the Brokers Regulations, SEBI (Last updated Feb. 26, 2010), <https://www.sebi.gov.in/enforcement/informal-guidance/feb-2010/>.

¹⁷⁷ *Informal Guidance sought by Muthoot Health Care Private Limited regarding eligibility criteria for Issue and listing of structured debt securities/ market linked debt securities*, SEBI (Last updated Mar. 14, 2023), <https://www.sebi.gov.in/enforcement/informal-guidance/mar-2023/>.

intermediaries, yet SEBI has never generally clarified the supersession or repeal of the earlier regulations;

2. Schedule IV of the Intermediaries Regulations, 2008 contains a list of amendments to certain other regulations, including the earlier specific regulations such as the SEBI (Merchant Bankers) Regulations, 1992, SEBI (Mutual Funds) Regulations, 1996 and the SEBI (Stock-Brokers) Regulations, 1992, causing greater confusion as to their applicability¹⁷⁸.
3. SEBI continues to list these earlier Regulations on their website as active regulations.

This shows a concerning lack of market knowledge regarding the applicability of the Intermediaries Regulations *vis-à-vis* other earlier regulations. Thus, it is not a conflict *in* laws, but confusion *regarding* them, that obfuscate the registration, governance and compliance requirements for stock market intermediaries. SEBI has clearly not done enough to clarify the applicability of the 2008 Regulations over the earlier ones.

ANSWERS TO RESEARCH QUESTIONS

Thus, from the above doctrinal research conducted, we answer our initial research questions as follows –

1. There is a severe lack of market knowledge regarding SEBI's '*Fit and Proper*' criteria as under the SEBI (Intermediaries Regulations), 2008;
2. SEBI has not done enough to clarify this regulatory uncertainty; and
3. SEBI's '*Fit and Proper*' criteria are excessively punitive and over-inclusive.

A JUDICIAL ANALYSIS OF THE '*FIT AND PROPER*' CRITERIA

From an adjudicatory standpoint, the Securities Appellate Tribunal ("SAT") and the Supreme Court have consistently sided with the Board in holding that the Fit and Proper criteria do not suffer from any vices. The subjective criteria for evaluation has been upheld by the SAT numerous times.

Regarding the subjective criteria of integrity, honesty, ethical behaviour, reputation, fairness and character, the Board expanded on this satisfaction criteria in *Jermyn Capital LLC, In re*

¹⁷⁸ SEBI (Intermediaries) Regulations, 2008, Sch. IV.

(2009)¹⁷⁹ and held that even a person who himself meets all the other objective criteria may be disqualified under the subjective criteria, if he is closely associated with someone of questionable character. The Board said –

*“Good reputation and character of the applicant is a very material consideration which must necessarily weigh in the mind of the Board in this regard. Reputation is what others perceive of you. A person is known by the company he keeps. In the very nature of the things, there cannot be any direct evidence in regard to the reputation of a person whether he be an individual or a body corporate. In the case of a body corporate or a firm, the reputation of its whole time director(s) or managing partner(s) would come into focus.”*¹⁸⁰

Similarly, in *Sahara Asset Management Company P. Ltd. v. Securities and Exchange Board of India* (2017)¹⁸¹, the SAT held the majority equity shareholder, who owned around 80% of the Company, to be *“nothing but the alter ego of the Company”*.

The SAT has even gone beyond the bare text of the Regulations and gone on to hold –

*“it is amply clear that while considering any application for grant of registration/renewal as any intermediary, the applicant and also the persons who hold responsible positions in the applicant and are responsible for its activities and/or are in a position to influence the decision making process by virtue of their substantial shareholding in the applicant or **otherwise**, have to pass the test of being a ‘fit and proper person.’”*¹⁸²

Even more vague notions of ‘public mistrust’ have been held as valid grounds for disqualification under the Fit and Proper Criteria.¹⁸³ The SAT has, more recently, gone to hold that the Fit and Proper criteria extend even to *“persons who hold responsible positions and are in a position to influence the decision-making process in the Company.”*¹⁸⁴

¹⁷⁹ Jermyn Capital LLC, In re, 2009 SCC OnLine SEBI 165.

¹⁸⁰ *Id* at ¶17.

¹⁸¹ Sahara Asset Management Company P. Ltd. v. Securities and Exchange Board of India, 2017 SCC OnLine SAT 173.

¹⁸² Altius Finserv Private Limited, In re, 2016 SCC OnLine SEBI 98.

¹⁸³ Parsoli Corp. Ltd., In re (Cancellation of Registration Certificate), 2013 SCC OnLine SEBI 156.

¹⁸⁴ Sahara Mutual Fund, In re (Cancellation of Certificate of Registration), 2015 SCC OnLine SEBI 419.

The wide, almost unfettered power of the Board has essentially been confirmed by SEBI in *Jermyn Capital LLC, In re* (2009), where it went on to hold – ¹⁸⁵

“The Board can take into account “any consideration as it deems fit” for the purpose of determining whether an applicant or an intermediary seeking registration is a fit and proper person or not. The framers of the Regulations have consciously given such wide powers because of their concern to keep the market clean and free from undesirable elements.”

The adjudicatory wing of the Board, including the SAT, have refused to restrict the scope of these Regulations, regularly citing public trust and investor confidence to be of greater importance than any principles of proportionality or presumptions of fairness. Over the past 15 years, the ambit of the Fit and Proper has only broadened.

The criteria have been challenged so frequently post-COVID that SEBI had to temporarily put these criteria on hold.¹⁸⁶

PROPOSED MODIFICATIONS IN THE ‘FIT AND PROPER’ CRITERIA AND THE INTERMEDIARIES REGULATIONS, 2008

In 1997, Price Waterhouse Cooper recommended, in its Draft Report of the SEBI Committee for Certification, that instead of solely laying down merely subjective criteria for determination of a persons’ fitness, *“every person irrespective of higher/professional qualifications should be required to pass the certification test prior to seeking employment with a capital market intermediary...”*¹⁸⁷ This test certification, the Report proposed, should be made mandatory within 2 years of introducing the test on a voluntary basis.

This recommendation was, however, never implemented. The author suggests the implementation of this recommendation. An objective test would serve a long way to improve the quality of financial intermediaries and help prevent the issues that are most often cited as the reasons for imposing more punitive actions upon intermediaries.

¹⁸⁵ *Jermyn Capital LLC, In re*, 2009 SCC OnLine SEBI 165.

¹⁸⁶ Priyanka Gawande, *SEBI holds ‘fit and proper’ rule*, LIVEMINT (Last updated Jul. 6, 2023, 11:07PM), <https://www.livemint.com/news/india/sebi-to-postpone-compliance-with-fit-and-proper-person-criteria-until-2-august-bombay-high-court-hears-11688665025392.html>.

¹⁸⁷ PRICE WATERHOUSE COOPER, DRAFT REPORT OF THE SEBI COMMITTEE FOR CERTIFICATION, USAID: FIRE PROJECT 7 (1997).

Most importantly, SEBI must clarify the primacy of the 2008 Regulations over all others. One way to do this is via a general Circular issued to declare the supersession of all earlier intermediary regulations – similar to how the RBI de-notifies its earlier Circulars.¹⁸⁸ Another method could be by simply taking down the earlier regulations from its list of active regulations from the SEBI website. Either of these two approaches can bring some much-needed certainty that financial intermediaries face while trying to register and secure compliance over their business.

Another suggestion would be to borrow from the UK's Financial Conduct Authority's practices and formulate a comprehensive to determine the honesty, integrity, and reputation of individuals that are to be appointed as directors and promoters of intermediaries. In the UK, pending criminal proceedings are considered as part of a holistic evaluation of a proposed candidate, but are not an automatic ground for disqualification.¹⁸⁹ This recommendation is also in line with the guidelines issued by the International Organization of Securities Commissions (IOSCO), which the SEBI is part of but whose guidelines it has still not incorporated.¹⁹⁰

Lastly, SEBI must amend its Fit and Proper criteria under Schedule II of the 2008 Regulations and restrict the overly broad ambit of both the persons classified as KMPs, as well as the subjective criteria enumerated in Clause 3(a) of the Second Schedule.¹⁹¹

CONCLUSION

Thus, an analysis of the Fit and Proper criteria under the 2008 Regulations answers our research questions. The Regulations are overly punitive and disproportionate, over-inclusive and cause confusion with the existing SEBI framework on intermediary regulations. In no other field are promoters and directors subject to more scrutiny than in the Securities market, and while this should indeed be the case. Furthermore, judicial interpretation of these criteria has made them even broader than they were originally intended to be.

¹⁸⁸ See, for example, the RBI Master Direction on Outsourcing of Information Technology Services, 2023.

¹⁸⁹ FINANCIAL CONDUCT AUTHORITY, FIT AND PROPER TEST FOR EMPLOYEES AND SENIOR PERSONNEL SOURCEBOOK 27 (2023).

¹⁹⁰ *Supra* note 11.

¹⁹¹ *Ibid.*

The only foreseeable and workable solution would be to restrict the criteria by amending the bare provision itself, since adjudication and interpretation has only made it worse for intermediaries. Conformity with IOSCO standards and implementing the best practices of other countries, including an objective test and scoring criteria to improve the quality of our financial institutions is essential to this process of reform.

It is telling that in a country like India, even politicians are elected representatives are not held to as high a standard as the CEOs and MDs of stock market intermediaries.

